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April 12, 2013

The Honorable Dave Camp
Chairman
Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Sander Levin
Ranking Member
Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20515

***RE: Comments: Manufacturing and Small Business/Pass-through Tax Reform Working Groups***

Dear Chairman Camp and Ranking Member Levin:

Thank you for the opportunity to submit these comments to both the Manufacturing and Small Business/Pass-through Tax Reform Working Groups on behalf of the National Tooling and Machining Association (NTMA) and Precision Metalforming Association (PMA) who together as part of "One Voice" represent nearly 3,000 metalworking manufacturing companies in the U.S.

One Voice members are small and medium-sized manufacturers averaging roughly 50 employees and are typically classified under the North American Industrial Classification System (NAICS) as 332 (Fabricated Metal Product Manufacturing) and 333 (Machinery Manufacturing). These classifications combined include 80,000 manufacturing establishments with 2.6 million employees. There are 300,000 manufacturing establishments nationwide according to the U.S. Census with approximately 12 million workers.

The manufacturing sector is among the strongest contributors to economic growth in this country providing family-sustaining careers. The average salary for an Ohio metalworking machinery manufacturing employee in his/her prime is more than $70,000 annually and significantly more for those with higher skills. A study by Rockwell Automation about the manufacturing multiplier effect, showed that in some advanced manufacturing businesses, every one manufacturing job supports 15 other jobs throughout the economy. The study includes data from Boston Consulting which estimates that manufacturers will add up to 800,000 jobs in the U.S. by mid-decade and that even just a four times employment multiplier will create about 2.4 million indirect jobs in the U.S. as a result of this growth.

We submit these comments to both the Manufacturing and Small Business/Pass-through Working Groups because we believe the two issues are inseparable. For example, an April 2011 Ernst & Young, LLP report showed that 81% of all manufacturers are structured as pass-through companies and the U.S. Census shows 89.5% of all manufacturing establishments have fewer than 500 employees. These statistics clearly demonstrate that the overwhelming majority of manufacturers are pass-through small businesses.

These comments will cover three areas of greatest concern to our members:

1. Need for C-Corp and Pass-Through Tax Reform
2. Why Small Manufacturers are Pass-Throughs
3. Deductions and Credits Used by Small and Medium Manufacturers

**Need for C-Corp and Pass-Through Tax Reform**

We applaud members of the Ways and Means Committee for recognizing the importance of undertaking an overhaul of our tax code and soliciting input throughout this process. Unfortunately, many believe tax reform is only about lowering rates or raising revenues. For small and medium-sized manufacturers like members of One Voice, these businesses need a globally competitive and stable tax code which allows them to plan. Small manufacturers must make business decisions well over a year in advance when budgeting for a machine costing into the millions. Our tax code inhibits job creation and business growth while our foreign competitors have the support of their government's tax policies – from lower corporate rates to a Value Added Tax (VAT) to stronger R&D incentives.

As Congress embarks on this task, it must consider comprehensive tax reform for both C-Corporations and pass-through businesses. Over the years, the code has become so intertwined we do not believe overhauling only one section of the code is possible without causing injury to hundreds of thousands of small businesses. While many expect more losers than winners in this process, small businesses cannot afford to write larger checks so big corporations receive a lower statutory tax rate. It is also important that the two broader business classification categories (generally referred to herein as C-Corporations and pass-throughs) remain unified in their desire for comprehensive reform that does not pit large companies against smaller businesses who in many cases are their suppliers. Roughly, one-third of One Voice members are C-Corporations and the majority of our customers are also typically structured as C-Corps.

For example, news reports surfaced during Secretary Geithner's tenure that some considered repealing the Section 199 Domestic Production Activities Deduction to pay for lower corporate rates. At the time, this would amount to a 3.15% effective tax rate increase for all pass-throughs who would lose the Section 199 Deduction. Today, we remain concerned that policymakers will eliminate critical deductions and credits small businesses use, thereby raising their effective tax rate while cutting the corporate rate and leaving pass-throughs to pay at the much higher individual levels.

