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SEC GOVERNMENT-BUSINESS
FORUM ON
SMALL BUSINESS CAPITAL FORMATION

FINAL REPORT

U.S. SECURITIES AND
EXCHANGE COMMISSION
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FINAL REPORT OF THE SEC GOVERNMENT-
BUSINESS FORUM ON SMALL BUSINESS
CAPITAL FORMATION

January, 1986

INTRODUCTORY STATEMENT FROM THE CHAIRMAN OF THE EXECUTIVE COMMITTEE

It is my pleasure to present the Final Report of the Fourth Annual SEC Government-Business Forum on Small Business Capital Formation. This annual conference is conducted by the Commission, as mandated by Section 503 of the Small Business Investment Incentive Act of 1980, in order to review the current problems and programs relating to small business capital formation. The Commission is also charged with advising Congress about the Forum proceedings and recommendations.

In accordance with tradition, I note that the Commission, while sponsoring and conducting this Forum, has not sought to influence in any way the substance of the findings or recommendations that follow. Although a number of these recommendations are of interest and relevant to the Commission, the Commission takes no position on any particular recommendation at this time. Rather, the views contained herein represent the considered opinions of the majority of the Forum participants.

Those in attendance included more than 140 small business proprietors, venture capitalists, financial analysts and others concerned with the state of small business capital formation. The Forum participants met in Washington, D.C. for a two and one-half day period from September 12th through the 14th of 1985. The principal topic of discussion involved tax matters and the materials that follow reflect the success of those deliberations -- more than twenty substantive tax-related recommendations.

The importance of small business to the general vitality of our national economy is evident. Small business establishments aid in the creation of new jobs and technological advancements. The recommendations of the Forum must be considered against this background. I hope that Congress and the appropriate governmental agencies will carefully consider these materials.

The Fourth Annual Forum has produced some thoughtful, as well as, workable proposals, and I am pleased to have been associated with this worthwhile endeavor. The achievements of the Forum are primarily attributable to the unselfish contribution of its participants. In addition, considerable assistance was provided by a number of government agencies including the U.S. Small Business Administration, the U.S. Department of the Treasury, the U.S. Department of Commerce and the Federal Reserve Board through their representation by non-voting members on the Forum's Executive Committee. I especially thank the professional and clerical staff of the Commission's Office of Small Business Policy for the location, assembly and distribution of resource materials to the Forum participants and effective resolution of numerous logistical and administrative details that are an integral part of any conference. As with each of the preceding Forums, the insight, guidance and direction provided by Mary E. T. Beach, Associate Director of the Commission's Division of Corporation Finance has been extremely valuable and is directly linked to the success of this year's efforts.

It is commendable and worth repeating that the private sector participants in this Forum give freely of their own time and expertise; they come to Washington at their own expense and devote their energies to the prospects of enhancing small business capital formation through this participation in the public policy formulation process.

Charles C. Cox
Commissioner
U.S. Securities and Exchange Commission

Members of the Executive Committee

Chairman - Charles C. Cox, Commissioner
Securities and Exchange Commission

Mary E.T. Beach, Associate Director, Division of Corporation Finance, Securities and Exchange Commission

Janice Booker, Community and Consumer Affairs, Office of the Comptroller of the Currency

Lewis Brothers, Jr., Director, Division of Securities and Retail Financing, State of Virginia

Paul Broude, Small Business United

Patrick Owen Burns, Chairman, American Association of Minority Enterprise Small Business Investment Companies

Nick Calio, Vice President, Government Relations, National Association of Wholesaler Distributors

Samuel A. Derieux, Past President, American Institute of Certified Public Accountants

Jeffrey D. DeBoer, National Association of Realtors

Lucy Falcone, Senior Advisor to the Chief Economist, U.S. Department of Commerce

Jerry Feigen, Office of Advocacy, Small Business Administration

Henry Gallagher, RESSI

Daniel A. Giannini, Coopers & Lybrand

Mildred Hermann, Financial Analysts Federation

John Huber, Director, Division of Corporation Finance Securities and Exchange Commission

Stan Keller, American Bar Association

Hershel Lipow, Director, Government Affairs, American Institute of Architects

John McClure, American Bankers Association

Peter McNeish, Executive Vice President, National Association of Small Business Investment Companies

Alan Mendelson, Assistant Vice President, Aetna Life Insurance Company

Steven Merrill, Chairman SEC Committee, National Venture Capital Association

Michael Miles, Sutherland, Asbill & Brennan

Ann Morrison, Federal Relations Assistant, Peat, Marwick, Mitchell & Co.

Allan Neece, Neece, Cator & Associates, Inc., (National Venture Capital Association)

Douglas F. Parrillo, Vice President, Department of Policy Research, National Association of Securities Dealers
Susan Rittenhouse, Maryland State Securities Commissioner

Abe Schneier, Issue Coordinator, National Federation of Independent Business

Herb Spira, Tax Consultant, Arthur Andersen & Co.

Howard H. Stevenson, Sarofim-Rock Professor of Business Administration, Harvard University

Eleanor Stockwell, Senior Deputy Associate Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System

Andrew M. Sullivan, Jr., Peat, Marwick, Mitchell & Co.

Frank Swain, Chief Counsel for Advocacy, Small Business Administration

Linda Tarr, Senior Attorney, Legal and Regulatory Policy Division, American Stock Exchange

Wayne Upton, Financial Accounting Standards Board

Dolly Wells, Director, Office of Consumer Affairs

Linda A. Wertheimer, Chairman, Subcommittee on Partnerships, Trusts and Unincorporated Associations, American Bar Association

Stan White, Robert Morris Associates

Ernest R. Widmann, Vice President, Financial Analysts Federation

Members of the Securities Task Force

Chairman: Stan Keller, Palmer & Dodge

Members :
- Mary Beach, Securities & Exchange Commission
- Lewis Brothers, Jr., Virginia State Corporation Commission
- Jerry Feigen, Small Business Administration
- Douglas Parrillo, National Association of Securities Dealers
- Susan Rittenhouse, Maryland State Securities Commissioner
- Linda Tarr, American Stock Exchange
- Howard Trauger, Bishop & Associates
- Wayne Upton, Financial Accounting Standards Board
- Linda Wertheimer, Winstead, McGuire, Sechrist & Minich

Members of the Tax Task Forces

Investor Incentives

Chairman: Andrew Sullivan, Jr., Peat, Marwick, Mitchell & Co.

Members :
- Janice Booker, Office of the Comptroller of the Currency
- Paul Broude, Small Business United
- Jeff DeBoer, National Association of Realtors
- George Henry, Committee on Small Business
- Mildred Herman, Financial Analysts Federation
- Peter McNeish, National Association of Small Business Investment Companies

Employee Incentives

Chairman: Daniel Giannini, Coopers & Lybrand

Members : David Binns, Employee Stock Option Association
Bob Bolle, Arthur Andersen & Co.
Jeff Gates, Minority Staff Counsel-Committee on Finance
Walter Holan, Profit Sharing Council of America
P. Joseph Walshe, Coopers & Lybrand

Capital Investment

Chairman: Hershel Lipow, American Institute of Architects

Members : Daniel Abdun-Nabi, Garvey, Schubert, Adams & Barer
Jeffrey Carr, Deloitte, Haskins & Sells
Samuel Derieux, Derieux, Baker, Thompson & White
Alan Mendelson, Aetna Life Insurance Company
Eleanor Stockwell, Board of Governors of the Federal Reserve System

Rates and Other Tax Burdens

Chairman: Herb Spira, Arthur Anderson & Co.

Members : Ralph Bristol, Treasury Department
Scott Cousino, Legg-Mason Investment Services
Mildred Herman, Financial Analysts Federation

John Satagaj, America Association of Nurserymen
Howard Stevenson, Harvard University
Stan White, Stillwater National Bank & Trust

1985 FORUM STAFF

Mary M. Jackley, Special Counsel

Michael T. Cronin, Staff Counsel

Hugh T. Wilkinson, Staff Counsel

TABLE OF CONTENTS

Table of Contents (Cont'd)

Table of Contents (Cont'd)

I. SUMMARY OF FORUM RECOMMENDATIONS AND RANKINGS

A. SECURITIES

RECOMMENDATION 1 Differentiation of Small Business from Other Investment Vehicles

It is recommended that consideration be given to developing a definition of small business offerings that will differentiate them from other investment vehicles and permit suitable rules to be adopted that deal specifically with these offerings. The definition would take into account the nature of the enterprise, the type of entity, the stage of growth of the company, the relative importance of anticipated profits and tax benefits, and the customary method of distribution.

RECOMMENDATION 2 Avoiding the Burdens of Periodic Reporting for Small Business

A. It is recommended that the SEC increase the asset threshold size of issuers required to register under Section 12(g).

B. It is recommended that the SEC simplify the regulatory and possibly the disclosure requirements applicable to smaller issuers within the reporting system; and

C. It is recommended that the SEC make it possible for an issuer to terminate its registration under Section 12(g) if its total assets fall below a minimum level (i.e. $1,000,000) regardless of the number of security holders.

RECOMMENDATION 3 Business Development Companies

It is recommended that the "pass through" provisions of subchapter M of the Internal Revenue Code of 1954 as amended be extended as an option for adoption by Business Development Companies (BDC's) and Small Business Investment Companies (SBIC's).

It is also recommended that the SEC provide a definitive report on the present status of Business Development Companies, their possible problem areas, and steps that can be taken to make the legislation and regulations more beneficial to both the BDC's and their Shareholders.

RECOMMENDATION 4 Eliminating Impediments to Employee Equity Incentives

It is recommended that the treatment of employee stock plans under federal and state securities law be reviewed with a view to:

1. Developing and adopting a specific exemption from the registration requirements of the Securities Act of 1933 for the issuance of shares by non-public companies to employees under plans that are fundamentally compensatory in nature, such as stock option, stock bonus, restricted stock, performance share, stock appreciation right and below-market purchase plans. Such an exemption should be as straightforward as possible and should impose no new requirements on small business.

2. Permitting registration on Form S-8 of the shares of a non-public company issuable to employees contemporaneously with the initial public offering.

3. Changing the rules governing resales of securities to exempt from federal registration resales of stock acquired under such plans promptly following an initial, registered public offering. An alternative might be to permit registration of resales on a short-form registration statement.

4. Clarifying the exemptions under state securities laws for issuances of stock under such plans and providing a specific exemption in those states where one is not now available.

5. Revising the rules under Securities Exchange Act Section 16(b) applicable to such plans to eliminate unnecessary requirements, to provide greater certainty and to facilitate their intended operation.

6. Reducing the impact of accounting rules applicable to such plans that result in substantial charges to earnings caused by rapid appreciation in the company's stock.

RECOMMENDATION 5 — Facilitating Rule 504 Offerings Under State Securities Laws

1. It is recommended that the states retain or adopt a uniform limited offering exemption for de minimus private offerings that is not dependent upon compliance with Rules 505 or 506.

2. It is recommended that the states adopt a uniform registration procedure for public offerings under Rule 504 that permits simplified disclosure and applies a lesser standard of merit review.

3. It is recommended that in order to further aid small business, the SEC and states should consider increasing the dollar amount that can be raised in reliance upon the exemption provided by Rule 504.

RECOMMENDATION 6 — Improving Liquidity for Small Businesses

It is recommended that a program be developed to improve liquidity for smaller public growth companies by easing requirements for entry into established trading markets and by further streamlining the means by which purchasers of restricted securities may resell their stock.

Specifically it is recommended that the SEC and the SBA jointly undertake a study to determine what criteria and business considerations are used by small and regional broker dealers to create a market for small local public companies. The study should include, but not be limited to, economic considerations such as minimum capitalization requirements, ability to receive and disseminate information, and insurance requirements under the Securities Investor Protection Corporation.

B. TAXATION

RECOMMENDATION 1 - Deduction of Dividends

It is recommended that corporate dividends be treated as a deductible expense, phased in at 10% per year over a ten year period.

RECOMMENDATION 2 Capital Gains Differential - Individual

It is recommended that the present 60% exclusion of realized long-term capital gains from taxable income (the "Capital Gains Differential") be maintained.

RECOMMENDATION 3 Capital Gains Parity - Corporate and Individual

It is recommended that corporations be granted the same rate of exclusion of realized capital gains from taxable income that individuals are granted, namely, 60%.

RECOMMENDATION 4 Small Business Participating Debenture

It is recommended that a Small Business Participating Debenture ("SBPD") be adopted for enactment into law. The SBPD proposal has undergone scrutiny throughout Congressional hearings, so that many technical and policy issues raised by the legislation have been narrowed and focused. However, the concept needs additional refinement to eliminate the following problem areas:

1. Definition of small businesses eligible to issue SBPDs: It is believed that the current limitation of $1 million in paid-in-capital is too low and therefore it is recommended that a level of $5 million be established.

2. SBPDs should not be issued between related parties within the meaning of Sec. 1561 and Sec. 267.

RECOMMENDATION 5 Repeal Personal Holding Company Tax

In light of the similarity in rates between corporations and individuals, it is recommended that the personal holding company provision be eliminated. As an alternative it is recommended that the provision be amended so as to ensure that the penalty tax not apply to active businesses.

RECOMMENDATION 6 Accumulated Earnings Tax

In view of the narrowing of the difference between corporate and individual rates, it is recommended that the accumulated earnings tax be repealed or, at the very least, the safe harbor amount increased to $500,000.

RECOMMENDATION 7 Incentive Stock Options (ISOs)

It is recommended that current law relating to Incentive Stock Options (ISOs) be changed in several respects:

(1) The $100,000 aggregate FMV per employee limit should be replaced with a reasonable multiple of salary, for example two times salary.

(2) The rule requiring ISOs to be exercised in sequential order should be eliminated.

(3) Directors should be included as "employees" and a limit should be imposed on directors' ISO grant that is not greater than that of the highest compensated employee participating in the plan.

(4) The difference between the option exercise price and the FMV of the stock subject to the ISO at the time of exercise should be eliminated as a tax preference item.

RECOMMENDATION 8 Profit-Sharing and other Defined Contribution Plans

It is recommended that the Federal Government recognize the importance of profit sharing and other defined contribution plans to small business and not enact legislation that would further complicate defined contribution plans or make them less attractive to small business.

RECOMMENDATION 9 Employee Stock Ownership Plans (ESOPs)

It is recommended that no changes be made in the current law relating to ESOPs.

RECOMMENDATION 10 Non-Discrimination Rules

It is recommended that current rules be reviewed for their impact on small businesses so that there are means by which small business can establish plans which can achieve safe harbor compliance. It is further recommended that proposed new rules be opposed on the basis of their negative effect on small businesses.

RECOMMENDATION 11 Fringe Benefits

It is recommended that health care benefits and any other employee fringe benefits not be taxed.

RECOMMENDATION 12 Investment Tax Credits

The Forum recognizes that Investment Tax Credits under current law create disparities in the effective tax rates applicable to capital intensive and non-capital intensive businesses. To create equality among taxpayers and stimulus to small business, it is recommended that the Investment Tax Credit be retained for both new and used qualifying property acquisitions with an annual limitation on eligible property of $250,000. Furthermore, the basis of depreciable property should be reduced by one hundred percent of the credit.

RECOMMENDATION 13 Research and Development Tax Credits

It is recommended that the President's proposal for continuation of the Research and Development Tax Credit and a more specific definition of those qualifying expenditures be fully supported.

RECOMMENDATION 14 Depreciation

It is recommended that:

The asset life classifications and depreciation rates proposed under CCRS be adopted, as the reduction in depreciation would be largely offset by reductions in corporate and individual tax rates.

