SMALL BUSINESS AND PASS-THROUGH ENTITY TAX REFORM DISCUSSION DRAFT

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

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SMALL BUSINESS AND PASS-THROUGH ENTITY TAX REFORM DISCUSSION DRAFT

WEDNESDAY, MAY 15, 2013

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The subcommittee met, pursuant to call, at 10:00 a.m., in Room 1100, Longworth House Office Building, the Honorable Pat Tiberi [chairman of the subcommittee] presiding.

[The advisory of the hearing follows:]

HEARING ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

Chairman Tiberi Announces Hearing on Ways and Means Small Business and Pass-Through Entity Tax Reform Discussion Draft

1100 Longworth House Office Building at 10:00 AM
Washington, May 7, 2013

Congressman Pat Tiberi (R–OH), Chairman of the Subcommittee on Select Revenue Measures, today announced that the Subcommittee will hold a hearing on the small business and pass-through entity tax reform discussion draft released on March 12, 2013, by the Committee on Ways and Means ("the Committee"). The Committee released the discussion draft to solicit feedback on the details of the draft proposals, which the Committee intends to include as part of comprehensive tax reform legislation that broadens the tax base, lowers tax rates, and simplifies the Code for households, small businesses, and corporations. **The hearing will take place on Wednesday, May 15, 2013, in Room 1100 of the Longworth House Office Building at 10:00 A.M.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND:

As part of its pursuit of comprehensive tax reform, the Committee released on March 12, 2013, a discussion draft of one specific component of broader tax reform legislation involving tax provisions affecting small businesses and pass-through entities (including partnerships and S corporations). The Committee released this draft because it hopes to achieve simpler, more uniform tax treatment for small businesses and pass-through entities, and in the interests of transparency, seeks feedback from a broad range of stakeholders, taxpayers, practitioners, economists, and members of the general public on how to refine these proposals. Ways and Means Committee Chairman Dave Camp (R–MI) asked Chairman Tiberi to schedule this hearing to gather analysis from outside experts on the details of the discussion draft.

The discussion draft contains several core components intended to simplify tax compliance for small businesses and to provide certainty with respect to the ability of small businesses to recover certain costs immediately. The draft also includes two separate options designed to achieve greater uniformity between S corporations and partnerships—one that revises current rules and a second that replaces current tax rules with a new unified pass-through regime. The Committee and Subcommittee are soliciting comments from stakeholders on both options.

In announcing the hearing, Chairman Tiberi said, **"Small businesses employ half of the private sector workforce and earn about half of all business income in the United States, so it is a major concern that nine out of ten small businesses are forced to rely on paid tax preparers because the Tax Code is too complicated for them to understand. We need our entrepreneurs using their capital to invest and create jobs, not to fill out paperwork and tax forms, and one of the Committee's top priorities in tax reform is to help them do that."**

FOCUS OF THE HEARING:

The hearing will focus on the Ways and Means small business discussion draft released on March 12, 2013. For purposes of this hearing, the Subcommittee is interested in comments and analysis relating to the basic architecture of the draft proposals including, in particular, the implications of the changes to the cash accounting rules, the questions that must be answered in designing a workable unified pass-through regime, and the real-world ramifications of the incremental proposals to modify the rules governing S corporations and partnerships.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, http://*waysandmeans.house.gov*/, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Wednesday, May 29, 2013**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–3625 or (202) 225–2610.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at http://*www.waysandmeans.house.gov*/.

Chairman TIBERI. Good morning. This hearing will come to order. Thank you for joining us for our hearing today on the Ways and Means small business tax reform discussion draft. In March of 2011, the Select Revenue Measure Subcommittee held a hearing on

small business and tax reform. We learned that the temporary complex nature of the Tax Code was forcing small business owners to invest their time and resource complying with the Tax Code instead of focusing on growing their businesses. The message was clear: simplifying the Code means more jobs created by small business owners. Indeed, comprehensive tax reform must result in a simpler, more stable code with lower statutory rates for small business owners.

Today nine out of 10 small business owners rely on a tax preparer. There have been over 4,500 changes to the Tax Code over the last 10 years. And with the addition of the 3.8 percent ObamaCare tax, small business pass-through entities, which pay their taxes at individual rates, will have a top Federal tax rate of 44.6 percent.