We are also concerned about attempts to rely on certain deductions and credits to reduce the effective tax rate for small businesses and pass-throughs to bring them closer to being "on par" with C-Corporations under tax reform. Some have cited using an expanded Section 179 Equipment Expensing provision to help small businesses reduce their tax burden. However, if a business is not purchasing equipment, it will not benefit from the Section 179 and will pay a higher effective tax rate leaving less money in the business to grow in other areas and hire employees.

A largely overlooked component of comprehensive tax reform is how the Treasury Department, Small Business Administration, and Congress define a small business under tax policy. Due to the nature of the manufacturing sector, we believe the most accurate test of whether a company meets the small business definition is the SBA model which places limits on the number of employees a business has based on the North American Industrial Classification System (NAICS). Generally, for our industry, the SBA defines a small business as having fewer than 500 or 750 employees. We believe basing the definition of a small business solely on a company's revenue will grossly misclassify thousands of small and medium-sized manufacturers and place them at a greater competitive disadvantage.

To better understand the impact of various tax reform proposals on small and medium-sized manufacturers, One Voice worked with Michigan-based accounting firm Plante & Moran to develop a tax template to model different scenarios. Attached to these comments is Exhibit "A" for the record, which is an example of a New England-based small manufacturing business structured as an S-Corporation with five shareholders and 200 employees. While larger than the average One Voice business, this company's confidential tax template shown here demonstrates what happens to a manufacturer when Congress fails to stabilize tax policy.

A pre-fiscal cliff calculation showed this New England manufacturer paying a combined federal, state, and local effective tax rate of 31.5% in 2011. An examination of the Fiscal Cliff scenario which went into effect for a few hours on January 1, 2013, resulted in a 46.91% effective tax rate for this company with virtually all deductions and credits eliminated and a 39.6% statutory individual income tax rate. This scenario showed the company would owe an additional $715,000 in federal taxes on $4.6 million in adjusted taxable income. This 15% increase in their effective tax rate means they have fewer resources to purchase new equipment and hire more employees in New England.

This live tax template, which we have previous provided to Committee staff, is an effective tool policymakers can use to gauge the impact of various tax proposals and scenarios on both a C-Corporation or pass-through business as they develop tax reform.

**Why Most Small Manufacturers are Pass-throughs**

As demonstrated by the April 2011 Ernst & Young, LLP study, 81% of all manufacturers are structured as pass-throughs. In December 2012, One Voice surveyed both NTMA and PMA members who collectively reported 68% of our members are structured as pass-throughs broken down as follows:

- S-Corporation – 58%
- Limited Liability Corp – 7%
- ESOP – 2%
- Sole Proprietor – 1%

Based on interviews and conversations with our manufacturing members, most are structured as pass-throughs, in part, because they are family-owned businesses who want to keep the company in the family when the current owners retire. Many of our members report they are transitioning from the second generation to the third generation of family owners. Increasingly, these businesses are preparing for the fourth generation. One Indiana-based S-Corporation manufacturer reports having nearly 50 shareholders ranging from great-grandparents who worked at the plant to high school students who spend their summers on the shop floor. However, to “simplify” the tax filing process, the company will withhold 39.6% from all shareholders because of the changes in individual income rates.

The current C-Corporation portion of the tax code creates numerous roadblocks for a business owner who is either transferring the company to a new generation or selling it to new owners – whether inside the family or outside. The tax code should encourage businesses to continue domestic operations and, when possible, pass it along to the next generation of manufacturers.

The double taxation of C-Corporation dividends, which the owners pay when they take their earnings out of the business, is among the greatest barriers to improving the global competitiveness of manufacturing in America. When the owner pays a higher tax rate, it means the company is paying more in taxes and has less to buy equipment and hire employees. In addition, what many people do not know is a small business owner has to personally guarantee loans for the company when buying equipment which can cost in the millions – the fewer resources a business has available to show creditors, the more difficult it is to obtain financing to expand.