The indexing of capital assets other than real property not be adopted due to the complexity and uncertainty surrounding its application.

The present tax law as it applies to the taxation of capital gains and ordinary income depreciation recapture for real and personal property be retained.

RECOMMENDATION 15 Industrial Revenue Bonds (IDBs)

It is recommended that the President's proposal regarding an early phase-out of the rules for industrial revenue bonds be rejected. The phase-out scheduled under present law should be retained.

RECOMMENDATION 16 Cash Basis Method of Accounting

It is recommended that the cash basis method of accounting be retained.

RECOMMENDATION 17 Interest Expense Deduction

The Administration's proposal regarding limitations on the deduction of interest expense does not adequately address the potentially adverse economic impact on the real estate development industry, nor on manufacturers and sellers of consumer goods typically purchased on credit (i.e., automobiles and other durable goods). It is recommended that the political and economic side effects of the proposal be thoroughly analyzed and researched before enactment in its present form.

RECOMMENDATION 18 Budget Deficit

The Forum is of the unanimous opinion that the primary issue before Congress is the Budget deficit and not tax reform.

RECOMMENDATION 19 Payroll Taxes

It is recommended that the Federal Government address increasing payroll-related costs of small employers and recognize that any action that increases these costs would further hamper the ability of small businesses to generate new jobs and to maintain the existing workforce.

RECOMMENDATION 20 Corporate Tax Structure

It is recommended that Congress adopt the following corporate tax structure:

Taxable Income	Tax Rate
$ 0- 50,000	15%
50,000-100,000	20%
100,000-150,000	25%
150,000-200,000	30%
Over $200,000	35%

RECOMMENDATION 21 FSC Export Income

It is recommended that small Foreign Sales Corporations (FSCs) be allowed to calculate their export income for tax purposes in the same proportion to total taxable income as foreign sales bears to total company sales.

RECOMMENDATION 22 Small FSC Rates

It is recommended that corporate tax rates for small Foreign Sales Corporations (FSCs) be established so as to encourage export sales among small FSCs. This small FSC corporate tax rate should be set at a substantial discount from domestic rates in order to achieve the goal of increased small FSC export activity. To be effective, this lower rate needs to be on the order of half the domestic rate.

C. SMALL BUSINESS ADMINISTRATION

RECOMMENDATION 1 Supporting the Small Business Administration

The Forum strongly supports the continuation and strengthening of the U.S. Small Business Administration.

D. RANKINGS

Participants were asked to rank the foregoing recommendations by issue in order of their importance to small business capital formation.

Table 1:

Ranking of Securities Recommendations

Recommendation No.	Ranking
4	1
1	2
2	3
3	4
6	4
5	5

Table 2:

Ranking of Tax Recommendations

Recommendation No.	Ranking
18	1
20	2
12	3
19	4
2	5
1	6
10	7
11	8
14	9
17	10
7	11
6	12
8	13
16	14
3	15
9	16
4	17
13	18
5	19
15	20
22	21
21	22

The recommendation supporting the Small Business Administration was not ranked with the other recommendations but was unanimously supported by all voting Forum participants.

II. INTRODUCTION

A. Background

President Reagan, in his Fourth Annual Report on the State of Small Business transmitted to Congress in May of 1985, stated "actions that promote a vigorous small business sector have been and will continue to be at the heart of this Administration's economic plans. Low inflation, reduced and more equitable taxes, fewer regulatory burdens, and a sound monetary policy are the underpinnings of our current economic growth and will continue to be my primary tools for promoting small business success." 1/

Small businesses' traditional role as the major job generator in the American economy has been well documented. Comparisons made for various periods between 1972 and 1982 confirm that small businesses respond quickly to market opportunities and create more than their proportionate share of new jobs as part of that response. In fact, small business dominated industries added jobs at a rate almost twice that of industries dominated by larger firms: 11.4% compared to only 5.3% from November 1982 through October 1984. In addition, studies indicate that up to 67% of all new jobs in this country are created by small businesses and that small firms account for 38% of the Gross National Product.

1/ See, The State of Small Business: A Report of the President Together with the Annual Report on Small Business and Competition of the Small Business Administration (Washington D.C.: U.S. Government Printing Office, May 1985) (emphasis added).

Over the past year, small businesses have demonstrated their ability to adapt to a changing economy. Despite this fact, small firms have had continuing problems in terms of capital formation. In recognition of these difficulties, Congress, pursuant to Section 503 of the Small Business Investment Incentive Act of 1980, mandated the Securities and Exchange Commission to conduct an annual Government-Business Forum on Small Business Capital Formation (the "Forum"). The statutory purpose of the Forum, which has been held on an annual basis since 1982, is to review the current status of problems and programs relating to small business capital formation. Congress directed that participation in the Forum should include various Federal agencies, such as the Treasury Department, the Board of Governors of the Federal Reserve System and the Small Business Administration, as well as organizations representing state securities commissioners and leading small business and professional organizations concerned with capital formation.

In 1982, the initial Forum addressed issues relating to income taxation, securing credit from banks, access to financial institutions and raising capital. Thirty-seven specific recommendations were submitted to Congress on December 1, 1982, at a joint hearing conducted by the Senate Small Business Committee and the Subcommittee on Tax, Access to Equity Capital and Business Opportunities of the House Small Business Committee.

The format of the 1983 Forum differed from that of 1982. Local forums, conducted as informal hearings, were held in cities across the United States in order to receive more direct input from the small business community. A group of more than 125 persons composed of small business-persons, bankers, financial advisers, venture capitalists and attorneys, made presentations in local forums held in Boston, Washington, D.C., St. Louis, Houston and San Francisco. The report of the 1983 Forum was presented to Congress in November, 1983. Although the 1983 Forum witnesses endorsed a significant number of the 1982 Forum recommendations, a much more diverse set of recommendations evolved out of the 1983 Forum. Certain subjects, such as community banking and minorities in small business, were new areas of focus at the 1983 Forum.

The 1984 Forum which was held in September, 1984 in Arlington, Virginia closely resembled the 1982 Forum. The principal issue areas selected for discussion were tax, securities state capital formation programs and the financial services industry. Forty specific recommendations were presented to Congress in the form of a report in January of 1985.

B. Issue Selection

Preparations for the 1985 Forum began in January 1985 when the Executive Committee was formed. The Executive Committee is comprised of representatives from government agencies and a number of private sector organizations in accordance with the Congressional guidelines. The Executive Committee determined that tax and securities issues were to be the major areas of focus of the 1985 Forum. Four Task Forces were subsequently formed to develop tax position papers and one Task Force was established to develop securities issue papers. These Task Forces were composed of several Executive Committee members as well as persons selected by each Task Force on the basis of their expertise in the area being considered. The following papers were developed by the five Task Forces:

<u>Securities Task Force</u>

1. Regulation of Small Business
2. Impact of Securities Law on Employee Equity Incentive Arrangements
3. Liquidity Needs of Growth Firms

<u>Tax Task Forces</u>

A. <u>Investor Incentives</u>

1. Dividends
2. Capital gains
3. Small Business Participating Debentures

B. <u>Employee Incentives</u>

1. 401(k) Plans
2. Employee Stock Option Plans (ESOPS)
3. Profit Sharing Plans

4. Incentive Stock Options (ISOs)

5. Health and welfare benefits

C. Capital Investment

1. Tax credits

2. Depreciation

3. Industrial Development Bonds (IDB's)

4. Accounting methods

5. Interest deductions including related parties

D. Rates and Other Tax Burdens

1. Payroll taxes

2. Graduated taxes

3. Cost of tax compliance

C. Conduct of the Forum

The first afternoon of the Forum consisted of a general session conducted by Executive Committee Chairman, SEC Commissioner Charles C. Cox. Opening remarks were presented by SEC Chairman John S.R. Shad. The balance of the afternoon was devoted to two panels which presented an overview of the substantive areas to be covered at the Forum. The tax panel was moderated by Professor Howard Stevenson of Harvard University, and consisted of Robert Ragland, Director of Taxation, National Association of Manufacturers, Robert Gough, Senior Vice-President, Senior Economist, Data Resources Inc., Lawrence Dildline, Manager, Price Waterhouse, and Hudson Milner, Financial Economist, Office of Tax Policy, Department of the Treasury. The securities panel was moderated by Stan Keller of Palmer & Dodge and consisted of Stephen Friedman, Debevoise & Plimpton, Roy Mouer, Johnson & Swanson, Professor Manning Warren, University of Alabama and Edgar Keats, a representative of the Baltimore, Maryland small business community.

The second day of the Forum consisted of intensive workshops covering tax and securities issues. Participants attended sessions relating to the workshop which they had preselected. Each discussion group developed its own views and comments on the issue papers and drafted recommendations to be voted on by all Forum participants on the Forum's final day. On the second day, Forum participants also attended breakfast and luncheon talks respectively by Lee L. Verstandig, then an Undersecretary for the Department of Housing and Urban Development and Senator Jim Sasser, D. Tenn.

On the final morning of the Forum, recommendations for each major issue were presented to and voted on by all the nongovernment Forum participants at a plenary session. This plenary session, which was attended by all Forum participants as well as members of the public and press, consisted of a three hour session where representatives from each issue Task Force presented that group's recommendations and supporting statement. Time was available for Forum participants to comment on or to offer amendments to the proposals prior to voting on their adoption as final recommendations of the Forum. Twenty-nine proposals were adopted by the Forum, and are presented in the pages which follow.

III. SECURITIES REGULATION

A. Statement of the Issue

The basic premise of both federal and state securities laws is that they facilitate capital formation while, at the same time, they protect investors and create integrity in the market place. Over the years, however, this dual Federal-State system of regulation has come to be viewed as an impediment to the capital formation process particularly as it affects smaller businesses. In recognition of this, the Securities and Exchange Commission ("SEC") and the various state securities regulatory agencies through the North American Securities Administrators Association ("NASAA") have made significant regulatory concessions to aid small business consistent with investor protection and the integrity of the market place.

For example, the SEC has taken steps to reduce the disclosure burdens for smaller firms. Form S-18, a special registration form for small companies wishing to raise up to \$5 million in a public offering was adopted in 1979.[2/] The form requires less financial and textual information than the SEC's basic registration form, Form S-1, and can be filed with the SEC's regional offices. The success of Form S-18 prompted the 1982 Forum to recommend an increase in the ceiling on Form S-18. The ceiling was increased to \$7.5 million in March 1982 and a study was recently completed on the need for a further increase to \$10 million.

The SEC has also established a system of classifying small issuers for purposes of exempting certain of them from

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2/ Release No. 33-6049 (April 3, 1979).

reporting and other obligations under the Exchange Act. Issuers need not register and begin filing periodic reports until they have 500 shareholders and $3 million in assets. This classification system provides a rational adjustment to the criteria for entry into, or exit from, the Exchange Act reporting system and eliminates the costs of complying with the registration and reporting provisions of the Exchange Act for the smallest issuers. In response to a recommendation of the 1984 Forum, the Commission recently proposed that this system be amended to provide that issuers need not register and begin filing periodic reports until they have 500 shareholders and $5 million in assets thus further alleviating the reporting obligation of smaller businesses.3/

For securities that are sold in non-public transactions, the SEC adopted Regulation D, a series of rules providing exemptions from the registration requirements of the Securities Act of 1933 ("Securities Act") for certain limited offerings. The regulation simplified and made more uniform the federal rules relating to limited and private offerings and eliminated unnecessary restrictions.

Shortly after the adoption of Regulation D, NASAA adopted a Uniform Limited Offering Exemption ("ULOE") to coordinate with Regulation D.4/ To date, more than half of the states

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3/ Release No. 33-6605 (September 30, 1985).

4/ 1 CCH Blue Sky Rep. ¶5294, at 1273-1275.

have adopted ULOE thus further facilitating the capital formation needs of smaller businesses in a manner consistent with investor protection. NASAA and the SEC are continuing to work together toward the universal adoption of ULOE.5/

The focus of the securities issues dealt with by participants at this year's Forum was on further alleviating the regulatory hurdles and impediments faced by smaller business thereby facilitating capital formation while maintaining a proven system of investor protection and market integrity. This is a particularly difficult balance to achieve. The costs of the regulatory burden on smaller and newer businesses are disproportionately high. However, the need for disclosure and regulation of such businesses is greater since the risk associated with small business investments is generally higher.

B. Recommendations

RECOMMENDATION 1 Differentiation of Small Business From Other Investment Vehicles

It is recommended that consideration be given to developing a definition of small business offerings that will differentiate them from other investment vehicles and permit suitable rules to be adopted that deal specifically with these offerings. The definition would take into account the nature of the enterprise, the type of entity, the stage of growth of the company, the relative importance of anticipated profits and tax benefits, and the customary method of distribution.

In order to determine whether or not smaller business should be regulated at all or differently from other businesses, the term "small business" must be defined. Present securities regulation provisions, particularly exemptions from registration,

5/ At their 1985 Fall Meeting in Calgary, Alberta, NASAA agreed to the issuance of a joint release with the Commission to propose the adoption of a new uniform Form D.

tend to treat small business securities offerings the same as other investment vehicles even though those other vehicles may present different securities regulation issues. For example, there is some question as to whether or not limited partnership offerings should be treated the same as corporate equity or debt offerings under Regulation D where the limited partnerships may not be small businesses.

RECOMMENDATION 2 Avoiding the Burdens of Periodic Reporting for Small Business

Periodic reporting under the Securities Exchange Act of 1934 ("Exchange Act") imposes significant burdens on small business resulting in what may be only a limited benefit to a small percentage of the investing public. Once a company reaches a certain size, or has conducted a public offering, it must comply with the reporting requirements of the Exchange Act. Small businesses must satisfy the same reporting requirements as larger firms but often do not have the same resources which would enable them to comply with such requirements. In addition, certain of the disclosure requirements relevant to larger businesses do not necessarily yield information pertinent to investors in small businesses. Further, the cost of disclosing certain information in some instances may outweigh the benefit to shareholders or potential investors.

RECOMMENDATION 2A

It is recommended that the SEC increase the asset threshold size of issuers required to register under Section 12(g).

As previously discussed, the periodic reporting classification system is based, in part, on the size of an issuer's assets. Presently, the threshold for asset size under Section 12 is $3,000,000. By raising the ceiling, certain smaller reporting companies would be relieved of the periodic reporting obligation. Others would never be required to enter the system. Those companies affected would be saved the expense of filing quarterly, annual and other reports.

RECOMMENDATION 2B

It is recommended that the SEC make it possible for an issuer to terminate its registration under Section 12(g) if its total assets fall below a minimum level (i.e. $1,000,000) regardless of the number of securities holders.

Presently, the duty to file periodic reports can be terminated only when a company has fewer than 300 shareholders or fewer than 500 shareholders and less than $3 million total assets for each of the three preceding fiscal years, provided that no registration statement has become effective during that three-year period. Companies which would be considered to be small businesses by virtue of their asset size would therefore be relieved of their periodic reporting obligation despite a larger number of securities holders.

RECOMMENDATION 2C

It is recommended that the SEC simplify the regulatory and possibly the disclosure requirements applicable to smaller issuers within the reporting system.

Once an issuer becomes a reporting company it is required, regardless of its size, to comply with the same reporting and disclosure provisions of the Exchange Act except in certain circumstances [6/]. In addition to financial disclosure, all reporting companies are required to provide, in narrative fashion, discussion of matters such as legal proceedings, description of business, management's discussion and analysis of financial statements, management compensation and other areas. This recommendation urges an examination of the periodic reporting and disclosure requirements for small issuers and implies that alternative and less burdensome requirements be initiated for smaller businesses.

