AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

WRITTEN TESTIMONY (FOR THE RECORD) BEFORE

THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS

HEARING ENTITLED

MODERNIZING THE TAX CODE:
HOW UPDATING THE INTERNAL REVENUE CODE
CAN BETTER SERVE SMALL BUSINESS

APRIL 10, 2008

AICPA WRITTEN TESTIMONY BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS

The American Institute of Certified Public Accountants thanks the House Small Business Committee for inviting us to submit comments on an upcoming hearing on modernizing the tax code. The AICPA is the national, professional organization of certified public accountants comprised of more than 350,000 members. Our members advise clients on federal, state, and international tax matters, and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, large and medium-sized businesses, as well as America's small businesses. It is from this broad base of experience that we offer our comments today.

This hearing will address an important issue for small businesses and the individuals that operate those businesses. Some main goals of modernization should be to foster economic growth, to lessen the enormous paperwork and compliance burden on smaller businesses, and to neutralize the tax code as much as possible with regard to various types of business entities. The AICPA has developed a series of Tax Policy Concept Statements that we recommend be consulted when evaluating legislative proposals. For your assistance in this regard, we have attached a copy of the first summary statement entitled *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*.

The suggestions below are some of the ways the AICPA believes the above goals could be met.

I. S Corporation Issues

A. SE TAX – Over the last several years, several proposals have been made to treat S corporation shareholder/employees as partners for purposes of employment taxes. Such proposals would cause shareholders to report varying degrees of income as taxable under the Self-Employment Contributions Act (SECA) and would require the payment of quarterly estimated taxes. Currently, shareholders who perform services for the corporation are treated as employees and have income and employment taxes withheld from their earnings like any other employee of a corporation. The earnings not attributable to services are subject to income taxation when earned, whether or not distributed, but are not subject to employment taxes, because the Federal Insurance Contributions Act (FICA) and SECA are intended to only tax earnings from labor.

We believe the S corporation framework works quite well with respect to employment taxes. An August 2006 TIGTA report indicated that 43 percent of S corporation audits for the year 2005 resulted in no adjustments.[1] That means almost half of audited S corporation returns were not challenged on the shareholder's reporting of employment taxes and of the audit changes made, it is unclear how many, if any, were challenged on this issue. There have been a few published cases showing that S corporation shareholders have grievously failed to report wages when they clearly should have, but a few publicized cases does not indicate

[1] See *Filing Characteristics and Examination Results for Partnerships and S Corporations* at http://www.treas.gov/tigta/auditreports/2006reports/200630114fr.html.

widespread misunderstanding or abuse. Our experience tells us that the opposite is true; most taxpayers are advised properly on the issue and are in compliance. Results and analysis of the IRS' National Research Project study of 5,000 S corporation audits, to the extent they focused on this issue, should hopefully provide further, useful insights. Generalized assumptions about noncompliance should not be made to the detriment of a majority of compliant taxpayers.

To improve and simplify compliance, Congress should endeavor to bring the partnership regime closer to the S corporation model and have partnerships utilize the FICA and W-2 system of reporting (see suggestion II.C. below). The self-employment and estimated tax payment system fosters lower compliance levels due to complexity and reliance on the individual taxpayer. S corporation shareholders should not be brought into such a system. S corporation elections continue to be made in large numbers, in large part, not to avoid employment taxes, but because Subchapter S is still perceived to be a simpler operational entity than LLCs and offers many benefits that are right for some taxpayers. For those in the minority that are abusing the system, increased audits should be used to reduce this problem.

B. REPEAL LIFO RECAPTURE TAX – C corporations in certain industries such as automobile dealerships, fine jewelry stores and others often account for their inventory using last-in-first-out (LIFO) inventory methods as specified in sections 472 through 474.[2] The LIFO method often reduces taxable income in current years because the later costs of inventory are usually higher than such costs from earlier years (layers). When a C corporation that uses the LIFO inventory method makes an S election, it is required to pay tax on the difference between the inventory values under the LIFO and FIFO methods (the LIFO reserve). This difference is the accumulated amount for the aggregate number of years that the corporation has been using LIFO and can be significant.