**Deductions and Credits Used by Small and Medium Manufacturers**

While each one of our member companies has different operations manufacturing products for a variety of industries, there are several core tax provisions used by our members to improve their global competitiveness. Based on a December 2012 survey of the National Tooling and Machining Association and Precision Metalforming Association, respondents identified using the following tax credits and deductions:

- Section 179 Equipment Expensing
- Bonus “Accelerated” Depreciation
- Section 199 Domestic Production Activities Deduction
- Research & Development Tax Credit (R&D)
- Last-In-First-Out (LIFO) Inventory Valuation
- Interest Charge Domestic International Sales Corporation (IC-DISC)
- Net Operating Loss (NOL)

Policymakers will have to make difficult decisions and decide which deductions and credits to eliminate or keep in place. To remain globally competitive, small businesses use several credits and deductions to free up resources to reinvest back in the business. However, uncertainty in the tax code, particularly as to the status of deductions and credits is one of the largest inhibitors of growth among manufacturing businesses.

The annual “Tax Extenders” package has almost become a ritual exercise on Capitol Hill. However, small manufacturers cannot purchase a machine on December 31st by midnight based on a vote Congress just took. It takes time to place this equipment into service even if the business has the free capital to make a last minute multi-million dollar purchase based on Congressional action, or inaction.

*Capital Equipment Expensing/Depreciation*

In 2011, according to the U.S. Census Annual Capital Expenditures Survey, manufacturers spent almost $157 billion on equipment, far outspending any other industry. This is true throughout the manufacturing sector, regardless of the company’s size. While most of the metalworking manufacturing businesses are smaller, often with fewer than 25 employees, the equipment they use to produce their goods can range into the millions of dollars and take months to place into service.

In the December 2012 One Voice survey, 89% of respondents claimed Section 179 Equipment Expensing while 88% used Bonus “Accelerated” Depreciation. Our members are overwhelmingly maxing out their Section 179 deduction, even under the expanded temporary provision, and then still turn to accelerated depreciation to support their investments in the company. A manufacturer of components for the tractor-trailer and automotive industries recently reported their intention to purchase a $7 million stamping press to help them meet anticipated expansion in 2014.

These two credits and deductions have a tremendous impact reducing the effective tax rate for metalworkers due to the intense capital equipment nature of their businesses. However, as stated earlier, the temporary nature of these tax provisions can cause business disruption. One manufacturer reported they did not purchase any new equipment in 2012 but would have had expensing provisions been in place at the beginning of the calendar year.

In another example, in 2011, a One Voice manufacturing company reported claiming $400,000 in Section 179 Equipment Deduction. However, at the time the company was making its next major business decision in 2012, the Section 179 limit was $139,000 with a phase out if you purchased more than $560,000 in equipment. The manufacturer needed a machine that cost $611,000 but purchasing this single piece of equipment meant losing the Section 179 deduction because it exceeded the phase out provision. The manufacturer only purchased $130,000 worth of smaller equipment to stay within the threshold of the tax provision only to see Congress extend an expanded Section 179 at the end of the year.

How could a small business react to this? Whether Congress passes an extension on December 31st or retroactively, a small business cannot purchase a machine that weighs 36,000 pounds, transport it, have electrical lines installed, run air lines to the machine and have it placed in service in 24 hours. Therefore, many small businesses do not benefit from these tax deductions and credits because they do not have the ability to plan and budget for major equipment purchases at the last minute.

Most importantly, this equipment requires hiring more employees to run the machines, manufacture a product, and generate economic growth. When Washington continues to create instability in the tax code, thousands of manufacturing business owners are forced to delay or cancel purchasing equipment, expanding their facilities, and hiring more employees.

*Section 199 Domestic Production Activities Deduction*

The Section 199 Domestic Production Activities Deduction is one of the few provisions in the tax code which directly incentivizes manufacturing in America. Nearly half of One Voice members claim the Section 199 which amounts to an effective three percent rate reduction for most domestic manufacturers. This provision directly makes profitable manufacturers more competitive and frees ups resources to invest back into the business.