RECOMMENDATION 3 Business Development Companies

It is recommended that the "pass through" provisions of subchapter M of the Internal Revenue Code of 1954 as amended be extended as an option for adoption by Business Development Companies (BDC's) and Small Business Investment Companies (SBIC'S).

It is also recommended that the SEC provide a definitive report on the present status of BDC's, their possible problem areas, and steps that can be taken to make the legislation and regulations more beneficial to both the BDC's and their Shareholders.

The 1984 SEC Government-Business Forum on Small Business

6/ Small issuers whose original registration statement was on Form S-18 may file financial statements prepared in accordance with generally accepted accounting principles (GAAP) rather than in accordance with Regulation S-X, the Commission's accounting standards when filing their first annual report on Form 10-K.

Capital Formation concluded that additional incentives were needed to affect an increased amount of investment capital to SBIC's and BDC's which would, in turn, increase the flow of equity and long term debt capital to the small business community. One such incentive would be an amendment to the Internal Revenue Code to eliminate tax on certain BDC and SBIC profits at the corporate level. This recommendation is being put forth again by the 1985 Forum.

Historically, venture capital financing developed as a province for knowledgable "insiders". According to the Venture Capital Journal, 7/ about 90 percent of the estimated $11.5 billion pool of venture capital comes from limited partnerships that are the "private preserves of wealthy families and financial institutions" or from corporate venture capital subsidiaries. Another $1 billion is supplied by the 360 SBIC's and 125 minority enterprise SBIC's organized under the Small Business Investment Incentive Act of 1958. Other than participants in these enterprises, the public did not have the opportunity to invest in the financing of new, early stage and emerging companies.

The Small Business Investment Incentive Act of 1980 amended the Investment Company Act of 1940 to establish a new system of regulation for certain closed-end investment companies that provide capital and make available significant managerial

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7/ As cited in Business Week, March 26, 1984.

assistance to small businesses. Those companies can elect to be treated as BDCs. Election as a BDC facilitates making a public offering while enabling the BDC to take advantage of a special system of regulation. In general, BDC's are permitted greater flexibility than other investment companies in dealing with their portfolio companies, issuing securities and compensating management.

The 1980 Act did not, however, conform subchapter M of the Internal Revenue Code to allow conduit or flow through tax treatment to the shareholders of a BDC under the same rules as are applied to a regulated investment company ("RIC"). An RIC is a corporation that qualifies as such under the Investment Company Act of 1940. Under subchapter M, the RIC is not subject to the corporate income tax. As a result, the RIC shareholders, but not BDC shareholders, receive conduit tax treatment. Flow through treatment also has not been accorded to shareholders of SBIC's.

This poses a dilemma for a company that already is eligible for conduit treatment. It can either remain an RIC, which is subject to the system of regulation applicable to most investment companies but receives conduit tax treatment, or it can elect to become a BDC, which is subject to an alternate system of regulation but is not eligible for conduit treatment.

Conduit treatment, particularly the elimination of the double tax on capital gains (<u>i.e.,</u> elimination of a corporate capital gains tax incurred when a BDC sells stock of its investee companies, leaving a shareholder level tax incurred when these gains are distributed or the BDC stock is sold), is of considerable importance to companies that specialize in venture capital investments. The absence of the cross reference may be restricting Congress' effort to promote investment in small business inasmuch as only a small number of BDC's have been established since 1980 and two of the largest BDC's have left the program 8/.

RECOMMENDATION 4 Eliminating Impediments to Employee Equity Incentives

It is recommended that the treatment of employee stock plans under federal and state securities law be reviewed with a view to:

1. Developing and adopting a specific exemption from the registration requirements of the Securities Act of 1933 for the issuance of shares by non-public companies to employees under plans that are fundamentally compensatory in nature, such as stock option, stock bonus, restricted stock, performance share, stock appreciation right and below-market purchase plans. Such an exemption should be as straightforward as possible and should impose no new requirements on small business.

2. Permitting registration on Form S-8 of the shares of a non-public company issuable to employees contemporaneously with the initial public offering.

3. Changing the rules governing resales of securities to exempt from federal registration resales of stock acquired under such plans promptly following an initial, registered public offering. An alternative might be to permit registration of resales on a short-form registration statement.

8/ The Heizer Corporation and Narragansett Capital Corporation.

4. Clarifying the exemptions under state securities laws for issuances of stock under such plans and providing a specific exemption in those states where one is not now available.

5. Revising the rules under Securities Exchange Act Section 16(b) applicable to such plans to eliminate unnecessary requirements, to provide greater certainty and to facilitate their intended operation.

6. Reducing the impact of accounting rules applicable to such plans that result in substantial charges to earnings caused by rapid appreciation in the company's stock.

Equity incentive arrangements are an important tool for business to attract, compensate and motivate employees. Use of these arrangements can be of particular importance to small business because cash may be less available for these purposes and the attraction of equity growth is needed to compete for the limited pool of talent. In addition, the need to motivate employees may be an important consideration for the smaller business seeking to grow.

Congress has from time to time encouraged employee equity incentives through tax policy 9/ but less attention has been paid to the impact of securities law on these arrangements,

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9/ Examples are the treatment of incentive stock options under section 422A of the Internal Revenue Code, employee stock purchase plans under section 423 and employee stock ownership plans qualifying under section 401. The predecessors of ISO's, qualified stock options under section 422 and restricted stock options under section 424, are earlier examples.

particularly for the non-public company.10/

Equity incentives can take various forms ranging from outright stock sales at market or below market prices to stock options, stock bonuses and cash plans based on equity performance. The proper securities law treatment of each of these arrangements may differ depending upon the nature of the arrangement. Where the arrangement is fundamentally an investment transaction (e.g., employee stock purchases at fair market value, perhaps as part of an offering to outside investors), the investor protection principles of securities laws should continue to prevail. In many cases, however, the nature of the transaction is essentially compensatory, to provide benefits to the employee, rather than investment-oriented (e.g., below market sales or favorable stock options). In these cases, while an investment element may exist, the compensatory aspects are predominant and should not be thwarted by securities law impediments designed primarily to protect investors in fund-raising transactions.

10/ In 1934, the Senate adopted an amendment to exempt from the Securities Act of 1933 stock plans for employees, but this exemption was eliminated in conference on the grounds that employees may need the protection afforded by registration the same as other members of the public. This legislative history should not prevent the adoption of exemptions that distinguish those circumstances in which employees do not need the protection afforded by registration.

Public companies are generally able to satisfy the registration requirements of the Securities Act of 1933 applicable to their employee equity plans by using the Form S-8 registration statement. But non-public companies do not have this alternative and full registration for their employee plans is not feasible.11/ Therefore, they must find an exemption from registration or maintain that no sale has taken place with the granting of the option. Although there are several exemptions available from the SEC's registration provisions, none are tailor made to suit the needs of employee plans.12/ An exemption tailored for employee equity incentive plans could identify those plans that are clearly compensatory rather than investment-oriented in nature and exempt them from registration with appropriate

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11/ A non-public company is unlikely to go to the trouble and expense of registration and subject itself to the periodic reporting requirements in order to make equity incentives available to its employees. It may not even have the certified financial statements needed for registration. Form S-8 is not available to a company that is not already public.

12/ Section 4(2) of the Securities Act requires that investors be sophisticated and may limit the number of investors. Rules 505 and 506 of Regulation D limit the number of non-accredited investors to 35. Rule 504 of Regulation D is limited in its availability since its ceiling is $500,000. The intrastate offering would eliminate companies with employees in more than one state. Finally, Regulation A may not be satisfactory since it requires public disclosure of information by a non-public company.

safeguards. Additionally, employee equity incentive plans that do not clearly come within the categorical exemption could be exempted based upon a dollar limitation since these are unlikely to be investment-oriented.

In the case of employees equity incentives, the major investment risk faced by the employee is the limitation on resale which arises, principally from resale restrictions under the federal securities law. Employees of public companies eligible to use Form S-8 do not face this same problem because shares acquired under the S-8 can be resold immediately without restriction (except in the case of affiliates). But this solution is not available for private companies and, except in a limited way, is not available for stock acquired by employees before the company becomes public. Under present rules, unregistered shares acquired by employees before the company's S-8 becomes effective can be included under S-8 in amounts up to 10% of the total shares issuable under the company's registered plans. While this helps, it does not cover many situations. Since there is no limitation on the number of shares that can be included for offerings under an S-8, there is little reason to limit the number of previously issued shares that can be included for reoffering. By eliminating this limitation, employees who acquire stock in a private company that goes public will be in the same position as employees who acquire their stock when the company is public.

State securities laws apply to employee equity incentive plans and, absent a clear exemption, can create impediments as onerous as those under federal securities law.

The Uniform Securities Act exempts "any investment contract issued in connection with an employee's stock purchase, savings, pension, profitsharing, or similar benefit plan", subject to filing of a prior notice with the state securities administrator. However, this exemption is not uniformly available in all states. Some states, by rule, have exempted certain option and other plans completely, but many of these exemptions are out-of-date because of changes in tax law.

The Revised Uniform Securities Act clarifies the language of the exemption and eliminates the filing requirement. It would be desirable to have this exemption adopted on a uniform basis by the states.

Under present federal securities law the short-swing profit rules of Section 16(b) of the Exchange Act require that any profit realized by statutory insiders from the purchase and sale (or sale and purchase) of stock within a six-month period is forfeited to the company. Although the SEC has adopted certain rules ameliorating to some extent the impact of the forfeiture provisions, the short-swing profit provisions continue to impose impediments to employee equity incentive plans that go beyond what is needed to prevent the speculative abuse by insiders that those provisions are designed to proscribe.

In addition, the rules themselves are complex and subject to interpretative uncertainty. Accordingly, a revision of these rules as they relate to employee equity plans to eliminate unnecessary impediments and to add certainty is desirable.

RECOMMENDATION 5 Facilitating Rule 504 Offerings Under State Securities Laws

Regulation D is a series of six rules 13/ providing exemptions from the Securities Act registration provisions for certain limited offerings of securities.14/ The regulation, which was adopted by the Commission in 1982, was intended to simplify and make more uniform the rules relating to limited and private offerings, eliminate unnecessary restrictions, facilitate capital formation in a manner consistent with investor

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13/ 17 CFR 230.501 through 506 (hereinafter Rules 501 through 506).

14/ Section 5 of the Securities Act requires that a registration statement be filed with the SEC before securities are offered for sale to the public, and prohibits the sale of those securities until the registration statement becomes effective. Rules 504 and 505 were promulgated pursuant to Section 3(b) of the Securities Act which permits the Commission to adopt rules and regulations exempting classes of securities from the registration provisions so long as the aggregate amount of such offering does not exceed $5,000,000. Rule 506 was promulgated pursuant to exemption from Section 5 for "transactions by an issuer not involving any public offering."

protection and reduce costs of securities offerings to small businesses.15/

Rule 504 is one of the substantive exemptions provided for by Regulation D. It provides an exemption pursuant to which issuers may raise up to $500,000 from an unlimited number of purchasers within a twelve-month period without registration under Section 5 of the Securities Act of 1933, as amended. Basically, the SEC through Rule 504 has adopted a "hands-off" policy towards such offerings, leaving regulation of offerings under Rule 504 to the states.

Rule 504 actually provides two exemptions from the Federal securities laws. One exemption allows a public offering, an offering made by general solicitation, if the offers and sales of the securities are made exclusively in one or more states, each of which provides for the registration of such securities and the delivery of a disclosure document prior to the sale of such securities. Such a public offering would permit the securities to be freely transferable under Federal statutes in those

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15/ Release No. 33-6389 (March 8, 1982). Rules 501 through 503 state general requirements for using Regulation D. Rules 504 through 506 detail provisions for specific types of exempt offerings.

states where they have been registered. The second exemption allows a private offering, an offering with no general solicitation and with resale restrictions on the securities sold, without imposing any limit on the number of offerees or purchasers and without requiring that specific information be furnished to offerees or purchasers.

Issuers attempting to raise capital in more than one state through securities offerings that are exempt from registration are faced with the responsibility of complying with the securities laws of each state in which the offering is made. The disclosure and prospectus delivery requirements vary considerably from state to state. The need for issuers to comply with disparate state requirements causes serious delays in the offering coming to the market and raises the costs of the offering. It is therefore important to provide an exemption under state securities laws for de minimus private offerings and a simplified uniform registration procedure for public Rule 504 offerings.

RECOMMENDATION 5A

It is recommended that the states retain or adopt a uniform limited offering exemption for de minimus private offerings that is not dependent upon compliance with Rules 505 or 506.

NASAA has endorsed a Uniform Limited Offering Exemption ("ULOE") intended to coordinate with Regulation D and to provide for uniformity among the states. ULOE, however, provides only for exemptions pursuant to Rule 505 16/ and, optionally, for Rule 506. 17/ NASAA has not endorsed a Rule 504 type exemption. In order to facilitate the capital formation process for smaller businesses, this recommendation urges the adoption of a ULOE for de minimus private offerings.

RECOMMENDATION 5B

It is recommended that the states adopt a uniform registration procedure for public offerings under Rule 504 that permits simplified disclosure and applies a lesser standard of merit review.

Uniform state disclosure and prospectus delivery requirements should be encouraged. Uniform state requirements together with a lesser standard of merit review would ease the burden on those small issuers raising capital and relying on Rule 504 for an exemption from the Federal registration requirements.

RECOMMENDATION 5C

It is recommended that in order to further aid small business, the SEC and states should consider increasing the dollar amount that can be raised in reliance upon the exemption provided by Rule 504.

Currently, an issuer may raise up to $500,000 from an unlimited number of investors pursuant to Rule 504. This recommendation would increase the ceiling for 504 offerings thereby assisting smaller businesses in raising capital.

16/ Rule 505 permits sales to 35 nonaccredited and an unlimited number of accredited investors with a ceiling of $5 million.

17/ Rule 506 permits sales to 35 nonaccredited investors who must be sophisticated and an unlimited number of accredited investors. There is no dollar limitation under Rule 506.

RECOMMENDATION 6 Improving Liquidity for Small Businesses

It is recommended that a program be developed to improve liquidity for smaller public growth companies by easing requirements for entry into established trading markets and by further streamlining the means by which purchasers of restricted securities may resell their stock.

Specifically it is recommended that the SEC and the SBA jointly undertake a study to determine what criteria and business considerations are used by small and regional broker dealers to create a market for small local public companies. The study should include, but not be limited to, economic considerations such as minimum capitalization requirements, ability to receive and disseminate information, and insurance requirements under the Securities Investor Protection Corporation.

A principal impediment to the capital raising processes of small businesses is the inability of such businesses to raise money quickly and inexpensively by selling their securities. The primary reason for this is the lack of liquidity of securities of smaller businesses, particularly those which are privately held. Securities of privately held companies do not have access to the public trading markets such as the exchanges or NASDAQ. Furthermore, securities purchased in private transactions may only be resold if stringent and very specific resale requirements are met. Even companies which have registered their securities for sale to the public may find a very limited public market after the initial distribution. While the eligibility requirements for exchange or NASDAQ listing and the rules restricting resales of securities purchased in private placements are consistent with the theory of investor protection, they tend to be more of an impediment to the liquidity needs of small firms than of larger businesses.

