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STATEMENT
AMENDMENTS TO THE INTERNAL REVENUE CODE
before the

SENATE FINANCE COMMITTEE

by

DUANE D. PEARSALL

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I am Duane Pearsall, President, Small Business Development Corporation, a small business consulting and investment firm located in Denver, Colorado. Thank you for this opportunity to testify on legislation designed to enhance and preserve the survival of small business.

A personal biography is attached, however it is sufficient to note only that I have been a small businessman for 25 years, founding four companies, one of which was a failure.

The most significant success was Statitrol Corporation, founded in 1963 to manufacture static control devices, using the principle of air ionization. In our attempt to improve product performance, we discovered how to use ionization in the detection of smoke. We soon found there was a need for early fire detection and, after two years of painful development, we became the first U.S. manufacturer to receive an Underwriters Laboratories' listing for a commercial ionization detector. We later introduced the first, low-cost home smoke detector in 1971, which encouraged many manufacturers to participate, and, the development of a \$200 million industry. Most important, of course, home smoke detectors are now credited with saving hundreds of lives and preventing thousands of burn injuries each year. Because of our company's success, I received the SBA national award as Small Businessperson of the Year in 1976.

As a result of that exposure, I was privileged to serve at different times on three significant committees, each of which contributed data supporting the need for revisions to our Internal Revenue Code. This, of course, is the only source for the internal generation of capital necessary for the survival of small businesses. These committees included first, the SBA Task Force on Venture and Equity Capital, which submitted its report in early 1977, more commonly referred to as the "Casey Report". Second was the Advisory Committee on Industrial Innovation, the final report of which was dated September, 1979.

The third, and perhaps most important, was a task force chaired by the Chief Counsel for Advocacy resulting in a report "Small Business and Innovation", May, 1979.

Before making specific comments on the various proposed amendments, I would like to ask the Committee's indulgence to first review a few financial characteristics of the overall small business sector of our economy. This may set the stage for a more sensitive consideration of the specific bills addressed in this hearing.

First, referring to the 1977 Casey Report, there was a statistic developed by our research staff that I have not been able to verify. It was reported that the total invested capital in the small businesses (under \$50 million in gross revenue) of our country equalled 3.1 times the total capital invested in businesses over \$1 billion in gross revenues in 1956. After twenty years, by 1975, total capital invested in the small businesses represented only approximately 77% of that invested in the larger businesses. It seems to me that the changes in industry concentration should be a mighty important characteristic as a basis for Congressional judgements, not only regarding relative tax burdens, but also on costs of regulatory compliance and any other forms of government interference with the free market. With the many expensive government studies giving us more information about such things as penguins than we ever wanted to know, there is conspicuously absent a simple data base on the very power source that keeps our country running -- American business.

The following numbers seem to verify why small business as a sector of our economy, is getting smaller. These figures are taken from a speech presented by the Chief Counsel of Advocacy, SBA, at a Denver conference, September, 1979.

"Quoting 1974 figures and considering total taxes to include federal, state, local, social security, unemployment, insurance and income; it is reported that manufacturing firms with \$50,000 to \$100,000 in gross receipts, that total taxes as a percentage of their net worth was 30%. For manufacturers with \$100,000 to \$500,000 in gross receipts - 23.5%; \$500,000 to \$1 million - 21.3%; \$1 million to \$5 million - 19.9%; \$10 million to \$50 million - 16.9%; \$50 million to \$100 million - 13.6%; and over \$1 billion - 11.5%."

On the surface, those numbers are appalling.

relative to tax credits, he cites the same regressive pattern. With 40 or 50 tax credits granted as incentives by the government, he cited the following relationships. "Under \$100,000 in gross receipts, the total credit was 5.8%. For \$1 million to \$5 million - 6.5%; for \$250 million to \$500 million - 7.8%; over \$1 billion - 61.1% of taxes due are covered by credits. Twelve times as much in tax credits is given to business taxpayers who gross over \$1 billion a year as to those who gross under \$100,000."

Further quoting another incentive, that is, for a lower cost of capital through tax-free industrial and pollution controls on financing, "Of 1,634 issues of these tax-free bonds through the year 1977, only 69 issues, or 4% were used by corporations with fewer than 500 employees. These 69 issues totalled \$460 million or only 2.6% of the total of \$18 billion for the 1,634 issues.

From my experience, and I currently serve on the boards of six small companies in the Denver area, the factor of relative debt to equity ratio between large and small businesses is significant. Add today's cost of borrowing to that disproportionate amount of borrowed capital and we can easily project a compounded disaster for hundreds of thousands of small businesses over the next few months.

Having sold my former business to a \$2 billion corporation, and serving as divisional president, I had the opportunity to participate in their corporate planning. It is only reasonable that every well-managed major corporation has been planning for a recession, and they are financially ready. On the other hand, I have not seen a small business with under 50 employees that is not stretched out financially in good times, and have little or no reserves. For lack of diversification, their markets are also more vulnerable to a recession. Barring a miracle or some type of emergency measure which will make capital available at 15% interest or less, we should expect to lose 5% of our small businesses, at least a half million, through simply closing their businesses or bankruptcy, within the next six months.

In preparation for this testimony, I have reviewed each of the ten subject bills with one of the more respected local CPA's specializing in small business.

