The Tax Downfall

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By AMANDA EARING, News Editor, Manufacturing.net [1]

The economic recovery may be in full swing, but many manufacturers are still struggling, and some federal tax policies have the potential to send these manufacturers to the soup line.

Of the manufacturers in the U.S., approximately 70 percent are mid-size to small manufacturers. Many of these small companies are structured as pass-through entities, which include almost 4 million S corporations and more than 3 million partnerships, and together account for 80 percent of U.S. businesses and one-third of total U.S. business activity. The tax cuts that helped them ride out the recession in 2001 and the current financial crisis will soon be expiring at the end of this year, and the administration has decided these tax breaks will revert back to the full tax rate.

The administration has said they will leave rates the same for the lower bracket, but the higher bracket would increase to the old rates.

In the spring of 2010, RSM McGladrey conducted a survey of manufacturers and found a high level of concern about the impact these tax increases will have.

“No matter how you slice it, taxes going up means these manufacturers’costs are going up and this makes them less competitive. The owner's investment is now giving them less return. As a result of that, they may be reluctant to invest more in the company because they don't get an adequate return,” says Tom Murphy, Executive Vice President of Manufacturing and Wholesale Distribution at McGladrey.

Larger companies are concerned as well, but they are typically structured differently and have the ability to tap a wider array of resources. For smaller manufacturers — many of which are family-owned businesses — the tax increases will have a negative impact on cash flows, which in turn impacts their ability to continually invest for future growth.

A separate report by the Manufacturers Alliance/MAPI, a public policy and economic research organization in Arlington, VA., echoes similar concerns.

The report, *A Closer Look at the Business Tax Burden: C-Corps, S-Corps, and the Impact of the Federal Budget's 2011 Tax Proposals*, examines the effects of the 2011 federal budget's tax provisions on pass-through businesses. According to the report, pass-through businesses in the manufacturing sector will see their tax bills increase by an average of 14 percent.

Thomas J. Duesterberg, Manufacturers Alliance/MAPI President and Chief Executive Officer, argues that policymakers should reform the tax code to assist — not punish — the manufacturing sector, which is a key to U.S. innovation, productivity and well-paying jobs.

"It is important to understand that tax increases intended to help contain deficits will exact a high price in terms of the competitive posture of U.S. manufacturing and the growth of the economy as a whole," he cautioned.

Murphy says the upcoming tax change will prompt manufacturers to make a decision: Either face a lower return on investment, consider alternative sources of production or manufacture elsewhere.

"Any time you raise the cost, it makes you less competitive globally. Many manufacturers will then ask, as long as these policies are not making us more competitive, why would we do it?" says Murphy.

Murphy points out that with manufacturers still struggling to recover from the economic downfall, a reduced cash flow could also hinder the hiring of additional employees.

"The vast majority of these smaller and mid-size companies are the key job creators in the manufacturing industry and vital to our economic growth," says Murphy.

In order to become globally competitive, many believe the U.S. government will need to lower these taxes for the small to mid-size manufacturer.

In fact, MAPI suggests that a more effective option to reduce the deficit can be found in the Bipartisan Tax Fairness and Simplification Act of 2010, which would simplify the personal income tax system and reduce the corporate rate from 35 to 24 percent. It also holds personal income tax rates near current levels instead of raising them, which will aid S corporations. Simulations in the report indicate that it would create nearly two million jobs on a net basis and add an extra $500 billion to the GDP by 2015.

And the corporate tax rate isn't the only tax policy concerning manufacturers.

The R&D credit, which expired at the end of 2009, has not yet been renewed. This tax credit has been renewed 14 times since 1986 and continues to be renewed every other year. According to Murphy, nearly 60 percent of manufacturers utilize the R&D tax credit.

“On a competitive basis, globally we rank last because we have no R&D tax credit as of today. However, there have been assurances that the R&D tax credit will be renewed,” says Murphy.

Not having an R&D tax credit hinders development of new products, improvement of processes, as well as other innovations, and may further delay investment decisions, making the U.S. even less competitive as other countries increase their own R&D tax credits.

“While we're struggling to decide to renew, countries we compete with globally are making their tax credit for R&D higher. So manufacturers believe we need not only a permanent R&D tax credit, but a strengthened or larger tax credit for R&D,” says Murphy.

For manufacturers still recovering from the recession, a higher tax bracket and no R&D tax credit could break them if they’re already struggling for profits.

“This is the wrong time to be increasing taxes for manufacturers. The recovery is still getting established and raising taxes now takes away money that could be used for investment to meet new growth starting to occur,” says Murphy.

To view the RSM McGladrey 2010 Manufacturing and Wholesale Distribution National Survey tax policy report, please click here *[2]. For more information on the Manufacturers Alliance/MAPI report and its findings, please* click here *[3].*

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