IV. TAXATION[18/]

A. Statement of the Issue

In his Fourth Annual Report on the State of Small Business, President Reagan highlighted the significance of tax reform and its impact on small business by noting that "[C]ongressional action on tax reform, however, is very much in order. Our efforts to lower the tax burdens on small business are not complete as long as the tax code is so cumbersome and complicated. Business must be allowed to develop based on opportunities in the market place, not on their ability to weave around the various tax technicalities that have developed over the years. Our goal is a simplified tax system with the lowest possible burden for the individual and small business. Our goal in this reform is not to balance the concerns of various special interests, but to achieve a fairer and simpler tax system for all tax payers, including our 14 million small businesses."[19/]

This year, proposals before Congress to restructure the nation's tax system may significantly alter the financial course of the small business sector. The role which Federal tax laws, both individual and corporate, play is key to small businesses' ability to obtain and retain capital. Disincentives to this dual need should be identified, and

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18/ This section was written based upon recommendations made prior to submission of recent tax proposals to and from the Congress.

19/ See, The State of Small Business: A Report of the President Together with the Annual Report on Small Business and Competition of the Small Business Administration (Washington D.C.: U.S. Government Printing Office, May 1985) (emphasis added).

legislative and regulatory proposals to rectify such problems should be endorsed in order to enhance the vitality of the small business community.

B. Recommendations

RECOMMENDATION 1 Deduction of Dividends

It is recommended that corporate dividends be treated as a deductible expense, phased in at 10% per year over a ten year period.

Under the present Internal Revenue Code, corporate taxable income paid as dividends to individual shareholders generally bear two taxes: the corporate income tax and the individual income tax. The system also views the use of certain corporate assets for personal benefit as imputed dividends. Excessive salaries may be found to constitute imputed dividends, for example. In addition a confiscatory accumulated earnings tax exists which effectively encourages corporations to make dividend distributions to shareholders. Double taxation of earnings distributed as dividends to shareholders also encourages corporations to finance their operations with debt rather than equity.

The recommendation would reduce the existing incentive for corporations to raise capital by issuing debt and would make equity securities more competitive with debt. Because dividend relief also would reduce the incentive to retain earnings, corporations would be likely to pay greater dividends and to seek new capital, both equity and debt, in the financial markets. Corporations thus would be subject to greater discipline in deciding whether to retain or how to invest their earnings. The increased level of corporate distributions would expand the pool of capital available to new firms. This should, in turn, enhance productivity and efficiency across the economy. Ultimately, this type of an approach could result in the elimination of the uncertainty involved in planning for the accumulation of corporate wealth. Phasing the proposal in over a ten year period appears to be a sensible approach to such a revision in tax policy.

<u>RECOMMENDATION 2</u> Capital Gains Differential - Individual

It is recommended that the present 60% exclusion of realized long-term capital gains from taxable income (the "Capital Gains Differential") be maintained.

The present tax system provides for a significant differential between tax rates on capital gains and ordinary income. In 1978 and 1981 capital gains tax cuts were made and have proven to be beneficial both in terms of capital formation and government revenues. Such cuts contributed to a burst of new risk capital, entrepreneurship and job creation. A better investment climate led to record numbers of new stock offerings, bolstered corporate equity value and employment opportunities. Concomitantly, despite the cut in the maximum capital gains tax, revenues attributable to capital gains increased in 1982.

The differential is an important incentive for capital formation because it encourages saving and investment, rewards risk-taking and enables emerging businesses to compete for both capital and managerial talent. Since the initial cut in 1978, growth companies have been successful and the market for such stocks has risen substantially. A facet of this process is that investment funds have been attracted to venture capital enterprises which have invested in growing small businesses or start-up companies. The attraction of capital to growth companies is a desirable factor from the vantage of small businesses.

RECOMMENDATION 3 Capital Gains Parity - Corporate and Individual

It is recommended that corporations be granted the same rate of exclusion of realized capital gains from taxable income that individuals are granted, namely, 60%.

Corporate and individual capital gains tax cuts should be similar in order to avoid having tax considerations dictate the form of doing business. Historically, individual and corporate rates have been changed together and been roughly the same. Neither individuals nor corporations should be discouraged from making risk capital investments, including venture capital. In the last series of cuts, the corporate rate did not keep pace with the individual rate. The percentage of corporate contribution to venture capital investment has decreased over this time period. Parity would make more funds available for investment in start-up companies and growing small businesses.

RECOMMENDATION 4 Small Business Participating Debenture

It is recommended that a Small Business Participating Debenture ("SBPD") be adopted for enactment into law. The SBPD proposal has undergone scrutiny throughout Congressional hearings, so that many technical and policy issues raised by the legislation have been narrowed and focused. However, the concept needs additional refinement to eliminate the following problem areas:

1. Definition of small businesses eligible to issue SBPDs: It is believed that the current limitation of $1 million in paid-in-capital is too low and therefore it is recommended that a level of $5 million be established.

2. SBPDs should not be issued between related parties within the meaning of Sec. 1561 and Sec. 267.

The SBPD generally would have the following features:

a. The SBPD could be a general or secured obligation of the company. It would pay a stated rate of interest not less than a standard rate negotiated by the parties (but not less than the Section 483 rate). The SBPD would provide for the payment of a share of the total earnings, preferably net earnings, of the issuer.

b. The small business entrepreneur would be able to deduct interest payments and amounts paid as a share of earnings as a business expense. The stated interest received by the investor would be taxable to the investor as ordinary income. The amount paid as a distribution of a share of the company's earnings would be taxable at the preferential long-term capital gains rate.

An SBPD would be treated as Section 1244 stock and, therefore, an individual investor would generally treat a loss on an SBPD as an ordinary loss.

c. The particular terms of the SBPD would be determined by the parties in accordance with the prevailing market. The SBPD would have a fixed maturity date, and voting and conversion rights would not be available. The SBPD could be a self-executing instrument (i.e., there would not be any need for government approvals, permits or filings).

d. The SBPD also could provide an investment tax credit to the investor. The nature of such tax credit varies among the different proposals.

The SBPD continues to be a solution to the problem of access to capital, particularly in the raising of funds for long-term financial needs such as the expansion of plant, production and sales. Enactment into law would enable small businesses to attract investors who believed in the company's growth potential and ability to earn capital surplus.

<u>RECOMMENDATION 5</u> Repeal Personal Holding Company Tax

In light of the similarity in rates between corporations and individuals, it is recommended that the personal holding company provision be eliminated. As an alternative, it is recommended that the provision be amended so as to ensure that the penalty tax not apply to active businesses.

The personal holding company provision imposes a penalty on the undistributed income of certain corporations controlled by a limited number of shareholders and receiving a large percentage of its income from specified sources. The purpose of the provision is to penalize the use of personal holding companies to avoid the graduated income tax on individuals and accumulated earnings tax on corporations. A corporation is a personal holding company if 60 percent or more of its income is personal holding company income and more than 50 percent of its stock is owned by five or fewer individuals. The tax is 70 percent of undistributed personal holding company income.

Many small businesses engaged in active operations are in lines of business that have a similarity to passive activities, e.g., real estate, software, technology research, licensing and franchising. These businesses were not the targets for the personal holding company tax, and it is believed that the need to prevent abuse by these active companies is small in comparison to the heavy burden this provision places upon small businesses.

<u>RECOMMENDATION 6</u> Accumulated Earnings Tax

In view of the narrowing of the difference between corporate and individual rates, it is recommended that the accumulated earnings tax be repealed or, at the very least, the safe harbor amount increased to $500,000.

Under the Internal Revenue Code the accumulated earnings tax is imposed on any corporation formed or availed of for the purpose of avoiding the income tax on shareholders by permitting earnings and profits to accumulate rather than be distributed. The present provision does not apply until aggregate accumulations exceed $250,000.

It is believed that unwise economic decisions by businesses may be driven by this tax. The tax adversely affects the goal of capital formation. Capital could be needed after the decision to pay out dividends in order to avoid an unreasonable accumulation has been made and effectuated. Accumulation of capital in a small business should be encouraged.

<u>RECOMMENDATION 7</u> Incentive Stock Options (ISOs)

It is recommended that current law relating to ISOs be changed in several respects:

(1) The $100,000 aggregate FMV per employee limit should be replaced with a reasonable multiple of salary, for example two times salary.

(2) The rule requiring ISOs to be exercised in sequential order should be eliminated.

(3) Directors should be included as "employees" and a limit should be imposed on directors' ISO grant that is not greater than that of the highest compensated employee participating in the plan.

(4) The difference between the option exercise price and the FMV of the stock subject to the ISO at the time of exercise should be eliminated as a tax preference item.

The Economic Recovery Act of 1981 ("ERTA") authorized corporations to grant to employees ISOs which, if certain conditions were met, eliminated any tax consequence either at the time of grant or when exercised. It further provided that profits from subsequent sales of the securities acquired by option would be accorded capital gains treatment if held for one year or longer.

As a result of almost three years of experience since ERTA's enactment in 1981 it is now apparent that one of the legislative ISO conditions has acted to severely limit the effective use of ISOs by companies seeking to increase their rate of productivity. Options must be exercised in the sequential order in which they were granted. This requirement severely diminishes their value if either the exercise price of options granted earlier exceeds the current FMV of the stock or if ISOs granted later have a lower exercise price.

TEFRA further eviscerated ISOs by including the spread between the exercise price and the FMV as a tax preference item. This means that if the taxpayer is subject to the alternative minimum income tax, a 20 percent tax is assessed on this paper profit. This provision has had an effect in many instances of virtually doubling the tax rate on gains from sales of option stock.

Finally, the effectiveness of ISOs as a tool for small business development has been limited by the fact that ISOs are not currently available to directors of corporations since directors are generally not considered to be employees. Smaller businesses which cannot match the salaries of larger companies are less able than larger firms to attract experienced advisors to serve on their boards of directors.

A key to job creation, innovation, productivity and market competitiveness in the international arena lies with the talents of imaginative, entrepreneurially-oriented employees in both emerging, growth-oriented, independent businesses and larger, well-established companies. It is precisely these types of individuals who are attracted by the opportunity to participate in high risk, high reward investment programs as opposed to less generous and less demanding, but more secure salaried positions offered by other concerns. Incentive stock options need to be legislatively modified to make them a more attractive, useful compensation device.

<u>RECOMMENDATION 8</u> Profit-Sharing and other Defined Contribution Plans

It is recommended that the Federal Government recognize the importance of profit-sharing and other defined contribution plans to small business and not enact legislation that would further complicate defined contribution plans or make them less attractive to small business.

In 1939, the Vandenberg-Henning Subcommittee of the Senate Finance Committee conducted an intensive study of profit-sharing plans and concluded: "We believe it (profit-sharing) to be essential to the ultimate maintenance of the capitalistic system." Partly influenced by these favorable findings, Congress passed legislation providing tax advantages for qualified, non-discriminatory deferred profit-sharing plans.

Today, there are currently 360,000 deferred profit-sharing plans in existence covering 20 million employees with well over $175 billion in assets. Of these 360,000 companies, it is estimated that 350,000 have less than 100 employees.

Profit-sharing has been particularly suited to smaller businesses that have cyclical profit patterns and capital needs that differ from a larger corporation. Thus, unlike a defined benefit plan, no contribution is required in a non-profit or low profit year. And, second, the employer need not be concerned with adverse pension investment results.

Over the years, legislation affecting profit-sharing has been directed in two general areas: first, to see that participants' rights and account balances are protected and, second, that plans do not discriminate in favor of the higher paid executives within a company.

Some of the legislation, particularly the "top-heavy" rules and complex fiduciary provisions, have tended to diminish the value of profit-sharing, particularly for smaller businesses.

The current tax reform proposals represent a strong attack on those features which are found predominantly in profit sharing and thus seem to represent an attack on profit-sharing. Some of the specific provisions in the Treasury tax reform proposal having the effect of restricting defined contribution plans are:

(1) The elimination of carry-over provisions for contributions to profit-sharing plans;

(2) The requirement that profit-sharing contributions not exceed 15% of each participant's compensation;

(3) The restriction on early withdrawals from qualified plans;

(4) The elimination of favorable tax treatment for lump sum distributions, including 10-year income averaging and capital gains treatment, for certain lump sums, and unrealized appreciation on distribution employer stock.

By making profit-sharing less attractive, small businesses will find the ability to attract quality professional and innovative personnel reduced. More importantly, profit-sharing plans are a major source of savings and retirement equity for many individuals who would not otherwise have the opportunity to build such retirement income and savings reservoirs.

RECOMMENDATION 9 Employee Stock Ownership Plans (ESOPs)

It is recommended that no changes be made in the current law relating to ESOPs.

Employee ownership has emerged as an important issue in just about every industry in the country. In an era of tough economic competition employers are looking for ways of keeping a lid on wages to the greatest extent possible in order to help control costs, while still motivating their employees to improve productivity. Employee stock ownership plans (ESOPs) offer employers an attractive means of increasing employee compensation without imposing a short term strain on cash flow, of motivating workers by offering them a share in the potential growth of the company, and of providing attractive financing alternatives for a company.

Employee stock ownership plans have been in existence since the late 1950's when Louis Kelso began to put into effect the ideas he had conceived in his book The Capitalist Manifesto. The idea of the ESOP, as Kelso envisioned it, was to begin to provide workers with access to capital credit so that they could participate as capitalists in the economy as a means of supplementing the wages they earned by their labor.

Congress has supported the ESOP concept by passing 16 different bills which include ESOP incentives, culminating in the passage last year of the Tax Reform Act of 1984. That bill included significant incentives for the establishment of ESOPs and has sparked a noticeable increase in the number of ESOPs nationwide. Many of the new provisions were intended specifically to encourage smaller businesses to install ESOPs and have had a direct effect on small business capital formation.

Small businesses are just beginning to assess the positive effects of the recently enacted IRC provisions regarding ESOPs.

The tax reform proposals do not recognize the fundamental role of ESOPs in small businesses and would impose unduly burdensome regulations.

RECOMMENDATION 10 Non-Discrimination Rules

It is recommended that current rules be reviewed for their impact on small business so that there are means by which small business can establish plans which can achieve safe harbor compliance. It is further recommended that proposed new rules be opposed on the basis of their negative effect on small business.

According to a recent survey conducted by the Employers Council on Flexible Compensation (ECFC)[20/], 453,096 small employers (between 1-100 employees) currently sponsor a 401(k) plan. These plans cover 4,475,367 employees. There are 29,184 large employers (over 100 employees) that currently have a 401(k) plan. These plans cover 16,351,330 employees. Total employees covered by 401(k) plans now exceed 20 million. The survey also indicated that 37% of small employers offer 401(k) plans as their only retirement plan and that 401(k) plans now cover 28% of the private sector workforce. In addition, over 120,000 small employers and almost 10,000 large employers intend to install a 401(k) plan within the next 12 months. The number of employees that would be covered by these new plans is over 3 million.

Special 401(k) rules on discrimination in contribution permit proportionately more contributions to be made for higher paid employees compared to lower paid employees than would be

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20/ The ECFC is a national association of employers that sponsor cafeteria and 401(k) plans. Among other functions, the ECFC serves as a national clearing house for information about flexible compensation.

permissible under traditional profitsharing or stock bonus plans. A 401(k) plan is also special in that the employee is given a choice as to whether to receive an amount in cash or to have it contributed to the plan on his behalf. Because of special tax rules, the employee is taxed currently only on the amount he chooses to receive in cash. The amount he chooses to have contributed to the plan is excluded from tax until distributed, just like any other employer contribution to a qualified profit-sharing or stock bonus plan.

These and other special features of 401(k) plans would be eliminated, or the attractiveness of such features substantially reduced, under the tax reform proposals. The proposed nondiscrimination rules are overly complex and difficult to apply fairly in the small firm context. Small firms may fail the proposed tests, based upon size alone. In many cases, firms with small numbers of employees cannot meet the tests as proposed under any circumstances.