- S.2136 - I am pleased with the reduction in percentage at the lowest level from 17% to 15%. The very small businesses need this relief, and more. I do not need to remind the Committee of the report of the White House Conference on Small Business which recommended not only lowering the percentage at the lowest bracket, but also raising the entire scale, reaching the 46% rate at \$500,000. Any improvement, however, is a step in the right direction.
- S.110 - Depreciation reform is a stimulus to capital formation and therefore a stimulant to productivity. However, when a heavy equipment operator purchased a D-8 CAT ten years ago, and now needs to replace it at a current cost of \$100,000, this bill does not seem to go far enough.
- S.2152 - Used equipment is just as strong a stimulus to productivity as new equipment. Since small business is the main customer for used equipment, increasing the level to \$200,000 is another step in the right direction.
- S.2171 - I understand that previous requirements for furnishing a W-2 was often impossible to meet, and this bill appears to be a housekeeping measure.
- S.1967 - Establishing a reserve for market-making activities appears to be a means of stabilizing the financial burden of certain underwriters in the over-the-counter market. Witnessing a strong O.T.C. market in Denver, this measure should be helpful.
- S.487
S.653 Each of these bills is helpful in attracting private investor capital into small business. Even with these incentives, however, it is extremely difficult to justify small business investments due to a serious illiquidity as compared with blue chip investments. Nevertheless, they are helpful and should be supported.
- S.2239 The original qualified stock option was a key factor in allowing my company to attract a capable marketing manager away from a blue chip company. Removal of the qualified stock option in 1976 was a serious blow to any growth-oriented small business. Avoiding the tax burden

at the point of exercise opens up opportunities for both the employee and the small business employer. The bill should be supported.

S.1481 - The Small Business Participating Debenture, in my view, is an exciting mechanism that should prove very effective in attracting private investment capital while at the same time allowing the entrepreneur to retain voting control over his company. These characteristics, combined with other features, make this bill the highest priority of all ten. I would predict acceptance and urge its enactment.

In summary, it is difficult to be enthusiastic for legislation that in some cases seems to fall short of what is needed. At the same time, with all of these bills taken as a package, I am most enthusiastic and support their passage.

As a last point, it would seem that Congressional support would be much easier if they could become aware of some of the relationships expressed by Mr. Milt Stewart, and quoted above, as well as having available a better picture of the characteristics of business structure in our economy in the form of current computerized data base.

Thank you for your consideration.

Senator CHAFEE. That completes the testimony. I want to thank every one of you very much for coming. I know you did that at some sacrifice.

I have a statement here which I would like to include in the record.

[The prepared statement of Senator Chafee follows:]

STATEMENT BY SENATOR JOHN H. CHAFEE OF RHODE ISLAND

It's no secret that soaring inflation and a weakened economy are sapping the strength of U.S. industry. It's also no secret that changes in federal tax laws can give industry the muscle it needs to regain that strength.

Laws to accelerate depreciation rates and reduce taxes on small businesses represent the kind of muscle building we need.

This country has serious economic problems. The President and the Congress are now collaborating to balance the federal budget for the first time in twelve years. Inflation is running at double-digit rates. Economic productivity growth has been declining steadily during the last 10 years. Finally, we are running a balance of trade deficit for the fifth year in a row.

We can no longer afford to play a waiting game with inflation and unemployment. These long-term problems need long-term solutions, not quick-fix band-aids. The solutions are changes in the federal tax laws, which will increase productivity, stimulate capital investment and return the United States to its industrial superiority of the early postwar years.

Once a giant in the world economy, the United States now looks like an aging champion whose dominance is threatened by a growing number of shrewd and vigorous competitors. The decline of the dollar in 1978 caused the United States to drop to eighth place last year in a list of the world's wealthiest countries on a per capita basis.

Since 1950, our share of the world's export market has dropped by 50 percent. During the same period, America's share of the world's imports rose 27 percent. In 1960, we imported \$15 billion of goods; we now import \$200 billion. As we import more and more foreign-made goods without improving our export sales, American jobs are in effect being shipped overseas.

It is clear to me and a growing number of my Senate colleagues that federal tax policy must be used more creatively to spur capital investment in U.S. industry. While it is of utmost importance for us to achieve a balanced budget in the near future, a carefully crafted tax cut that stimulates economic growth will help achieve that goal.

Increased capital investment will create more jobs for our rapidly expanding labor force. As it creates better jobs with more efficient tools, it will make U.S. industry and American workers more competitive with their foreign counterparts.

On July 31, 1979, I joined in introducing the Capital Cost Recovery Act of 1979 in the Senate. It provides an accelerated, simplified alternative to the present system of complex depreciation rules. And most importantly, it is equally accessible to both large and small businesses.

The bill calls for a 10-year depreciation for commercial and industrial buildings, a five-year depreciation for business machinery and equipment, and a limited three-year depreciation for automobiles and light trucks used for businesses purposes.

This schedule will enable business to recover the costs of new investments quickly enough to assure that we are providing our work force with the most modern and productive tools available. The capital cost recovery portion of the bill is central to improving our competitive position in the world market. Among leading industrial nations, the U.S. has one of the longest capital costs recovery periods. We cannot continue to save and invest only minimal amounts in our gross national product year after year and expect to advance our position in the world market.

Accelerated depreciation rates have strong support in Congress and from prominent economists who also favor limited personal income tax cuts. Because demand exceeds the ability of industry to produce efficiently, we are suffering double-digit inflation. It is politically and economically necessary to provide individual tax relief through incentives to save and invest, such as a personal tax exemption for interest income. These individual tax cuts will go hand in hand with tax relief for businesses.

On June 6, 1979, I introduced the Graduated Corporate Tax Act of 1979, calling for an increase of the corporate surtax base from the current level of \$100,000 to a new level of \$150,000. Current law assesses a graduated tax rate from 17 percent to 40 percent up to \$100,000 of a company's profits, at which point the 46 percent rate