

Testimony of

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Before the

**Congress of the United States
House of Representatives
Committee on Small Business
Finance and Tax Subcommittee**

Hearing on
**“S-Corps – Recommended Reforms that Promote Parity, Growth and
Development for Small Business”**

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Good Morning. My name is Byron E. Shinn, CPA and I am the President of Shinn & Company, P.A., a Florida licensed CPA firm located in Bradenton, Florida. Chairwoman Velazquez, Ranking Member Chabot, and members of the committee. I am honored to be testifying today as a CPA who prepares hundreds of Small Business S-Corporation tax returns each year.

I have worked in public accounting my entire career, spanning over 28 years and currently have a small business CPA firm providing tax, audit and accounting services to small businesses, non-profit organizations and governmental entities. We have been operating as an S Corporation since 1993.

I have been appointed to the Florida State Board of Accountancy and served as its chairman in 2001. I currently serve on the Probable Cause Panel of the Board which oversees licensees in Florida. I was on the National Ethics Committee of the National Association of State Boards of Accountancy (NASBA) immediately after Enron and WorldCom, which changed the independence rules for CPAs. I also serve on the University Of South Florida School Of Accountancy Advisory Board.

Summary of Testimony

The S Corporation tax rules are very complex and costly to administer. With the development and popularity of LLC usage, many of these state chartered corporations are choosing to be treated as partnerships to take advantage of the Federal partnership tax rules. It seems only fair and logical to converge the tax structure of these two types of returns into identical benefits and reduce administrative costs for small businesses.

With the current financial strain on small business and the banking industry, I would recommend the suspension or repeal of the Passive Loss limitations (IRC Section 469) which limit the current deduction of losses incurred by the taxpayer on rental real estate and other investments reported from pass-through entities such as S-Corporations and partnerships.

Observations

S-Corporation vs. Partnership - Recently, there has been a convergence of the S-Corporation tax rules toward the partnership rules in regard to the fringe benefit area. However, one of the biggest differences in the tax structure between the two types of entities deals with the calculation of tax basis available for the deductibility of tax losses passed through from the small business. Partnerships generally allow for entity debt to be included in the calculated tax basis, whereas, for an S Corporation, the direct shareholder loans are the only debt added to shareholder basis. That includes loans and other debt that the business has outstanding, including shareholder guaranteed debt. This just doesn't tie to the financial reality of the small business. The loans guaranteed by the

owner are real and have a dramatic impact on the owner's credit scores and business planning.

Complexity and administrative costs - The complexity of S-Corporation reporting and filing continues to be more extreme and costly to administer. Some examples include IRC Section 199, Domestic Production Activities Deduction, and the use of an Installment Sale of Assets with the Liquidation of the business.

LLC - In the last decade many states have developed statutes which created the "LLC" or Limited Liability Corporations. This development has provided a general acceptance of the LLC structure as the preferred structure for legal protection while still having the maximum flexibility since they generally can be treated for federal tax purposes as a partnership or an S-Corporation.

Tax Abuses – The wide-spread abuse by taxpayers to avoid payroll taxes on earned income by the aggressive treatment of payments from an S-Corporation to the owners by recharacterizing the payments as a dividend distribution, avoiding the FICA and Medicare taxes due on the payments.

Financing – Generally, small business financing includes the owner's equity that exists in their home as added collateral for the financial institution in order to make the business loan. With the current residential real estate devaluation, many banks are limiting renewal and in many cases closing down the remaining line of credit balance which forces the small business to high interest funding sources such as credit cards. This is devastating, since the banks look at the business assets as having only a low liquidation value, reducing future borrowing power and hamstringing the future of the business.

SBA Loans – The SBA loan packages and documentation requirements take 60 to 90 days from start to completion, even though acceptance time may be less than 10 days after the completed package has been processed. The costs associated with the complexities of the SBA loan documentation are substantial and time consuming. It has been my experience that a non-real estate traditional bank loan, without SBA guarantee usually takes between 14 to 30 days.

S-Corporations versus C-Corporation – S-Corporations are very effective for the owners to avoid double taxation that exists with a "C" corporation. This is due to the double taxation on the dividend distributions.

Passive Loss Rules – The Passive Loss rules of IRC Section 469 have created a situation that generally has a taxpayer who incurs a real cash flow loss from taking a tax loss currently and treats it as a suspended tax loss. This has aggravated the residential real estate market since many middle income taxpayers have invested in real estate and the rules dramatically reduce or totally suspend these losses and prevents a current tax savings. This could go to helping save the property from foreclosure. This would also reduce the pressure on our financial institutions.

GAAP – Generally Accepted Accounting Principles in the US is converting to IFRS, International Financial Reporting Standards. In May of this year, The AICPA Council approved IFRS for non-public companies. This brings fundamental changes to financial accounting standards, including an emphasis on fair value rather than historical cost. Many accounting method changes will be requested with the IRS in the coming years and continue to increase administrative costs to the small business owner.

Qualified shareholders of S Corporations – Currently IRAs are not considered a qualified shareholder for S-Corporations.

Recommendations –

Passive Loss Rules - With the current real estate and foreclosure crisis, a repeal or a suspension of the passive loss rules would provide a significant tax relief for the property owners. This would give some immediate help to the owners of rental real property. I would still keep the passive loss rules in place for the publicly traded partnerships and other investments that are NOT real estate related. Many middle income Americans got caught up in the real estate boom and purchased several rental properties which they are now stuck with little chance for sale in the near future. Foreclosure becomes a real option since many of these homes have first and second mortgages that exceed their current market values. If the banks foreclose, the banks are likely to absorb a large part of the loss. If the taxpayer could receive a current tax benefit for the actual cash loss, they may try to hold on and this would reduce the financial impact on our financial markets and reduce the number of Americans impacted by this awful collapse of our real estate market.