RECOMMENDATION 11 Fringe Benefits

It is recommended that health care benefits and any other employee fringe benefits not be taxed.

The health and welfare benefits provided to employees help to contain labor and administrative costs. For many employees, group health insurance and other benefit plans are their only form of protection or coverage. Taxation of health insurance and other benefits will increase labor costs. Employees will demand higher salaries to cover the new tax, employers' administrative burdens will be increased, and employers' FICA taxes will be increased due to the inclusion of the benefits in taxable compensation. Such taxation will tend to impede the capital formation process for smaller businesses.

RECOMMENDATION 12 Investment Tax Credits

The Forum recognizes that Investment Tax Credits under current law create disparities in the effective tax rates applicable to capital intensive and non-capital intensive businesses. To create equality among taxpayers and stimulus to small business, it is recommended that the Investment Tax Credit be retained for both new and used qualifying property acquisitions with an annual limitation on eligible property of $250,000. Furthermore, the basis of depreciable property should be reduced by one hundred percent of the credit.

The current rules are the product of the 1981 tax revisions. In its report, the Senate Finance Committee stated that the liberalization of the investment tax credit will be an effective way of stimulating capital formation, increasing productivity and improving the nation's competitiveness in international trade.

Testimony taken by the Senate Finance Committee and House Ways and Means Committee in June 1985, regarding elimination of the tax credit adduced the following:

(1) Capital intensive industries argued that adopting the President's Proposal would sacrifice U.S. competitiveness abroad,

would increase costs of capital equipment, and would decrease cash flow.

(2) Chief executive officers of more labor intensive companies argued repeal would neither reduce business investment nor harm U.S. competitiveness.

The U.S. Chamber of Commerce in a June 1985 release declined to take a position on the President's Proposal noting that its provisions would reduce taxes for some industries while raising taxes for others.

In general, the President's Proposal supports the elimination of the investment tax credit in conjunction with the adoption of a new Capital Cost Recovery System. The proposal supports eliminating the credit based on perceived flaws in the current system. The flaws include: (1) the fact that the investment incentives are neither systematically protected from inflation nor allocated in a neutral or efficient manner (Example: investment tax credit reduces effective tax rates more during periods of low inflation than in periods of high inflation); (2) the tax credit is front-loaded, limiting its attractiveness to start-up, fast growing or currently unprofitable businesses. The frontloading makes the credit attractive for tax shelters redirecting resource and energy to the pursuit of tax rather than economic advantages leading to weakened economic growth and productivity; and (3) repeal would simplify the tax code through the elimination of complex rules.

The Treasury Proposal advocates the elimination of the investment tax credit in conjunction with inflation adjustments in depreciation allowances, capital gains, inventories, and interest income and expense. This adjustment for inflation, it is argued, will eliminate the need for, among other things, the investment tax credit.

However, the Forum believes that a reasonable dollar ceiling on allowable investment tax credits would provide small businesses with tax relief and at the same time create neutrality of tax incidence between companies competing in different segments of our economy.

<u>RECOMMENDATION 13</u> Research and Development Tax Credits

It is recommended that the President's proposal for continuation of the Research and Development Tax Credit and a more specific definition of those qualifying expenditures be fully supported.

The President's proposal recommends that the current credit for the incremental research and experimentation be extended for an additional three years (until December 31, 1988), in lieu of terminating on December 31, 1985, as called for under current law.

The proposal would also revise the definition of qualified research eligible for the credit in order to target research activities likely to result in technological innovations. The definition would focus on new or technologically improved products and processes in order that research expenses would qualify for the credit only if they relate to a process or experimentation encompassing the evaluation of alternatives that involve a serious degree of uncertainty as to whether the desired result can be achieved. The proposal also recommends that additional exclusions be examined and identified in order to prevent non-innovative research expenses from qualifying for the credit.

The purpose behind the existing credit for research and experimentation expenditures is to provide an incentive for creating technological innovations. Empirical evidence supports the proposition that the current law provides a valuable tax benefit and incentive to small business in the formative stages experiencing growth in research and development activities. The President's proposal recognizes the value of the credit in accomplishing this objective. However, the President's proposal also perceives that the current provisions are overly broad by allowing taxpayers to claim a credit for expenses even though there is little doubt as to the outcome of the procedure.

RECOMMENDATION 14 Depreciation

It is recommended that:

The asset life classifications and depreciation rates proposed under CCRS be adopted, as the reduction in depreciation would be largely offset by reductions in corporate and individual tax rates.

The indexing of capital assets other than real property should not be adopted due to the complexity and uncertainty surrounding its application.

The present tax law as it applies to the taxation of capital gains and ordinary income, depreciation recapture for real and personal property be retained.

Current law provides for an Accelerated Cost Recovery System (ACRS) as adopted in 1981. ACRS generally permits faster cost recovery and greater depreciation deductions than realized under pre-1981 law.

ACRS was introduced in large part to provide investment stimulus that is essential for economic expansion. The ACRS was adopted during a period of high inflation and in order to maintain the real value of depreciation deductions. The Senate Report stated, with regard to the adoption of ACRS, that reductions in the real value of depreciation deductions due to high rates of inflation diminish the profitability of investments and discourage business from replacing old equipment with newer more modern assets.

Commerce Department figures indicate that business capital spending has recovered sharply from the depths it reached during the 1981-1982 recession. In 1984, gross spending for new plant and equipment was $425 billion, an increase of 20% from the $353 billion that was spent during 1983. Additionally, investment spending beyond what was needed to replace old structures and equipment rose even more dramatically from $50 billion in 1983 to $107 billion in 1984. Moreover, in the eight quarters following the end of the 1982 recession, outlays for producers' durable equipment increased by $45 billion (measured in constant 1972 dollars) or by 41%. This reflects an annual growth rate of approximately 19%, which is far greater than the 8% growth rate realized in a similar period following the 1975 recession. Many commentators attribute this investment boom, in large measure, to the ACRS and investment tax credit provisions adopted in 1981.

The tax reform proposal would repeal ACRS in favor of a Capital Cost Recovery System (CCRS), which would base depreciation on the inflation adjusted cost of property rather than on historical cost. Under CCRS, there would be classes of property each with different recovery periods and depreciation schedules. The depreciation schedules are based upon the declining balance rate switching to the straight line method. Extended depreciable lives and rates do not appear to severely impact small businesses due to reduction in corporate and individual rates.

CCRS would adjust depreciation allowances for inflation by means of a basis adjustment. Under CCRS, after adjustment for allowable depreciation in the prior year, an assets unrecovered basis would be adjusted for inflation during the current year using an appropriate government price index. The applicable depreciation rate would be applied to the resulting adjusted basis. The inflation adjustments would continue after the switch to the straight line method. The Forum believes that indexing of capital assets adds to the complexity and uncertainty of tax reform and should be limited to real property. The complexity of indexing is not justified for assets with short useful lives but is justified for real estate assets because of their substantially longer useful lives over which inflation effects are much more significant.

Under CCRS the asset's adjusted basis would be used for purposes of computing gain or loss upon disposition of the depreciable asset. All gains would be treated as ordinary income, with no preferential treatment under current law. The Forum believes that the present law should be retained as it applies to preferential treatment of capital gains with existing recapture provisions.

The tax reform proposals recommend changing to CCRS for several reasons. First, in periods of low inflation ACRS reduces tax rates on investments in depreciable assets creating artificial incentives for investments in depreciable property. These investment distortions, it is argued, hamper economic efficiency and operate as an undeclared government industrial policy. Additionally, ACRS incentives are not distributed among depreciable assets in a neutral or systematic manner. The proposal notes that there is a substantially lower effective tax rate for machinery and equipment than for structures, and goes on to argue that a more neutral cost recovery system would preserve incentives while equalizing effective tax rates across assets. Additionally, it is noted that ACRS has contributed to the growth of tax shelters by promoting substantial up front deductions and the churning of assets.

The President's proposal advocates CCRS as a more neutral, simplified and efficient system of depreciation. Neutrality is said to be achieved through classifying property on the basis of economic depreciation and, with appropriate rates and schedules, yields the same effective tax rate for all depreciable assets. Simplification, it is noted, is achieved by eliminating recapture and reducing the impact or importance of existing complex rules.

RECOMMENDATION 15 Industrial Revenue Bonds (IDBs)

It is recommended that the President's proposal regarding an early phase-out of the rules for industrial revenue bonds be rejected. The phase-out scheduled under present law should be retained.

IDBs have become an important source of capital for small businesses in recent years as traditional credit markets have become less accessible to them due to high and volatile interest rates. In this economic climate, small businesses have turned increasingly to IDBs as a source of financing for growth and expansion. State programs providing funds for small businesses have also relied heavily on IDBs as a primary source of funds.

A sunset provision contained in the Tax Reform Act of 1984 would eliminate the tax-exempt status for all small issue IDBs by 1989. This sunset provision was the result of Congressional and Treasury Department concerns that small issue IDBs were increasingly being used by large businesses, that they were being used to fund types of facilities less deserving of a federal subsidy, and that they were not in any way targeted to economically needy areas.

The tax reform proposals, as written, would repeal the tax exemption for all private-purpose bonds on January 1, 1986. As a result, many contemplated projects would be cancelled and there would be uncertain effects on projects under construction or subject to binding contracts. Accordingly, the phaseout schedule under the present law should be retained.

<u>RECOMMENDATION 16</u> Cash Basis Method of Accounting

It is recommended that the cash basis method of accounting be retained.

The cash basis method of accounting is a clear and consistent measure of taxable income for service oriented organizations, which recognizes the economic reality of earnings and cash flow. Service organizations should not be required to incur interest and finance charges in order to pay taxes on uncollected receivables. The distinction and purpose of financial and tax accounting has not been recognized in the President's proposal. Thus, the financial conformity requirement for utilization of the cash method of accounting fosters arbitrary competitive disadvantages among organizations in the same industry solely by virtue of the unrelated non-tax motivated requirements of lenders and equity investors. The proposal actually encourages uninformative financial reporting. Furthermore, competitive disadvantage also is created by the relative difference in size of similar businesses.

The cash method of accounting does "clearly reflect income" of a professional service organization. The opportunities to defer or to distort the income of a service organization are circumscribed by business practices and conditions of the marketplace for those services. Salaries typically must be paid bi-weekly, payables are small, and no business is likely to forestall the collection of receivables. The cash method has been a permissible method of accounting for decades because it affords simplicity and certainty to tax reporting.

Based on the foregoing analysis, the cash basis method of accounting should be retained.

RECOMMENDATION 17 Interest Expense Deduction

The Administration's proposal regarding limitations on the deduction of interest expense does not adequately address the potentially adverse economic impact on the real estate development industry, nor on manufacturers and sellers of consumer goods typically purchased on credit (i.e., automobiles and other durable goods). It is recommended that the political and economic side effects of the proposal be thoroughly analyzed and researched before enactment in its present form.

The Administration's proposals applicable to investment and personal interest expense are intended to apply primarily to limited investors in real estate tax shelters as well as wealthy taxpayers who incur indebtedness to acquire significant personal assets, such as vacation homes. As the provisions are not generally applicable to interest incurred in the conduct of a trade or business, many small businesses will not be impacted. With respect to the indirect effect on the real estate industry, however, the interest provisions cannot be analyzed apart from the effect of other proposals for reform. These other proposals would subject real estate to the "at risk" rules, significantly extend the recovery period of real property, and require recapture of prior cost recovery deductions.

It is undoubtedly true that present law has, in many instances, encouraged the acquisition of real property at inflated values by tax shelters in order to generate a return to wealthy individuals derived largely from the tax benefits rather than the economic considerations of an investment. The major flaw in the Administration's analysis, however, is that it fails to address the potentially adverse impact of the proposal on the overall economy. The real estate development industry, which is comprised of many small businesses, may suffer an economic recession by a curtailment of the deductibility of interest expense associated with commercial and residential real property (in conjunction with the other proposals for reform).

The Government historically has subsidized the cost of residential rental property in one form or another, either through exemption of the "at risk" rules or by issuance of tax exempt bonds. The associated escalation in the cost of rental dwellings created by the Administration's proposals, which may be politically and economically unacceptable for low and middle income families, has not been analyzed thoroughly. Furthermore, the proposals do not take account of the potentially adverse impact on the value of residential real property presently held by investors and assigned as collateral to financial institutions.

The Administration's proposal regarding the capitalization of interest on self-constructed property is intended to provide a better matching of revenues and expenses by the recovery of construction period interest through depreciation, amortization, or cost of sales. The proposal penalizes small business and other taxpayers, however, in that debt, which is not specifically attributable to the asset under construction, is first allocated to those assets. The proposal fails to recognize that businesses typically incur non-specific indebtedness for purposes of carrying the costs of other assets, such as inventories and receivables, as well as to finance the cost of other working capital requirements. The Administration's proposal could result in the capitalization of cost in excess of the asset's fair market value, or cost of acquisition from an unrelated party, solely by an arbitrary allocation of interest on non-specific indebtedness. The proposal also does not clearly define assets with a "long useful life" that would be subject to the provisions. The proposal includes those assets with a CCRS life of 5, 6 or 7 years. There are, however, only six classes of CCRS lives under the Administration's proposal for reform to recovery periods.

<u>RECOMMENDATION 18</u> Budget Deficit

The Forum is of the unanimous opinion that the primary issue before Congress is the Budget deficit and not tax reform.

The Forum participants expressed their views with an apparent deep degree of urgency regarding the need for control of our budget deficit. Tax reform is secondary to budgetary control and should be one of the means to help support a sounder budgetary policy.

<u>RECOMMENDATION 19</u> Payroll Taxes

It is recommended that the Federal Government address increasing payroll-related costs of small employers and recognize that any action increasing these costs would further hamper the ability of small businesses to generate new jobs and to maintain the existing workforce.

Payroll taxes fund two popular social programs - Social Security and Unemployment Compensation. These taxes work a heavier impact upon smaller businesses since such businesses are generally labor intensive and a larger portion of their total payroll is subject to these taxes. Indeed, studies have shown that for small businesses, payroll taxes have made up to 70 to 80 percent of their taxes and in many cases up to 100 percent of their taxes.

Over the last two decades small businesses have been the primary creators of new jobs in the U.S. economy. Payroll taxes inhibit the creation of such new jobs. These taxes also increase costs for small businesses and interfere with the maintenance of a stable workforce and effective competition.

RECOMMENDATION 20 Corporate Tax Structure

It is recommended that Congress adopt the following corporate tax structure:

Taxable Income	Tax Rate
$ 0- 50,000	15%
50,000-100,000	20%
100,000-150,000	25%
150,000-200,000	30%
Over $200,000	35%

The above structure will address two primary zones of potential economic expansion [(1) Successful small firms with growing earnings of $25,000-$100,000, and (2) more mature small firms with earnings growing from $100,000 - $300,000 in sales] where retained earnings are the primary source of expansion capital because outside sources of capital are frequently inaccessible or unavailable on an economic basis. The above schedule is modeled after the House Ways and Means Corporate Tax Proposal of 1981 with the top rate modified to 35% (as opposed to 34% in the original proposal). The primary features are doubling brackets by stages and reducing to the top rate by stages.

As the deficit is a preeminent concern of small business, this proposal is designed to be revenue positive. By the Forum's calculations, these changes would yield a revenue increase of about $2.8 billion compared to the President's proposal, if done immediately, and more than this if these changes are phased in. The firms which will benefit by this proposal are the proven job creators as demonstrated by the President's recent Reports on the State of Small Business.