The LIFO recapture tax under section 1363(d) is often the most significant hurdle faced by a corporation desiring to make an S election and, therefore, should be repealed. In many cases, this tax makes the election cost-prohibitive. The LIFO recapture tax was enacted in 1987 in response to concerns that a taxpayer using the LIFO method of accounting, upon conversion to S corporation status, would avoid corporate level tax on LIFO layers established while the corporation was a C corporation. While this is a legitimate policy concern, requiring inclusion of the LIFO reserve into income upon conversion to S status is unwarranted because the section 1374 built-in-gains tax (BIG) addresses that situation by taxing those layers, to the extent they are invaded, within ten years of conversion.

Even more importantly, S corporations don't avoid invading LIFO layers for the ten-year period simply to avoid the BIG tax. Generally, for non-tax business reasons, neither S nor C corporations invade their LIFO reserves within ten years. In fact, they often go decades before doing so. In other words, if a corporation remains a C corporation, it will not likely pay any corporate level tax on LIFO layers; the only reason any corporate level tax is generally paid on LIFO layers is when an S election is made. S corporations should not have this dark shadow cast over them -- certainly not beyond the ten-year BIG period -- simply

[2] Section 474, Simplified dollar-value LIFO method for certain small businesses, is specifically used by businesses with less than $5,000,000 of average annual gross receipts in the preceding three years.

because they are following conventional business practice in utilizing the LIFO method of inventory maintenance.

C. STING TAX – If a profitable C corporation[3] makes an S election, it must then be careful not to earn too much income from royalties, rents, dividends, interest or annuities. If it earns more than 25 percent of these types of passive income, it is required to pay a 35 percent tax on the net amount. If it does so three years in a row, its S election is terminated. Excessive passive investment income (PII) should not terminate an S election; section 1362(d)(3) should, therefore, be repealed. S corporations are already penalized with a tax at the highest corporate rate for having such income in any given year. If PII as a terminating event is not repealed, then, at a minimum, the three-year limit should be lengthened to at least five years and/or the 25 percent threshold in sections 1362(d)(3) and 1375(a)(2) should be raised, like in the case of personal holding company (PHC) income, to 60 percent. PII and PHC income of section 543(a) are virtually identical. Additionally, the tax rate imposed on PII should not be the highest corporate rate, but, again, like in the case of PHCs, should be 15 percent as imposed under section 541. Both the PII and PHC statutes have a common legislative history and purpose.

D. CHARITABLE CONTRIBUTIONS – The temporary provisions recently enacted in the Pension Protection Act of 2006 (section 1203(a)) and the Technical Corrections Act of 2007 (section 3(b)), but now expired, should be extended permanently. These provisions allow S corporation shareholders to much more fully deduct their pro rata share of the fair market value of charitable contributions made by the S corporation while reducing their S corporation stock basis by only their pro rata share of the contribution's adjusted basis. While shareholders' basis still remains a limitation on current deductibility as drafted under the expired provision, a far greater portion of the charitable contribution is allowed as the appreciation inherent in the contributed property no longer affects (reduces) that basis. An even better way to draft this provision would be to increase shareholder basis by the fair market value of the contributed property (and then reduce it again by the same amount when the deduction is taken), resulting in a zero net reduction of basis and thus guaranteeing a full fair market value deduction in the current year, regardless of basis limitations. This latter treatment would more closely resemble the treatment of charitable contributions in the partnership context.

E. NRAs - Nonresident alien individuals (NRAs) should be allowed as S corporation shareholders and/or as potential current beneficiaries (PCBs) of electing small business trusts. NRAs are able to contribute capital to an S corporation and participate in the benefits and obligations of an S corporation as long as the S corporation is aware that such result can be obtained indirectly and is willing and able to pay a professional to restructure the operations of the S corporation through partnerships. The operating partnerships, in turn, permit NRAs to hold ownership interests and thus NRAs indirectly receive passthrough items from the S corporation's operations. If NRAs were permitted to be direct owners of S corporations, they would be subject to withholding just as NRA partners and there would be no revenue loss at the individual level. Such direct ownership benefits should not be

[3] The C corporation must have accumulated earnings and profits at the time it makes an S election in order to be subject to the tax on excessive passive investment income.

available only to the sophisticated taxpayer. The smaller, struggling S corporations, particularly those in border states, should be free to raise capital from these individuals.

NRAs should also be permitted to be potential current beneficiaries of electing small business trusts, a type of trust that is a permitted S corporation shareholder and that pays tax at the highest corporate rate, regardless of who its beneficiaries or potential current beneficiaries are. Since PCBs are each treated as a shareholder, current law requires that they not be NRAs to avoid terminating the S election. Changing this rule would promote family tax planning for owners of S corporations who have spouses and other family members who are NRAs.