Convergence of S-Corporation rules with Partnerships – Since both are generally treated as pass-through tax entities; immediate convergence of many of the differences in the tax law should be combined. A list of a few of the differences that should be adjusted immediately include –

-Tax Basis and the inclusion of Entity Debt – The S-Corporation currently can only include the shareholder loans made direct to the entity, whereas the partnership includes generally all the entity debt for determining tax basis. This calculation is used for tax loss deductibility in the tax year. This is a huge disparity and has dramatic repercussions to the owners.

-Built-In Gains Rule – This was to avoid double taxation and has a ten year waiting period while a partnership has a disguised sale rule which goes for 7 years. The waiting period needs to be the same at 7 years.

- Disproportionate Distributions – This is NOT allowed currently in S-Corporations which are very important to raise capital from investors when investors want a fixed minimum return and many times will require the debt to be converted into equity. In either case this would terminate the S-Corporation with the current rules. An

immediate rule change is highly recommended due to the very restrictive lending which has recently evolved due to the real estate market collapse.

-IRA ownership – Currently S-Corporations can NOT be owned by an IRA, while a partnership can. This would provide an alternate source of funds for the small business and would provide parity with partnerships.

-Acquisition of interest step-up – IRC Section 754 allows for the additional step-up of asset values to the purchase price allowing for additional depreciation for the acquiring partner in a partnership, however, in an S-Corporation no such opportunity exists. This is a huge loss for raising capital and is a huge restraint on an S-Corporation.

-Tax on Liquidation or Transfer of Assets – Generally, the sale and/or distribution of assets from an S Corporation to a partnership creates a tax trap. In order to help existing S-Corporations convert to a partnership, I would recommend that if all the business assets of an S-Corporation are transferred to a new partnership, then a tax-free transfer should be allowed with a similar waiting period as the disguised sale rules that currently exist for property that is transferred into a partnership.

To Reduce Tax Abuses – As stated, I have observed over the years many S-Corporations that had a minimal or non-existent compensation for the managing shareholder and owner employees. This needs either identical treatment as a general partner in a partnership where all the payments are subject to FICA and Medicare, or that specific language is developed which provides better guidance, such as a reasonable rate of return on the investment along with a reasonable level of compensation for services provided to the company.

I have seen physicians with compensation as low as \$ 12,000 along with dividend distributions of \$ 250,000 or more and there is no more than \$ 200,000 in net equity in the company. This is better than a 100% rate of return on the equity of the company along with a very understated salary for services provided to the business.

If the physicians had been in a partnership or an LLC that was treated as a partnership, then both distributions would generally have been subject to the payroll taxes. Parity is sorely needed in this area also.

Financing and SBA Loans – My experience has been that most small businesses do not have the internal resources to complete an SBA loan package, therefore, they are forced to spend time and money with outside professionals who are familiar with the forms and format requested. In addition, the time from start to finish and funding is excruciatingly long. A real review of the necessary forms and processes needs to occur to streamline this process. The SBA loan process needs to be no longer than 14 days for NON-real estate and no longer than 30 days for real estate loans. This would make it competitive with conventional financing. I believe that SBA guarantee support is imperative to maintain a viable source of financing as we move into these trying times before us with the banking situation that is occurring in 2008. The financial institution capital has been

dramatically strained due to the foreclosure proceedings and business recession occurring in the marketplace today.

Accounting Method Changes to consider – Many of the small business accounting methods allowed are very basic and should be reviewed immediately. To name a few –

- **Bad debt expense** should be allowed based on the historic collection percentage of the business account receivable history. Currently, only specific receivables can be written off, unless the taxpayer is a bank or financial institution. Many businesses are forced by their bank to book an allowance for bad debt based on their historic trends however the tax rule is very outdated.

-**Inventory adjusted to lower of cost or market**-Inventory should be allowed to be adjusted downward automatically to lower of cost or market regardless of the method initially elected by the taxpayer, since this is also required by their bank and by GAAP. The current rule forces a taxpayer to request a change in accounting to take this change into account. An automatic provision would help speed up benefits and parity.

-**Repeal the rule which caps “Bonus Depreciation” to the current year profit**-The current tax law limits bonus depreciation and IRC Section 179 expense to the business income reported in the current year. If the company has made the qualified expenditures, then why prevent the tax benefit? DON'T we want to help motivate investment in US small businesses? I recommend the deletion of the income limitation for IRC Section 179 expenses.

-**FICA Tip Credit**-Consider increasing the limitation on the usage of the FICA Tip Credit by restaurant owners. Most owners can not utilize the tip credit because the window for available usage is so small.

-**Installment Sale allowed for inventory sale**- Currently, if a business sells inventory and holds paper from the buyer, the seller is required to report all the income in the year of the sale. I have seen many instances with builders and mobile home park owners which sell manufactured homes and hold a note as the seller and they are not allowed to use the installment sale. They are forced to pay the tax well in advance. There is no argument of ordinary income versus capital gain. It is just timing. With the current real estate situation, this would help the small business stay afloat.

Conclusion

In conclusion, I have given you a detailed list of items that I have accumulated from discussions with various business owners that I have surveyed recently along with actual situations that I have encountered.

Probably the two most important items would be (1) the convergence of the S-Corporation rules over to the partnership arena, and (2) the suspension of the passive loss rules for rental real estate. This would maximize flexibility and would still have a 7 year

look-back rule for abuse similar to the disguised sale rules currently in the partnership area. The passive loss suspension would help with the real estate situation that is impacting almost every American and financial institution.

All of these items listed have been noted from real situations that have come up in my involvement with small businesses over the past 28 years. I pray that your leadership will promote parity, growth and development for small business in the US.

Thank you again for the opportunity to share ideas with the committee.