Comprehensive tax reform cannot be limited to an exercise of only lowering the corporate rate, as the President has suggested; it must also focus on lowering rates for small business owners who employ over 50 percent of the private sector workforce and whose tax compliance costs are 65 percent higher than large businesses.

The small business tax reform discussion draft is a step forward in creating a better Tax Code for small businesses, but that is not to say it can't be improved upon, and that is why Chairman Camp has released this as a discussion draft to ensure that through a public, transparent process, stakeholders, including small business owners themselves, have the opportunity to tell us what they need from tax reform to help them create jobs, increase wages for their employees.

Looking forward to a great bipartisan discussion today. I thank our witnesses for being here, taking time out of their busy schedules. And now I yield to Ranking Member Neal for his opening statement.

Mr. NEAL. Thank you, Mr. Chairman, for calling today's hearing on Chairman Camp's small business tax reform legislation. Small businesses are the engines of job creation in the country, and nearly 60 million Americans work for small business. That is about half of our private sector workforce.

When I travel around my district back in western Massachusetts, I am amazed by the entrepreneurial spirit of the small business owners that I meet. These businesses manufacture medical device equipment and sophisticated plastics and paper. They brew great lagers, or as we call it in western Massachusetts, great beer. And they provide hospitality and entertainment to many of our visitors.

Small business owners in Massachusetts and throughout the country are certainly the backbone and strength of the American economy.

As we tackle tax reform, it is critical that we implement tax policy that helps America's small business grow and prosper. It is through that prism that I think we should review Chairman Camp's proposals today. I also commend Chairman Camp for including so many proposals in his bill that are bipartisan. His draft would make permanent increases in expensing for small businesses, the proposal that has received much bipartisan support over the years. He has also included proposals based on legislation

introduced by our colleagues Ron Kind and Jim Gerlach, Mike Thompson and Aaron Schock.

I think this once again demonstrates that there are opportunities for common ground in our approaches to tax policy, and that we can and should do tax reform on a bipartisan basis. So I thank you for calling the hearing, Mr. Chairman.

And I am going to excuse myself for a brief period of time only to testify in front of Chairman Chris Smith's committee on an issue that I have long been involved in this morning. So I will just be gone for a brief period of time and back. And with that said, I yield back my time.

Chairman TIBERI. Thank you, Mr. Neal. And we thank you for your leadership on this issue.

Now I would like to turn to the panel and welcome the four individuals who are here today. I will introduce the four and then we will begin the testimony with Mr. Harris, who I will introduce first, Mr. Roger Harris, president of Padgett Business Services in Athens, Georgia. Thank you for being here, sir. Second, Mr. Willard Taylor, former partner at Sullivan & Cromwell, and currently a professor of law at New York State—excuse me—New York University. Thank you for being here.

Third, Mr. Blake Rubin, a partner at McDermott, Will & Emery here in Washington, D.C. Thank you, sir. And fourth, Mr. Tom Nichols, a shareholder at Meissner Tierney Fisher & Nichols in Milwaukee, Wisconsin. Thank you for being here, sir.

With that, you will each have 5 minutes to present your oral testimony. Your full written testimony has been submitted for the record. And, Mr. Harris, you are recognized for 5 minutes.

STATEMENT OF ROGER HARRIS, PRESIDENT, PADGETT BUSINESS SERVICES

Mr. HARRIS. Thank you, Mr. Chairman. And thanks to the members of the Committee for the opportunity to be here today.

I am Roger Harris. I am president and chief operating officer of Padgett Business Services. And I think to help understand my comments, it is good to understand what we as a company do and who we define as our small business customer. Padgett Business Services has provided accounting, income tax preparation, tax advice, payroll services to small businesses for almost 50 years throughout the United States through our network of offices.

We have always defined our customer as a small business owner with fewer than 20 employees. And a lot of people look at those businesses individually and say they are mom-and-pop businesses; however, if you look at them as a group, they are a tremendously powerful force in this economy, and I think we need to make sure that their needs and their interests are addressed in any tax reform discussion.

And I think it would be very difficult to find anybody in this room or this town or this country who doesn't think the Tax Code that we currently have has seen its better days and needs to be replaced.