<u>RECOMMENDATION 21</u> FSC Export Income

It is recommended that small Foreign Sales Corporations (FSCs) be allowed to calculate their export income for tax purposes in the same proportion to total taxable income as foreign sales bears to total company sales.

The United States deficit in the balance of trade with other countries has been increasing at a significant rate. The merchandise trade deficits in 1982 and 1983 were $42.7 billion and $69.4 billion, respectively. Currently, most export sales are made by large companies, while small firms' capabilities to export remain underutilized. Ways should be found to encourage small and medium-sized companies to export their products.

In response to this need, the Domestic International Sales Corporation (DISC) provisions of the Internal Revenue Code and the newly adopted FSC provisions were drafted, in part, to encourage small and medium-sized companies to export their products. Of equal importance to new and small firms, is that such tax incentives must be drafted so as not to create unwieldy and economically burdensome procedural requirements. Such burdens too often bar small and medium-sized companies from utilizing these provisions and discourage segments of the business community from exploring export opportunities.

Congress and the Internal Revenue Service must assure that the new FSC provisions will maximize the availability of export incentives to small and medium-sized companies and encourage them to export into foreign markets. By adopting the above proposal small business FSCs could be relieved of tremendous administrative and record keeping burdens associated with the currently overly complex FSC rules. The compliance burdens associated with such requirements reduce the attractiveness of FSCs and inhibit export sales expansion by small companies.

<u>RECOMMENDATION 22</u> Small FSC Rates

It is recommended that corporate tax rates for small FSCs be established so as to encourage export sales among small FSCs. This small FSC corporate tax rate should be set at a substantial discount from domestic rates in order to achieve the goal of increased small FSC export activity. To be effective, this lower rate needs to be on the order of half the domestic rate.

Present rate differentials for small FSCs is not sufficient to encourage foreign exports by small business. Exports are key to our current trade deficits rather than import restrictions, and small business represents a significant potential for increased exports. Exporters generally represent our most competitive "sunshine" industries with potential for growth in revenues and increased jobs.

This recommendation would establish a favorable tax environment for small FSC export sales. Additionally increases in small FSC foreign sales would assist in having a downward effect upon U.S. trade deficits.

IV. SMALL BUSINESS ADMINISTRATION

RECOMMENDATION Supporting the Small Business Administration

The Forum strongly supports the continuation and strengthening of the U.S. Small Business Administration.

The policy of Congress which led to the establishment of the Small Business Administration can be stated as follows:

> The essence of the American economic system of private enterprise is free competition. Only though full and free competition can free markets, free entry into business, and opportunities for the expression and growth of personal initiative and individual judgment be assured. The preservation and expansion of such competition is basic not only to the economic well-being but to the security of this Nation. Such security and well-being cannot be realized unless the actual and potential capacity of small business is encouraged and developed. It is the declared policy of the Congress that the Government should aid, counsel, assist and protect insofar as is possible, the interests of small business concerns in order to preserve free, competitive enterprise . . .21/

The reasons supporting the original Congressional authorization of the SBA remain true today.

The SBA has an impressive record of providing critical assistance to large numbers of small business owners and operators. Small business assistance programs such as financial assistance, procurement assistance, and advocacy are vital for new business development and continued economic prosperity. "The SBA's record of economic accomplishments, in terms of number of jobs created and revenues generated far exceeds the cost to the government and adds up to a convincing case for maintaining the agency."22/

21/ S. 408, 99th Cong., 1st Sess. (February 18, 1985).

22/ S. Rep. No. 20, 99th Cong., 1st Sess. (March 28, 1985).

V. FORUM PARTICIPANTS

Lawyers

Abdun-Nabi, Daniel (Garvey, Schubert, Adams & Barer)
Brannan, Suzanne (Hazel, Beckhorn & Hanes)
Cambell, Thomas (Queen & Smith)
Cheney, Ronald L. (Harrison and Maguire, P.C.)
Coleman, George W. (Jenkins & Gilchrist)
Delk, Glen A. (Asbill, Porter, Churchill, & Nellis)
Fein, Ronald L. (Jones, Day, Reavis, & Pogue)
Friedman, Stephen J. (Debevoise & Plimpton)
Glazer, Donald W. (Ropes & Gray)
Harris, Jean (Wentworth & Lundin)
Hopper, George (Hopper, Kanouff & Smith)
James, Joseph V. (Sole Practioner)
Kaplen, Jared (Keck, Mahin and Cate)
Keller, Stanley (Palmer and Dodge)
Krislov, Lint (Gottlieb & Schwartz)
Levy, Steven (Kutak, Rock & Campbell)
Martin, Edwin M. (Hale & Dorr)
Mehlman, Barry (Rogers & Wells)
Miles, Michael (Sutherland, Asbill & Brennan)
Mouer, Roy (Johnson & Swanson)
O'Connor, Dennis (Dennis O'Connor & Assoc.)
Oliver, Jack (Tanner & Tanner)
Piedmont, Joseph (Cannon, Kline & Blair)
Schwartz, Harry K. (Lane and Edson)
Seeling, Carol A. (Abramson & Fox)
Slayton, John H. (Pillsbury, Madison & Sutro)
Somers, Jeffrey P. (Gadsby & Hannah)
Stone, Harold (Store & Hinds)
Sturtevant, Albert (Rose, Schmidt, Chapman, Duff & Hasely)
Vandergrift, Benjamin M. (Pillsbury, Madison and Sutro)
Wertheimer, Linda A. (Winstead, McGuire, Sechrist & Minich)

Small Business Persons

Carey, Stephen (Financial Services Corporation)
Cohen, Ronald (Cohen & Co.)
Deans, Robert F. (Business Software Suppliers, Inc.)
Fennell, Paul (P.D. Fennell & Company)
Forman, Mark (Union Pacific Corporation)
Graham, David (Pan Tech Management)
Haist, Nancy M. (CEECO)
Henderson, John A. (Topographic Science Corp.)
Horton, Lee (Spectrum Digital Corporation)
Hrisak, Dan (Management Accounting Magazine)
Johnson, Gordon (Johnson Associates)
Keats, Ed (Retired Small Businessperson)
Klotz, Howard S. (Contemporary Communications Corporation)
Moon, William (Iowa 80 Truckstop)
Olson, Kenneth (Focus % Corporation)

(Small Businesspersons - Continued)

Olson, Oscar M. (Small Business Unity Committee)
Raines, William F. III (Source Data Inc.)
Rennie, Jack (Pacer Systems, Inc.)
Rorke, Marsh L. (Mohawk Research Corp.)
Schundler, Robert J. (The Schundler Company)
Selwood, Ron (Metech, Inc.)
Weston, Daniel A. (Corporate Capital Resources Corp.)
Young, Reynolds (Old Dominion Enterprises, Inc.)

Accountants

Blount, Diane C. (Arthur Young & Co.)
Bolle, Bob (Arthur Anderson & Co.)
Carr, Jeff (Deloitte Haskins & Sells)
Derieux, Samuel A. (Derieux, Baker, Thompson, & White)
Dildine, Lawrence (Price Waterhouse)
Gerdesmeier, Ken (Financial Accounting Standards Board)
Giannini, Daniel A. (Coopers & Lybrand)
Goldstein, Harvey A. (Singer, Lewak, Greenbaum, & Goldstein)
Goodman, Gayle (Ernst & Whinney)
Haddad, Robert (Price Waterhouse)
Hevey, Gary R. (Peat, Marwick, Mitchell, & Co.)
Hopper, George W. (Hopper, Kanouff, Smith, Deryman, Terry, & Duncan)
Morrison, Ann (Peat, Marwick, Mitchell, & Co.)
Rappaport, Donald (Price Waterhouse)
Spira, Herb (Arthur Anderson & Co.)
Tiegen, Elaine M. (American Institute of Certified Public Accountants)
Upton, Wayne (Financial Accounting Standards Board)
Walsh, Joseph P. (Coopers & Lybrand)

Trade Groups

Aiken, Debra (U.S. Chamber of Commerce)
Amorosi, Joanne (Air Conditioning Contractors of America)
Berno, Donald C. (U.S. Chamber of Commerce)
Binns, David (ESOP Association)
Broude, Paul (Small Business United)
DeBoer, Jeffrey (National Association of Realtors)
Edwards, Lynn (NAHRO)
Gough, Robert (Data Resources Corp.)
Herman, Mildred (Financial Analysts Federation)
Holan, Walter (Profit Sharing Council of America)
Jones, John R. (Real Estate Securities Syndication Institute)
Kolbe, Stan (Air Conditioning Contractors of America)
Lipow, Herschel (American Institute of Architects)
McNeish, Peter (National Association of Small Business Investment Companies)
Parrillo, Douglas (National Association of Securities Dealers)

(Trade Groups - Continued)

Ragland, Robert A. (National Association of Manufacturers)
Satagaj, John (American Association of Nurserymen)
Schafield, William (Financial Executives Institute)
Schneier, Abe (National Federation of Independent Business)
Thomas, Diane (American Association of MESBICS)

Venture Capitalists

Carfield, Frank (National Venture Capital Assoc.)
Coleman, Richard (Review Management Corp.)
Jones, Charles C. (Sunbelt Funding Corp.)
Little, Arthur (National Venture Capital Association)
Merrill, Steven (Merrill, Pickard, Anderson & Eyre)
Neece, Alan (Neece, Cator and Associates)
Todd, Renate K. (Fulcrum Venture Capital Corp.)
Wachtel, Bonnie K. (Wachtel and Company)
Walters, Pat (Sunbelt Funding Corporation)
Weekes, Eric (North Street Capital Corporation)
Weston, Daniel (Corporate Capital Resources, Inc.)

Financial Consultants and Banks

Causino, Scott (Legg-Mason Investment Services)
McClure, John (Mercantile Trust Company, N.A.)
McCrory, Troy (NCNB-SBIC Corporation)
Mendelson, Alan (Aetna Life Insurance)
Ruhm, Thomas F. (Bessemer Securities Corp.)
Trauger, Howard A. (Bishop & Associates)
White, Stan (Stillwater National Bond & Trust Co.)

State Government Officials

Brothers, Lewis Jr. (Virginia Division of Securities and Retail Franchising)
Jack, Eloise (West Virginia Office of Commercial & Industrial Development)
Lewis, Stanley (South Carolina Department of Securities)
Licht, Richard (Lieutenant Governor-State of Rhode Island)
Phillips, Wayne (Montana State Auditor & Securities Commission)
Rittenhouse, Susan (Maryland State Securities Commission)
Sewell, Abner W. ("Buster") - (Nevada Deputy Secretary of State Securities Commissioner)
Strickland, Bruce Jr. (North Carolina Department of Commerce)
Tyson, Carl (Michigan Department of Commerce)
Williams, Kevin (Tennessee Department of Economic & Community Development)

Federal Agency Staff

Benderson, Eric (Small Business Administration)
Bennett, Tom (White House Fellow)
Booker, Janice (Office of Comptroller of the Currency)
Burns, Bob (Securities and Exchange Commission
Bybee, Kathy (Department of Commerce)
Feigen, Jerry (Small Business Administration)
Fullerton, Don (Department of the Treasury)
Graul, Leland (Securities and Exchange Commission)
Gordon, Janet (Office of Comptroller of the Currency)
Harris, Malloy (Office of Comptroller of the Currency)
Haworth, Hugh (Securities and Exchange Commission)
Hurst, Grant (Securities and Exchange Commission)
Jackson, Daryl (Small Business Administration)
McGowan, Gregory (Securities and Exchange Commission)
Milner, Hudson (Department of the Treasury)
Opper, Jan (Department of Housing and Urban Development)
Ou, Charles (Small Business Administration)
Savage, Michael T. (Department of Housing and Urban Development)
Stockwell, Eleanor (Federal Reserve Board)
Swain, Frank (Small Business Administration)
Wells, Dolly (Department of Treasury)
White, Patricia (Federal Reserve Board)
Wirtz, Wayne (Securities and Exchange Commission)
Zweig, Robert (Securities and Exchange Commission)

Congressional Staff

Gates, Jeff (Senate Finance Committee)
Haynes, Mike M. (Senate Small Business Committee)
Henry, George (House Committee on Small Business)
Williams, Steve (Senate Small Business Committee)

Academics

Alkire, Durwood (University of Washington)
Erdman, Daryl (St. Thomas College)
McConnell, Dennis (University of Maine)
Rapp, Sharon (University of Southern California)
Reiling, Henry (Harvard University)
Stevenson, Howard A. (Harvard University)
Warren, Manning G. III (University of Alabama)

VI. EXHIBIT

SMALL BUSINESS FINANCING TRENDS

This brochure is intended to provide participants at the SEC Government-Business Forum on Small Business Capital Formation background material on trends in small business financing. Statistics are provided for the ten-year period 1975 - 1984 for all securities offerings registered under the Securities Act of 1933.

In Summary, the statistics indicate that:

- Both initial public offerings (IPOs) and total registered offerings declined in 1984 compared to the previous year.
- The number of IPOs has been far more volatile in recent years than either total registered issues or the S&P 500.
- More than 85 percent of the IPO issuers in 1984 had assets of $10 million or less and over two-thirds had assets of $500 thousand or less.
- Underwriters reduced their participation in bringing small company IPOs to market in 1984. However, there was an increase in the percentage of offerings brought to market on an agency best-efforts basis.
- The Finance, Insurance and Real Estate industries showed a significant increase in IPOs in 1984. Together with the Manufacturing and Service Industries, they accounted for the bulk of IPOs.

All of the material presented (excluding Table 1) is derived from the SEC's Registration and Offerings Statistics File, which contains information on all registered offerings since 1970. This file is available to the public on magnetic tape for computer processing. Information on exempt offerings is available in a published SEC study, An Analysis of Regulation D.

For information on the Registration and Offerings Statistics File, the study of exempt offerings, or any of the data presented in this brochure, please contact Robert E. Zweig in the SEC's Directorate of Economic and Policy Analysis, (202) 272-2850.

Jeffry L. Davis
Director of Economic
and Policy Analysis

Table 1

NET SOURCES OF FUNDS FOR CORPORATE BUSINESS 1/
1975 - 1984
(Billions of dollars)

Year	Total	Internal	External		
			Total	Securities	Other Sources
1975	$157.0	$119.7	$ 37.3	$39.8	$ -2.5
1976	211.0	134.2	76.8	35.8	41.0
1977	254.1	157.4	96.7	32.3	64.4
1978	317.5	175.7	141.8	28.7	113.1
1979	345.2	188.8	156.4	19.5	136.9
1980	335.2	189.5	145.7	50.5	95.2
1981	364.2	230.4	133.8	23.7	110.1
1982	309.4	234.3	75.0	45.2	29.8
1983	436.3	280.5	155.9	53.4	102.5
1984	$482.6	$334.8	$147.8	$-21.5	$169.3

1/ New financing less retirements for non-farm, non-financial corporations.

Source: Table B-87, "Sources and Uses of Funds," 1985 Economic Report of the President and Flow of Funds Statistics, Board of Governors of the Federal Reserve System.