Awareness and slow economic recovery has reduced the number of One Voice manufacturers who claim the deduction. However, we view this as an important tool to support manufacturing in America during tax reform. We believe, as referenced earlier by the manufacturing jobs multiplier effect, this industry generates more economic output than virtually any other does.

*Research & Development Tax Credit (R&D)*

Among one of the most politically popular provisions which many manufacturers support is the Research & Development Tax Credit (R&D). Whether they realize it or not, most manufacturers of all sizes conduct their own R&D, which greatly contributes to the technological advancements and efficiencies throughout the industry.

In the December 2012 One Voice survey of its manufacturing members, 41% reported using the R&D Credit down from 53% in 2011. This is a troubling sign that prompted our associations to look further into the reason for the decline in reported usage of the R&D Credit. Increasingly, the smallest of manufacturers believe it is not worth the effort, resources, and potential audit to claim the credit if it is not sizeable enough. Small businesses, regardless of the sector, typically lack the in-house accounting department resources that much larger firms have to help them navigate the red tape associated with the credit.

The more likely reason small manufacturers are not claiming the R&D Tax Credit is that increasingly the businesses and their owners are captured under the Alternative Minimum Tax (AMT). Under current law, those subject to the AMT cannot claim the R&D Tax Credit. According to the Tax Policy Center, "for the typical manufacturing firm, gross receipts and deductions are 10 to 20 times larger than its net income. A 5 to 10 percent change in includable receipts or allowable deductions is sufficient to create an AMT liability."

To further punctuate the problems with the AMT, a One Voice company with 24 employees testified before the House Small Business Committee and reported he recently tried unsuccessfully to claim the $1,000 tax credit for hiring a long-term unemployed worker because the company is subject to the AMT.

*Last-In-First-Out (LIFO) inventory valuation*

To certain manufacturers, there are accounting practices which, if reversed, could have a devastating effect on a company. Switching from Last-in-First-out (LIFO) to a First-in-First-out (FIFO) accounting method could cost a small manufacturer millions, or worse, the business. Among One Voice manufacturing members, 34% reported using the LIFO method in 2012.

However, this statistic is misleading because for those companies who utilize LIFO it has a six and seven figure impact. A One Voice member company reported accumulating over $4 million in LIFO reserves built up over the past 18 years and facing a potential $400,000 tax liability if Congress enacts certain LIFO repeal proposals.

Not only does LIFO directly affect our businesses, many raw material suppliers, particularly steel/metal service centers, rely on LIFO. A repeal of this provision will have significant impact on the price of the steel and raw materials we purchase, which in the case of some metalstampers accounts for 70% of their input costs.

*Interest Charge Domestic International Sales Corporation (IC-DISC)*

Increasingly, small and medium-sized manufacturers are looking overseas for new business opportunities. In the One Voice December 2012 survey, 46% of members report they directly exported their product overseas last year. Further, 83% are indirect exporters who ship their manufactured product to a customer who then exports an assembled good.

As businesses continue to grow their exports, tax provisions such as the Interest Charge Domestic International Sales Corporation (IC-DISC) have helped manufacturers reach new markets and expand their businesses.

*Net Operating Loss (NOL)*

The Great Recession devastated the manufacturing industry which lost millions of jobs over the past decade. While most policymakers may assume the worst is behind us, countless manufacturers remain under the Net Operating Loss (NOL) carry forward provisions. Many One Voice members privately report that the NOL literally saved their companies and allowed them to continue their operations and retain manufacturing employees. While business conditions are improving, the economy has a long way to go before a full recovery and the NOL is an important provision which helped manufacturers weather the Great Recession.

## Conclusion

Effective April 1, 2012, the U.S. has the highest corporate tax rate in the developed world and pass-through businesses saw their tax rates increase January 1st. In order to strengthen the competitiveness of small and medium-sized manufacturers, we need to simplify and stabilize the tax code and implement policies that encourage investment and eliminate tax disadvantages. The current tax structure is a myriad of high rates, temporary credits, loopholes, and outdated policy that restricts growth and reduces competitiveness.

The outdated and inefficient tax code has the single greatest impact on a business manufacturing in America. Many foreign governments use their tax policy to promote their domestic manufacturing industry leaving U.S. businesses at a competitive disadvantage.