F. CHARITABLE CONTRIBUTION AND FOREIGN TAX CREDIT CARRYOVERS SHOULD NET BIG TAX – Currently, code section 1374 allows net operating loss carryforwards arising under section 38 in a C year to reduce the net recognized built-in-gain of a newly converted S corporation and general business credit carryforwards to reduce the newly converted S corporation's built-in-gain (BIG) tax dollar for dollar. We believe charitable contributions made during a C year should also carryforward to reduce such corporate level gain. Similarly, since the foreign tax credit is not included in the laundry list of general business credits, it has escaped favorable treatment in the S corporation conversion context. We believe foreign tax credit carryovers from C years should also be allowed to offset the BIG tax.

G. PTTP - When an S corporation's election terminates, a period called the post-termination transition period (PTTP) begins and governs issues such as suspended losses, deductions, distributions, and more. Generally the PTTP begins immediately after the S election terminates and continues for one year. A PTTP may begin and end beyond the one year period if a later audit results in a redetermination of tax for an S year. In our opinion, a 120-day PTTP should also begin when a taxpayer files an amended return after the S period ends. We believe the method of redetermination of tax, whether by the IRS or by the taxpayer, should be immaterial in deciding whether a former S corporation should be permitted to obtain the benefits of a PTTP.

II. Partnership Issues

A. HUSBAND & WIFE JOINT VENTURES – The husband and wife joint venture election under section 761(f) should be clarified to cover state law partnerships and limited liability companies. While assisting spouses in obtaining social security credits for work performed in a husband-wife business is to be commended, many husband-wife partnerships will not be able to take advantage of this benefit and potential simplification solely because they created a general partnership or limited liability company under the rules (typically based on the Revised Uniform Partnership Act or the Uniform Limited Liability Company Act) of a state that governs those entities. The current law requires a technical correction because, as currently interpreted by the IRS[4] to say that the only businesses that qualify for this election are those that are not owned and operated in the name of a state law entity such as a general

[4] See http://www.irs.gov/businesses/small/article/0,,id=177376,00.html.

or limited partnership or a limited liability company, it severely limits the number of husband-wife partnerships able to report their shares of the business on their Form 1040.

B. TECHNICAL TERMINATION RETURN DUE DATES - Technical terminations of partnerships require the filing of two short-year returns on two separate dates. To simplify administration and alleviate confusion over filing dates, we recommend that both short year returns be due on the same date, i.e. the later date that currently relates to the date the partnership return would have been due had it not technically terminated.

C. PARTNERS SHOULD RECEIVE FORM W-2 – Revenue Ruling 69-184 interprets the definition of employee found in section 3121(d) stating that remuneration for services to a partnership by a partner is not wages. Nevertheless, partnerships that treat partners as employees for purposes of income and employment tax withholding are not compromising revenue collections for the government and do so because they find it easier than reporting their earnings as partners. Partners also find it easier to have these taxes withheld than to estimate and pay their taxes quarterly. Individual general partners should be permitted to receive a Form W-2 for their guaranteed payments for services and to be treated as employees for purposes of income and employment tax withholding related to such payments. Such a rule would simplify reporting for many partnerships and partners and have a positive impact on the tax gap by improving compliance through required employer withholding. It would also match the law to this common, harmless practice. In addition, partnerships that want to reward existing employees with a small partnership interest would now be able to maintain that employee's status on payroll and the employee would be able to continue receiving familiar paychecks like they have always received. Switching a lifelong employee to a Schedule K-1/estimated tax arrangement would be confusing and complicated in this situation. We therefore anticipate that partnerships would more readily offer small partnership interests to encourage loyalty from valued employees if they were permitted to treat partners as employees for this purpose.

D. TAX-FREE CONTRIBUTIONS OF CAPITAL TO A PARTNERSHIP – Section 118 currently permits an exclusion from gross income for contributions to the capital of a corporation. When the contributor is an existing shareholder, the effect on basis is as follows: the shareholder's basis is increased by the amount of the contribution; the corporation's basis in the contributed property equals, under section 362(a), the shareholder's carryover basis plus gain recognized by the contributing shareholder on the transfer, if any. When the contributor is a non shareholder, the basis to the corporation of the contributed property is, under section 362(c), as follows: if the property is other than money, the property's basis is zero; if the contribution consists of money, the basis of any property purchased with that money during the 12 months following the contribution is reduced pro rata. Partnerships are utilized in today's business world much like corporations were in 1954 when this rule was codified. As long as similar basis rules are enacted under subchapter K (along with rules to prevent abuse upon distribution to partners of section 118 property contributed by non-partners), there is no theoretical reason section 118 should not be expanded to apply to partnerships. Section 118 would benefit small partnerships, for example, as municipalities are often looking to provide monetary incentives to construction companies to build in their jurisdictions. When this opportunity arises, different construction

firms should not have to alter their competitive bids for these projects based on their organizational form. A corporation should not be in a better position to receive a tax-free incentive than a limited liability company.