Prepared by: Directorate of Economic and Policy Analysis
U.S. Securities and Exchange Commission

Figure 1

NET SOURCES OF FUNDS FOR CORPORATE BUSINESS

1975 - 1984

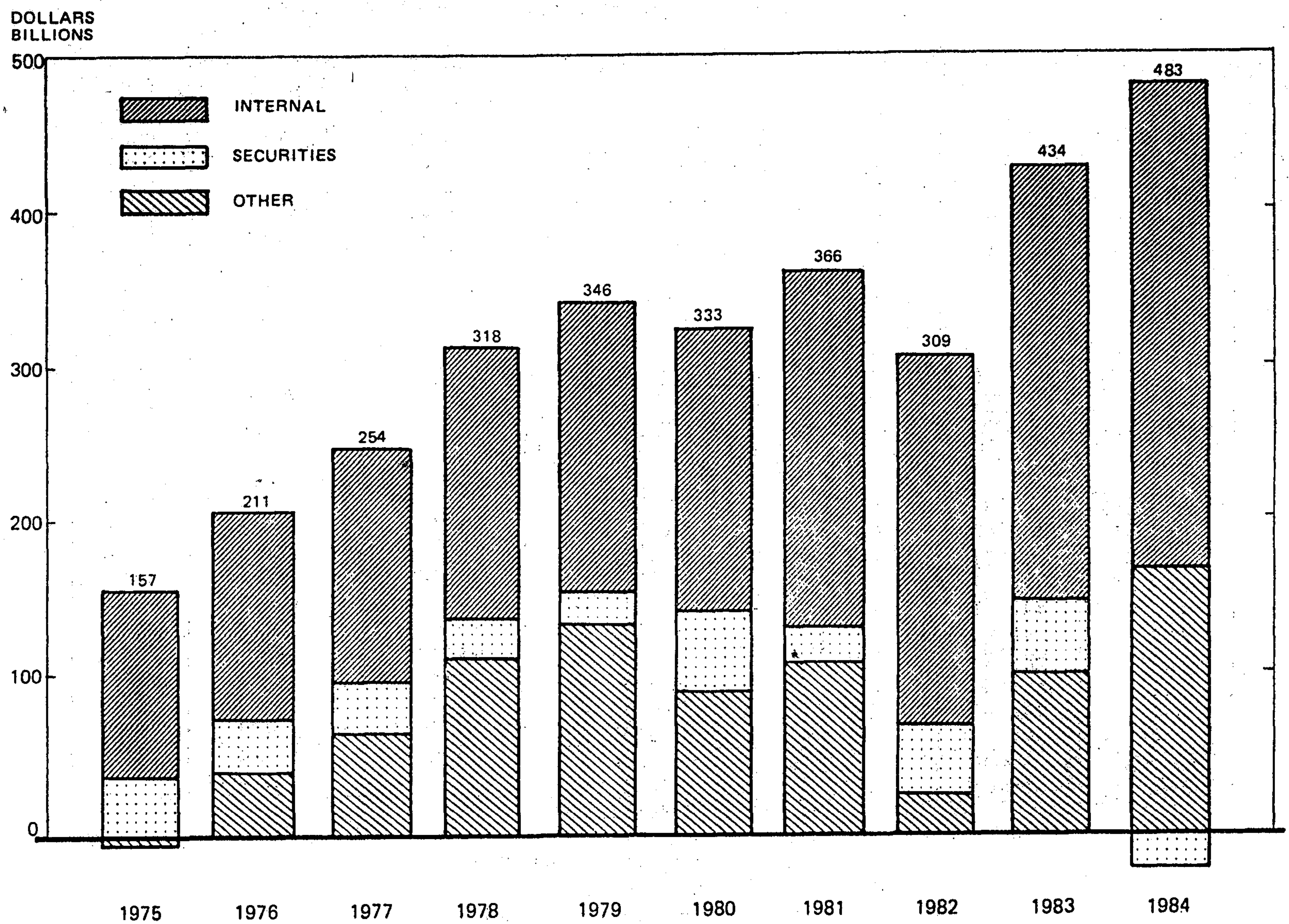


Table 2

EFFECTIVE REGISTRATIONS FOR CASH SALE 1/
1975 - 1984
(Amounts in millions of dollars)

TOTAL REGISTERED OFFERINGS

Year	Number of Issues	Total	Bonds, Debentures and Notes	Preferred Stock	Common Stock	All Other Equity
1975	1,417	$40,239	$30,550	$3,089	$ 5,634	$ 966
1976	1,457	34,931	24,945	2,238	6,852	896
1977	797	31,713	21,898	2,387	5,902	1,526
1978	833	28,364	18,900	1,743	5,224	2,497
1979	873	34,883	24,439	1,942	5,643	2,859
1980	1,629	63,535	42,534	3,239	11,184	6,578
1981	1,946	62,281	35,894	1,595	13,910	10,882
1982	1,875	70,092	42,599	4,744	12,900	9,849
1983	3,163	97,341	46,810	7,570	27,720	15,241
1984	2,401	$84,763	$59,331	$4,125	$ 8,025	$13,282

INITIAL PUBLIC OFFERINGS 2/

Year	Number of Issues	Total	Bonds, Debentures and Notes	Preferred Stock	Common Stock	All Other Equity
1975	203	$ 1,257	$ 205	$ 50	$ 73	$ 929
1976	229	1,265	267	0	163	835
1977	216	2,167	723	30	118	1,296
1978	244	3,100	469	12	264	2,355
1979	288	3,585	374	29	505	2,677
1980	584	8,623	1,210	4	1,249	6,160
1981	998	14,659	1,475	12	2,977	10,195
1982	813	10,694	1,474	3	1,518	7,699
1983	1,589	25,312	3,334	98	7,599	14,281
1984	1,411	$20,065	$ 3,219	$ 263	$3,889	$12,694

1/ Includes U.S. business only.
2/ Initial Registered Public Offering ("IPO") of securities under the Securities Act of 1933.

Source: Registrations and Offerings Statistics File

Prepared by: Directorate of Economic and Policy Analysis
U.S. Securities and Exchange Commission

Figure 2

EFFECTIVE REGISTRATIONS FOR CASH SALE

(Value of Offerings: 1975 - 1984)

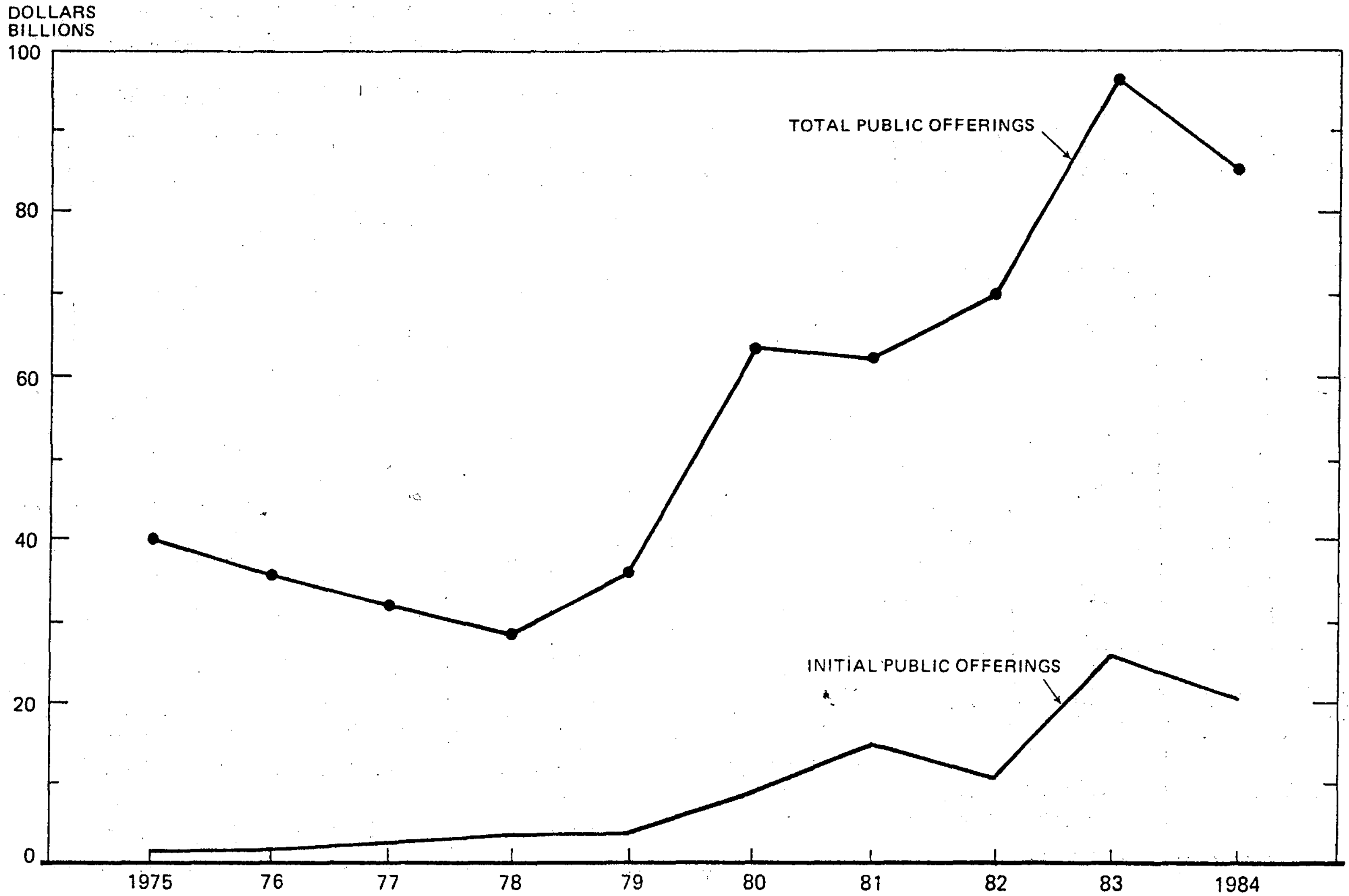


Table 3

IPO COMMON STOCK BY ISSUERS' ASSET SIZE
1975 - 1984
(Amounts in millions of dollars)

ASSET SIZE

	\$500,000 or Less		\$500,001 to \$1,000,000		\$1,000,001 to \$5,000,000		\$5,000,001 to \$10,000,000		\$10,000,001 and Greater		Total	
Year	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount
1975	14	$ 23.8	0	$ 0	2	$ 1.8	1	$ 0.8	6	$ 46.3	23	$ 73.5
1976	12	38.8	0	0	4	5.7	7	22.3	19	96.4	42	163.2
1977	30	53.4	4	5.0	7	16.5	7	26.0	7	17.3	55	118.2
1978	38	100.0	2	2.1	4	5.5	7	22.4	17	133.7	68	263.7
1979	54	182.0	15	43.8	11	50.2	9	53.6	20	175.0	109	504.6
1980	149	424.2	24	71.9	37	150.1	20	95.1	43	507.5	273	1,248.8
1981	269	1,112.3	34	123.8	120	484.6	43	330.8	78	925.9	544	2,977.4
1982	189	676.4	30	81.0	40	130.1	22	171.2	34	459.4	315	1,518.1
1983	462	1,704.6	51	228.0	124	775.4	77	880.9	187	4,009.6	901	7,598.5
1984	487	$1,672.3	24	$ 69.9	84	$ 755.0	36	$252.0	90	$1,139.6	721	$3,888.8

Source: Registrations and Offerings Statistics File

Prepared by: Directorate of Economic and Policy Analysis
U.S. Securities and Exchange Commission

Figure 3

INITIAL PUBLIC OFFERING INDEX

(Number of Issues: 1974 - 1984)

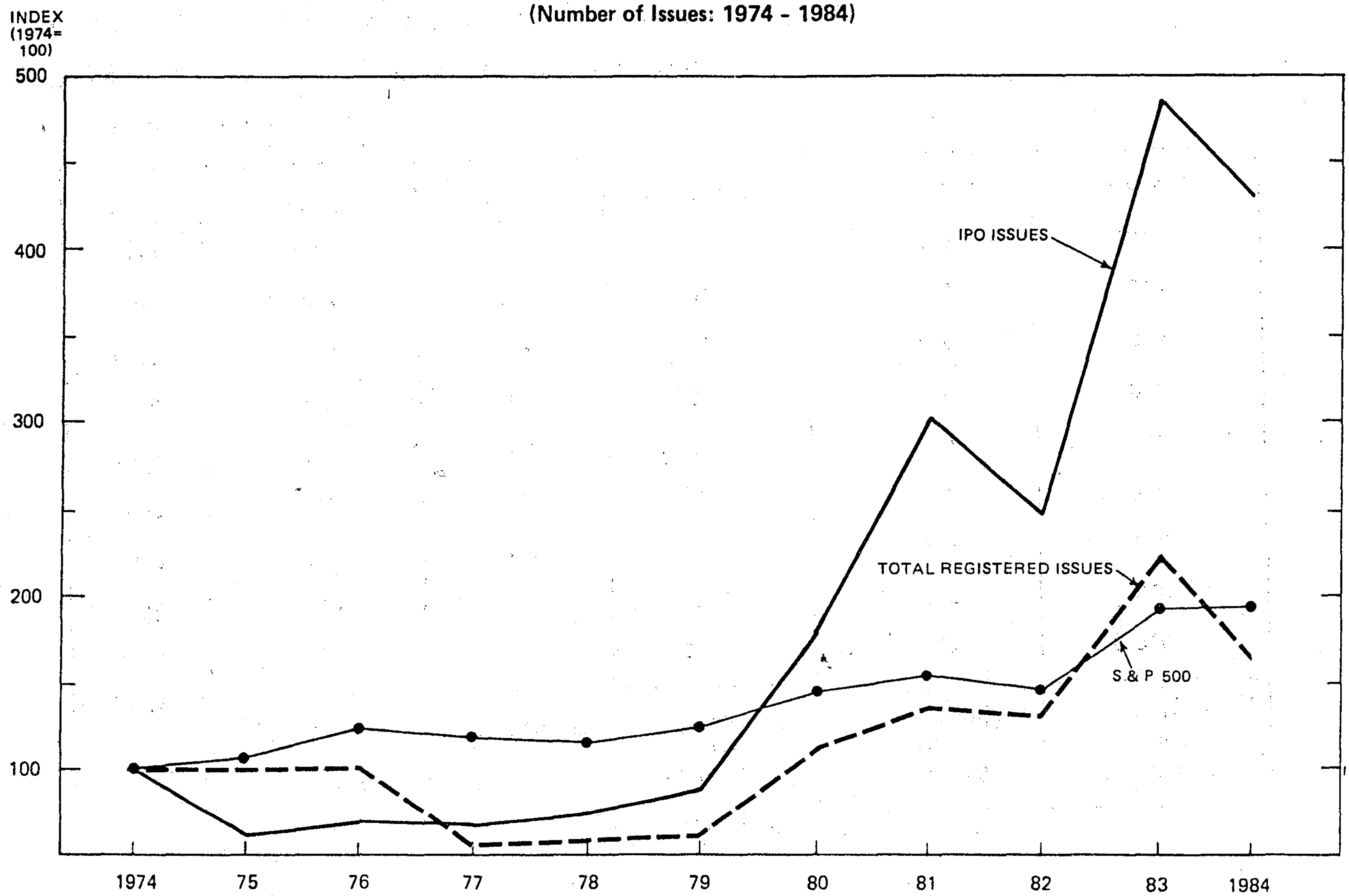


Table 4

VALUE OF TYPICAL COMMON STOCK IPO BY ISSUERS' ASSET SIZE 1/
1975 - 1984
(Millions of dollars)

Year	Asset Size $500,000 or Less	$500,001 to $1,000,000	$1,000,001 to $5,000,000	$5,000,001 to $10,000,000	$10,000,001 and Greater
1975	$1.1	$0	$0.9	$0.1	$ 7.0
1976	1.0	0	1.1	2.7	5.0
1977	1.1	1.1	2.3	2.6	2.0
1978	1.2	1.1	1.4	3.0	7.0
1979	1.5	2.0	2.0	3.4	5.2
1980	2.0	3.0	3.6	4.6	8.6
1981	2.8	3.6	3.5	6.6	8.6
1982	2.2	2.4	3.0	5.0	5.9
1983	2.5	3.0	4.2	7.5	13.0
1984	$2.0	$3.0	$3.2	$4.9	$ 8.1

1/ Median Offering.