U.S. manufacturing employers are more than willing to “pay their fair share” to help support government services and infrastructure. However, we cannot solve our nation’s financial problems by increasing the tax burden on small businesses without addressing the budget and runaway spending.

Small manufacturers, whether C-Corporations or pass-throughs, are the backbone of the economy and policymakers in Washington should reform the tax code to encourage these businesses to grow and hire more employees.

We commend the committee for undertaking this important process and encourage you to move on comprehensive tax reform for all businesses. We look forward to continuing to work with the Committee and answer any questions you may have.

Sincerely,

Dave Tilstone
NTMA President

William E. Gaskin
PMA President

Exhibit "A"

**Annual Tax Liability on Manufacturing Entity & Owner - Summary**
**New England Company**

| | Current Law - 2011 | | Current Law - 2013 | | 35% - Base Case | | 25% Case | | 39.6% - Worst Case | |
|---|---|---|---|---|---|---|---|---|---|---|
| | C Corporation | Flow-Through | C Corporation | Flow-Through | C Corporation | Flow-Through | C Corporation | Flow-Through | C Corporation | Flow-Through |
| **Significant Inputs & Assumptions** | | | | | | | | | | |
| Adjusted Taxable Income | 4,653,597 | 4,653,597 | 4,653,597 | 4,653,597 | 4,653,597 | 4,653,597 | 4,653,597 | 4,653,597 | 4,653,597 | 4,653,597 |
| Owner Wages/Bonuses | 257,275 | 257,275 | 257,275 | 257,275 | 257,275 | 257,275 | 257,275 | 257,275 | 257,275 | 257,275 |
| Distributions Paid | 328,410 | 328,410 | 328,410 | 328,410 | 328,410 | 328,410 | 328,410 | 328,410 | 328,410 | 328,410 |
| IC-DISC Commission | - | - | - | - | - | - | - | - | - | - |
| Owner's Itemized Deductions (except SALT) | 300,000 | 300,000 | 300,000 | 300,000 | 300,000 | 300,000 | 300,000 | 300,000 | 300,000 | 300,000 |
| Is LIFO repealed? | NO | NO | NO | NO | NO | NO | YES | YES | YES | YES |
| Domestic Producers Deduction (DPAD) Repealed? | NO | NO | NO | NO | NO | NO | YES | YES | YES | YES |
| Research Credit Repealed? | NO | NO | YES | YES | NO | NO | YES | YES | YES | YES |
| IC-DISC Benefits Repealed? | NO | NO | NO | NO | NO | NO | YES | YES | YES | YES |
| Itemized Deduction Phase-out Reinstated | NO | NO | YES | YES | YES | YES | YES | YES | YES | YES |
| Itemized Deductions Subject to a Tax Rate Limitation | NO | NO | NO | NO | NO | NO | NO | NO | NO | NO |
| Itemized Deductions Repealed? | NO | NO | NO | NO | NO | NO | YES | YES | YES | YES |
| Consider Depreciation Expense in Calculation? | NO | NO | NO | NO | NO | NO | NO | NO | NO | NO |
| Depreciable Property Placed In-Service | 11,571,879 | 11,571,879 | 11,571,879 | 11,571,879 | 11,571,879 | 11,571,879 | 11,571,879 | 11,571,879 | 11,571,879 | 11,571,879 |
| Bonus Depreciation % | 100.00% | 100.00% | 0.00% | 0.00% | 50.00% | 50.00% | 50.00% | 50.00% | 50.00% | 50.00% |