III. Taxpayer-Tax Practitioner Parity Issue - Section 6694 Legislative Proposals

The penalty provisions in section 6694 of the Internal Revenue Code regarding tax return preparers were amended in May 2007 as part of the Iraq war funding legislation. Included in the changes made to section 6694 was an increase in the tax return reporting standard a preparer has to satisfy with respect to undisclosed, non-tax shelter items. Previously, a preparer could sign a return taking a position with respect to such an item if there was a "realistic possibility" it would be sustained on its merits. Now, a preparer can sign a return taking a position only if there is a "reasonable belief that more likely than not" it would be sustained on its merits. This is a major change in tax policy, but was not the subject of a hearing, was not based on a recommendation from Treasury, and came as a surprise even to the IRS.

This change in standard impacts several fundamental policies related to the representation of taxpayers and causes serious problems, not only for tax return preparers, but also for taxpayers and the government. Of particular concern is the fact that the reporting standard for preparers is now higher than the reporting standard for their taxpayer-clients (which remained at "substantial authority"), creating the potential for conflicts of interest between preparers and their clients. The conflict exists because the tax preparer, in order to escape from penalty liability imposed if the IRS doesn't agree with the position taken, must have the client make a disclosure that the client would not be required to make if they were not using professional assistance. This potential for conflict of interest could discourage small business owners from seeking the assistance of tax advisors (or encourage the use of less scrupulous tax advisors who are willing to sign returns that do not satisfy the higher standard now applicable to preparers.) Tax preparers should be able to act as advocates for their clients.

H.R. 4318 and a similar proposal in the Administration's Fiscal Year 2009 Revenue Proposals would remedy these problems by equalizing the tax return reporting standards applicable to preparers and taxpayers for non-tax shelter items at "substantial authority," which is the standard that currently applies to taxpayers.

IV. Estate Tax Issues

The priority list of suggested reforms below focus on the complexity of the current system, taxpayer planning and compliance burdens, ease of administration, and revenue constraints.

A. GENERATION-SKIPPING TRANSFER TAX - The technical modifications to the generation-skipping transfer tax (GSTT) rules enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) should be made permanent. These technical modifications provide relief from several GSTT "traps" that existed under previous law. However, as with other provisions of EGTRRA, these changes will sunset on December 31, 2010, unless action is taken to make them permanent.

B. ESTATE TAX EXEMPTION - The applicable exclusion (exemption) amount should be increased in order to eliminate filing and tax burdens for 90 to 95 percent of estates. We also suggest indexing the exemption for inflation.

C. STEP-UP - The full step-up in basis to fair market value for inherited assets should be retained. This would avoid the complexities of carryover basis.

D. UNIFORM EXEMPTION – A uniform exemption amount for estate, gift, and generation-skipping transfer tax purposes should be created. We emphasize the need for all three exemptions to be uniform in order to simplify planning for individuals.

E. STATE TAX CREDITS - The reinstatement of the full state estate tax credit, or provision of another mechanism (such as a surtax) would allow states to uniformly "piggyback" on the federal estate tax. To avoid diminishing tax revenues, many states have decoupled from the federal estate tax and enacted their own estate tax regimes, resulting in unnecessary complexity and uncertainty in both planning and administration.

F. ESTATE TAX RATE - The top estate tax rate should be made no higher than the maximum individual income tax rate. We note that there have been some proposals in the past that have included a rate structure with a very limited number of tax brackets and a large gap between brackets. For example, such a system might provide for only two brackets, say 15 percent and 30 percent, with estates over a certain size paying the higher bracket (30 percent in this example), and estates below that number paying the lower bracket (e.g., 15 percent). In such a proposal, there may be significant uncertainty in the planning process for married couples with significant estates. For example, taxpayers may have to consider if estate tax should be paid at the death of the first spouse to die at a 15 percent rate compared to an alternative of paying the tax in the future but at a higher rate. In addition, this type of "cliff" taxation leaves too much room for disparity among similarly situated taxpayers, where one receives estate planning advice and pays significantly less tax when compared to the individual who does not receive such advice.