Source: Registrations and Offerings Statistics File

Prepared by: Directorate of Economic and Policy Analysis
U.S. Securities and Exchange Commission

Figure 4

ASSET SIZE OF COMMON STOCK IPO ISSUERS

1984

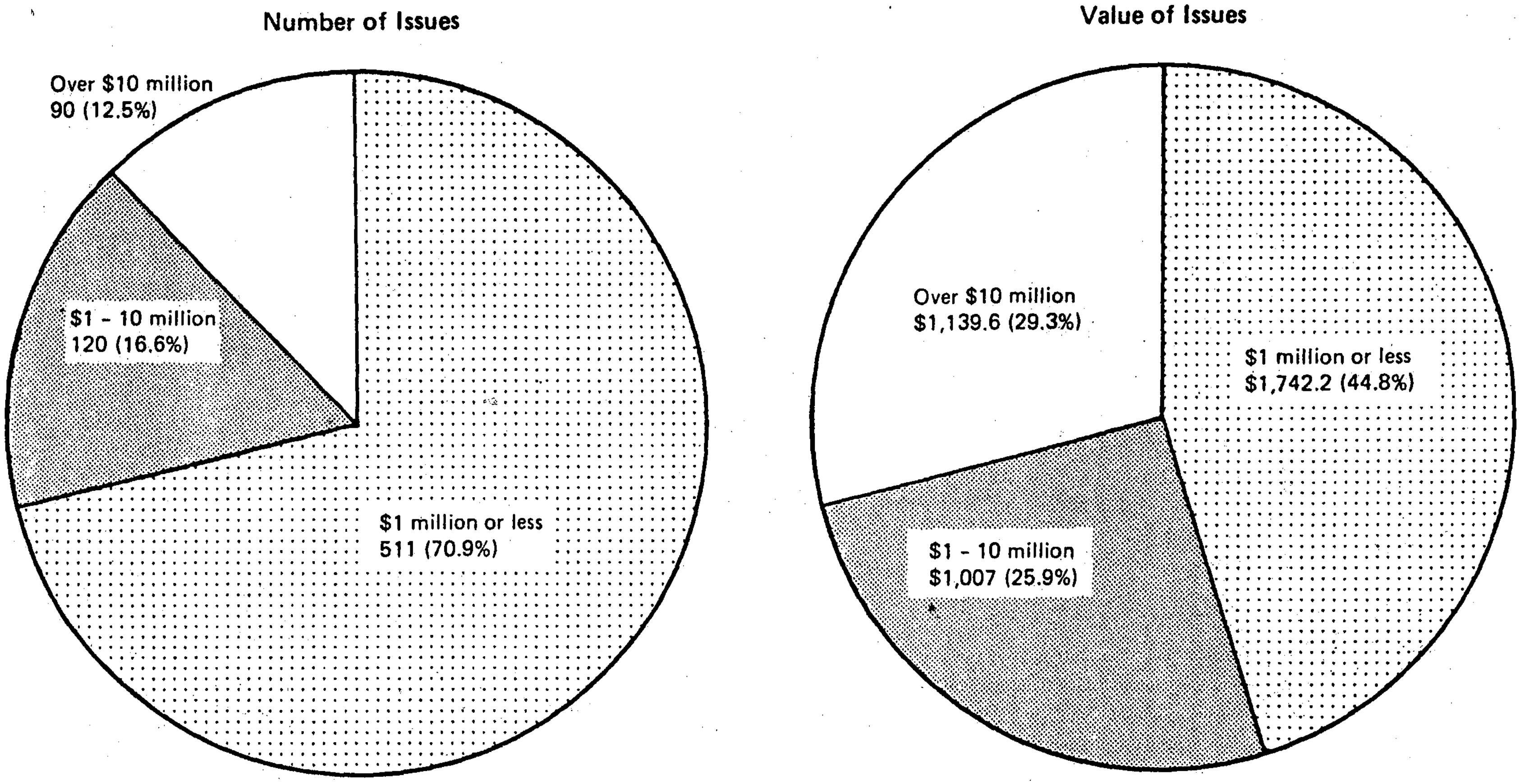


Table 5

SMALL COMPANY IPO ISSUES BY METHOD OF DISTRIBUTION 1/
1975 - 1984
(Millions of Dollars)

Year	Underwritten		Agency Best Efforts		Company Direct		Total	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount
1975	0	$ 0	0	$ 0	17	$ 26.2	17	$ 26.4
1976	7	24.4	0	0	16	42.4	23	66.8
1977	16	43.4	21	21.1	11	36.5	48	101.1
1978	13	27.8	30	76.3	8	26.0	51	130.1
1979	31	142.1	47	143.2	11	44.3	89	329.6
1980	93	413.2	117	261.5	20	66.5	230	741.2
1981	258	1,263.9	175	671.7	33	116.2	466	2,051.8
1982	87	498.6	141	374.6	53	185.4	281	1,058.6
1983	387	2,717.0	240	604.2	85	267.8	712	3,589.0
1984	222	$1,229.3	290	$990.3	119	$529.6	631	$2,749.2

1/ Offerings of common stock by issuers with assets of $10 million or less.

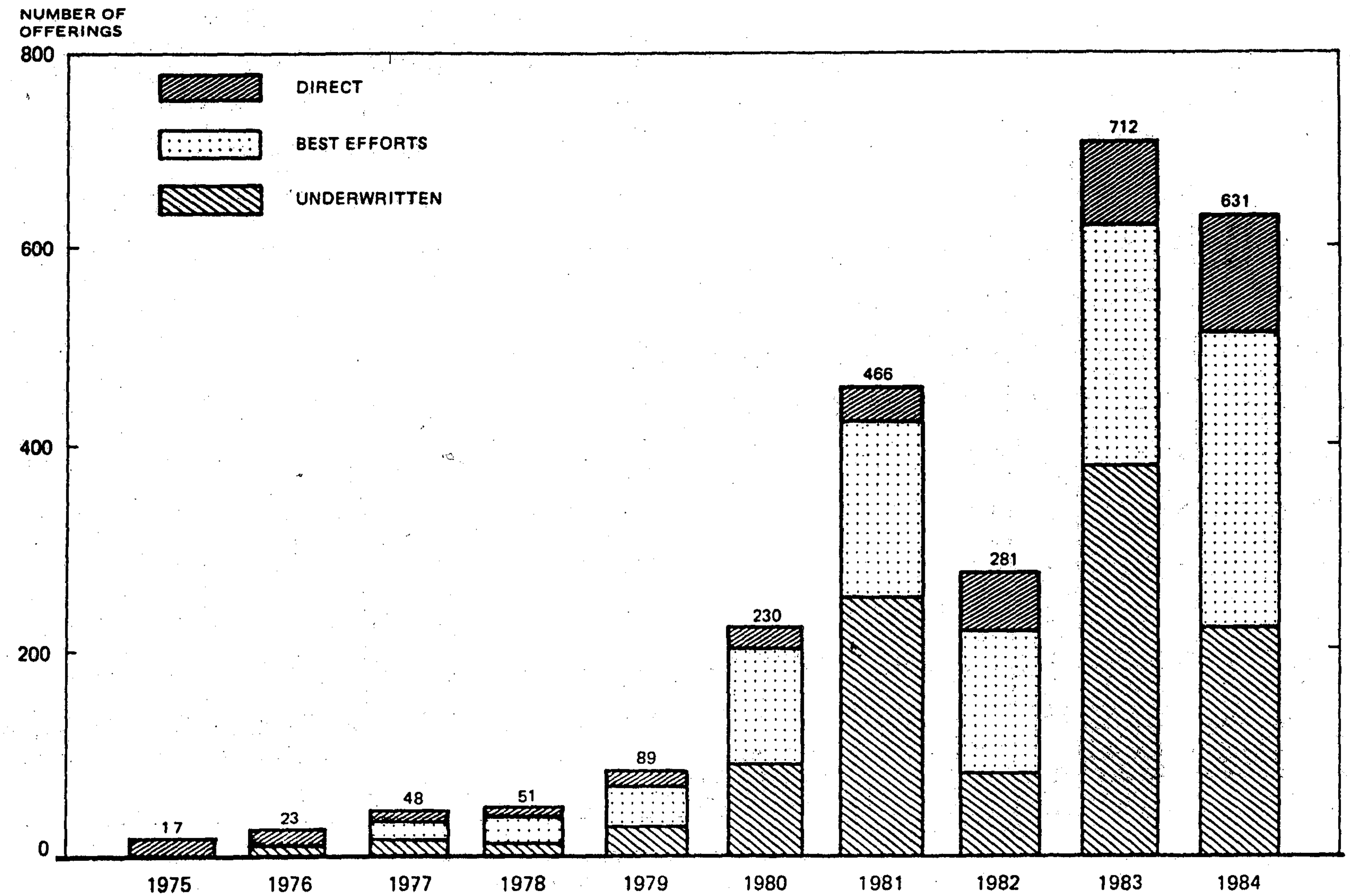
Source: Registrations and Offerings Statistics File

Prepared by: Directorate of Economic and Policy Analysis
U.S. Securities and Exchange Commission

Figure 5

METHOD OF DISTRIBUTION OF SMALL COMPANY IPO ISSUERS[1/]

1975 - 1984



1/ Offerings by issuers of common stock with assets of $10 million or less.

Table 6

VALUE OF SMALL COMPANY IPO ISSUES BY INDUSTRY 1/
1975 - 1984
(Amounts in millions dollars)

	Agriculture Forestry and Fishing		Mining and Construction		All Manufacturing				Transportation Communication and Utility Service		Wholesale and Retail Trade		Finance Insurance and Real Estate		Services	
					High Technology		Other Manufacturing									
Year	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount
1975	1	$ 3.5	1	$ 0.6	0	$ 0	3	$ 1.9	1	$ 1.2	2	$ 1.8	7	$ 14.7	2	$ 2.7
1976	0	0	0	0	4	18.0	2	1.3	1	2.0	6	7.6	5	9.3	5	28.6
1977	1	0.6	5	5.9	10	28.1	8	19.1	2	1.1	4	3.6	10	17.9	8	24.8
1978	3	3.6	6	6.8	19	34.6	7	20.9	0	0	7	16.2	7	46.1	2	1.9
1979	0	0	19	51.8	26	63.0	6	17.5	4	20.1	10	19.7	13	85.1	11	72.4
1980	5	12.2	56	186.8	60	180.5	19	52.1	16	65.8	17	48.7	38	145.4	19	49.7
1981	6	15.0	141	669.3	101	477.1	66	223.5	21	108.9	37	113.8	23	212.5	71	231.7
1982	7	20.0	41	105.8	44	135.7	38	102.1	19	52.6	23	58.2	41	297.3	68	286.9
1983	12	29.4	22	60.4	157	1,001.0	106	466.0	42	210.7	93	417.7	62	476.7	218	927.1
1984	8	$21.1	38	$66.7	101	$ 371.2	114	$325.7	43	$231.2	57	$228.5	111	$1,034.3	159	$470.4

1/ Offerings by issuers of common stock with assets of $10 million or less.

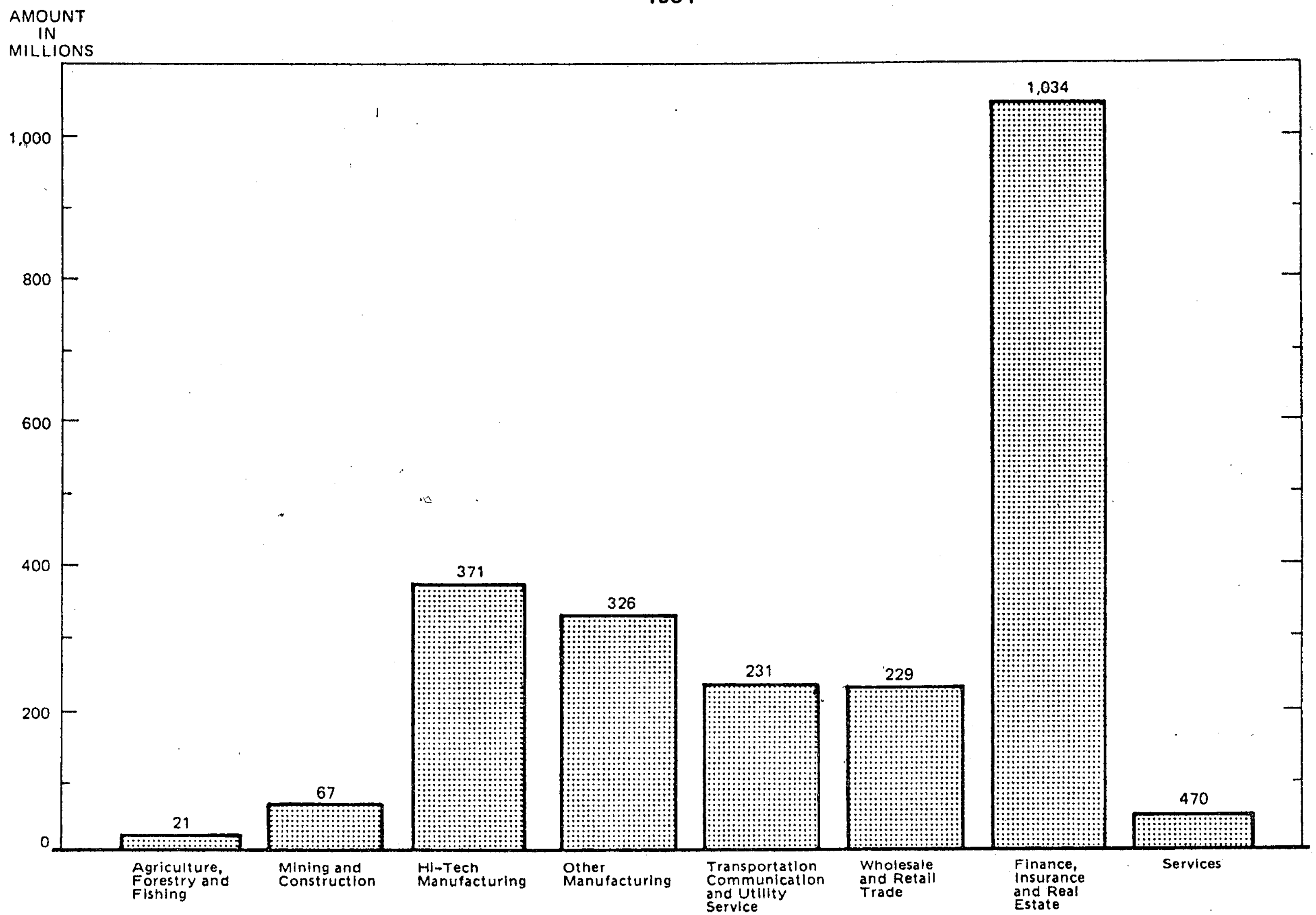
Source: Registrations and Offerings Statistics File

Prepared by: Directorate of Economic and Policy Analysis
U.S. Securities and Exchange Commission

Figure 6

SMALL COMPANY IPO ISSUERS BY INDUSTRY 1/

1984



1/ Offerings by Issuers of Common Stock with assets of $10 million or less.