| Maximum §179 Deduction | 500,000 | 500,000 | 25,000 | 25,000 | 500,000 | 500,000 | 500,000 | 500,000 | 500,000 | 500,000 |
| Minimum §179 Phase-out Limitation | 2,000,000 | 2,000,000 | 200,000 | 200,000 | 2,000,000 | 2,000,000 | 2,000,000 | 2,000,000 | 2,000,000 | 2,000,000 |
| Maximum Corporate Income Marginal Rate | 34.00% | 34.00% | 34.00% | 34.00% | 34.00% | 34.00% | 25.00% | 25.00% | 34.00% | 34.00% |
| Maximum Individual Ordinary Income Marginal Rate | 35.00% | 35.00% | 39.60% | 39.60% | 35.00% | 35.00% | 25.00% | 25.00% | 39.60% | 39.60% |
| Federal Individual Dividend Preferential Rate | 15.00% | 15.00% | 39.60% | 39.60% | 15.00% | 15.00% | 25.00% | 25.00% | 39.60% | 39.60% |
| Federal Individual Capital Gain Preferential Rate | 15.00% | 15.00% | 20.00% | 20.00% | 15.00% | 15.00% | 20.00% | 20.00% | 20.00% | 20.00% |
| Unearned Income Medicare Surcharge | 0.00% | 0.00% | 3.80% | 3.80% | 0.00% | 0.00% | 3.80% | 3.80% | 3.80% | 3.80% |
| State & Local Income Tax - Entity Level | 9.50% | 0.00% | 9.50% | 0.00% | 9.50% | 0.00% | 9.50% | 0.00% | 9.50% | 0.00% |
| State & Local Income Tax - Owner Level | 5.30% | 5.30% | 5.30% | 5.30% | 5.30% | 5.30% | 5.30% | 5.30% | 5.30% | 5.30% |
| Millionaires Tax | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 3.00% | 3.00% | 3.00% | 3.00% |
| Millionaires Tax Threshold | - | - | - | - | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 | 1,000,000 |
| **Summary & Statistics** | | | | | | | | | | |
| Cash Used to Pay Federal Taxes | 1,229,660 | 1,214,197 | 1,388,748 | 1,498,005 | 1,229,660 | 1,263,790 | 1,153,439 | 1,268,360 | 1,574,401 | 1,928,685 |
| Cash Used to Pay State Taxes | 446,044 | 246,092 | 446,044 | 246,092 | 446,044 | 246,092 | 446,044 | 246,092 | 446,044 | 246,092 |
| Cash Retained by Owner | 495,030 | 680,712 | 399,446 | 644,004 | 495,030 | 631,119 | 399,919 | 519,484 | 334,768 | 499,510 |
| Cash Reinvested in Business | 2,465,345 | 2,495,079 | 2,401,842 | 2,247,979 | 2,465,345 | 2,495,079 | 2,636,677 | 2,602,144 | 2,280,867 | 1,961,793 |
| Total Cash Income | 4,636,080 | 4,636,080 | 4,636,080 | 4,636,080 | 4,636,080 | 4,636,080 | 4,636,080 | 4,636,080 | 4,636,080 | 4,636,080 |
| % of Cash Used to Pay Federal Taxes | 26.52% | 26.19% | 29.96% | 32.31% | 26.52% | 27.26% | 24.88% | 27.36% | 33.96% | 41.60% |
| % of Cash Used to Pay State Taxes | 9.62% | 5.31% | 9.62% | 5.31% | 9.62% | 5.31% | 9.62% | 5.31% | 9.62% | 5.31% |
| % of Cash Retained by Owner | 10.68% | 14.68% | 8.62% | 13.89% | 10.68% | 13.61% | 8.63% | 11.21% | 7.22% | 10.77% |
| % of Cash Reinvested | 53.18% | 53.82% | 51.81% | 48.49% | 53.18% | 53.82% | 56.87% | 56.13% | 49.20% | 42.32% |
| Effective Tax Rate on Cash Income | 36.14% | 31.50% | 39.58% | 37.62% | 36.14% | 32.57% | 34.50% | 32.67% | 43.58% | 46.91% |
| Effective Tax Rate Change Compared to 2011 Law | | | 3.43% | 6.12% | 0.00% | 1.07% | -1.64% | 1.17% | 7.44% | 15.41% |
| Effective Tax Rate Differential of Entity Structure | 4.65% | -4.65% | 1.96% | -1.96% | 3.58% | -3.58% | 1.83% | -1.83% | -3.33% | 3.33% |