V. Alternative Minimum Tax Issues

Due to the complexity, the increasing impact on unintended taxpayers, and compliance problems, the AICPA supports repealing both the individual and corporate AMT. However, we recognize that simply eliminating the AMT would cause a large loss of tax revenue.

If repeal is not possible, we urge Congress to consider, with respect to the individual AMT, the following alternative solutions, which we believe would reduce or eliminate most of the complexity and unfair impact of the AMT as currently imposed:

A. Increase and index for inflation the AMT brackets and exemption amounts, and eliminate phase-outs.

B. Eliminate the standard deduction and personal and dependency exemptions as adjustments to regular taxable income in calculating AMT.

C. Eliminate miscellaneous itemized deductions as an adjustment to regular income tax so that middle income taxpayers are able to deduct such items as employee business expenses for AMT.

D. Eliminate the AMT medical expense adjustment so that middle income taxpayers are allowed the same amount of medical expenses for both regular tax and AMT.

E. Eliminate state and local income and other taxes as an adjustment.

F. Allow tax credits enacted to promote important public goals – such as the low-income tax credit, tuition tax credits, etc. – to be credited against AMT liabilities.

G. Exempt all taxpayers with regular tax AGIs under $100,000 from AMT.

H. Have only one AMT tax rate and set that rate to below the third lowest regular tax rate of 25 percent.

I. Require that AMT's impact on future tax legislation be reported with the revenue estimates for proposed legislation, i.e., whether the intended tax benefits of any change are negated by the AMT regime.

J. Allow a minimum tax credit for *all* AMT, not just AMT attributable to deferral preferences, in order to place the individual AMT on parity with the corporate AMT.

K. Liberalize the capital loss limitation rules when calculating AMT associated with incentive stock option (ISO) transactions (e.g., specifically allow a negative basis adjustment for ISO differences to be ordinary rather than capital loss).

L. Eliminate the definition of "qualified housing interest" and allow all deductible residence interest as a deduction for AMT.

M. Exclude AMT from the estimated tax penalty.

VI. Fiscal Year Flexibility

An entrepreneur's first year in business is the most difficult. The Small Business Tax Flexibility Act (S. 270 and contained in H.R. 46 sponsored by Chairwoman Velazquez) would permit small start-ups to choose the fiscal year that best fits their business cycle and give entrepreneurs one 12-month year to concentrate on getting the business up and running before they must close their books and deal with their first tax return. It also helps their cash flow, one of the most critical areas for start up businesses. Starting a business is capital intensive. Being able to defer the payment of taxes allows the business more time to stabilize its cash flow. These start-ups would

also benefit from the extra attention their CPAs could give them, including being available to give business advice during the January to April tax "busy season."

CPAs and their clients would also benefit from spreading tax preparation work over more of the year. Now, CPAs and other return preparers must squeeze in all their tax preparation and audit work for partnerships, S corporations and individuals as well as calendar year C corporations and trusts, between January 1 and April 15 of each year. As a consequence, CPA firms must hire a significant portion of their staffs to work just during the first few months of the year. The effect of such hire-and-fire policies is destructive for recruiting, retention and training efforts. Further, the 70-hour workweeks typically required for these months are decidedly anti-family.

VII. Other Proposed Legislation Helping Small Business

CELL PHONES – The AICPA supports H.R. 5450, *the MOBILE Cell Phone Act of 2008* and its companion bill S. 2668 which would reclassify cell phones and personal digital assistants (PDAs) from listed property (under section 280F(d)(4)(v)) to that of business property. Such a reclassification would update the tax treatment of cell phones and PDAs by (1) eliminating the onerous substantiation requirements on taxpayers, including small business owners, (2) removing such taxpayers from being subject to penalties and taxes for not meeting the substantiation requirements under audit, and (3) reducing the possibility of tax preparers being subject to unnecessary penalties.

According to a 2004 NFIB Small Business Poll, 78% of small-business owners use a cell phone for business purposes.

* * * * * * *

The AICPA appreciates the opportunity to present these options for modernizing the Internal Revenue Code and would be pleased to discuss or clarify them with Members or staff of the House Committee on Small Business at any time.