I can tell you that our small business owners particularly want to find something new that they can work with. They want something that is simple. They want something that has some predict-

ability to it. They would like something that encourages or increases their cash flow. And more importantly, they want something that mirrors their checkbook to some extent. They are tired of having to be explained what is the difference in their cash flow and their taxable income. So they want something that mirrors their checkbook as close as possible.

I am happy to say that the draft proposal that the committee put out a few weeks ago, I think works towards these goals and is a great starting point for these people. Particularly beginning with the 179, if you look at the proposals for it to make permanent the $250,000 deduction limit and the $800,000 phaseout permanent in the sense that it is indexed, for our clients, those limits are very sufficient and would work wonderfully well, and would eliminate a lot of record keeping of tracking assets, because it would cover most of their purchases.

I recognize, however, that for some industries, particularly heavy equipment industries, those values or those numbers may not be enough, but for our businesses, those values are great. And they also, because they have the ability to write them off currently and not have to track them, it mirrors cash accounting, which is the second part of the proposal that we are particularly pleased with, is that this proposal will expand the number of businesses who qualify for cash accounting.

Again, getting down to the basic principle of a small business owner that when money comes in, it is income, when money goes out, it is an expense, and what is left is their income. Because if there is anything they hate more than paying taxes, it is having to pay taxes with money they don't have. So the closer that we can mirror their checkbook, this proposal goes a long way to do that.

We would like to see it perhaps go a little bit farther, and I am sure we can talk about it more, but I think carving out something out like a safe harbor for the smallest businesses in this category to have to ignore—be able to ignore the tracking of inventory. I think at times, we think inventory is nothing but looking on a shelf and making calculations of how many of what sits on a shelf, and it is much more complicated than that, and I think we should be able to come out with a carve-out, again, for these small businesses that allows inventory reporting to be at their option if they are at the smallest end.

The next part of the proposal talks about startup and organizational expenses. And it doubles the number from 5 to $10,000, which, again, for many of our clients will be sufficient and will have the impact of, in essence, making it cash accounting. However, here again, I would like to see for, again, the smallest of small businesses more leniency in that area, in that when you start a business, in the year that you start your business, all your expenses of startup should be deductible.

From a personal standpoint, it is very hard to tell a small business owner that the expenses that you paid in July are fully deductible, but that exact same expense that you paid in February when you were trying to get your doors open may or may not be deductible. To them, it was the same check to the same purveyor, and they believe it should be deductible.

Finally, I will put on my practitioner hat and address the filing dates for these business returns. I want to commend the recommendation of moving the partnership date back to March the 15th to create that 30-day window to still have the individual return prepared. I think that is long overdue. That used to be the date for the S Corp return. This proposal moves it up to March 31st. I would like to see it stay at March 15th and have a unified date for pass-throughs so we all know that all pass-throughs are due the same day, and we all have the same 30-day window to get the individual return. I am not a sure partner or shareholder see themselves any different.

With that, my time is about up. I want to thank the committee again for the opportunity to be here today and I look forward to your questions.

Chairman TIBERI. Thank you, Mr. Harris.

[The prepared statement of Mr. Harris follows:]

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Statement of Roger Harris
President and Chief Operating Officer
Padgett Business Services
Before the U.S House of Representatives Committee on Ways and Means

May 15, 2013

Good afternoon, I am Roger Harris, President and Chief Operating Office of Padgett Business Services. For nearly fifty years, Padgett Business Services has been providing accounting, income tax planning and preparation, payroll and payroll tax services to thousands of small business owners through our network of 300 offices across the United States. Our clients generally have 20 or fewer employees and are what some people would consider "mom & pop" businesses. Based on recent studies almost 90% of all firms that have employees operate in our target market. In addition to my forty plus years with Padgett, I also had the honor of serving on the Internal Revenue Advisory Council for four years and was its Chair for two of those years. I believe this experience gives me a balanced approach to small business taxation – I have had the opportunity to see what works and what doesn't work in the real world.

I think it would be difficult to find anyone in this country who does not believe that the current tax code is too complicated, too expensive to comply with, and needs to be replaced. I want to commend the work of this Committee and others that have started the process of looking at what can be done to reform our tax code. For many of our clients, the cost of complying with the tax code exceeds the taxes they pay each year. As someone that has spent an entire career working with small business owners I can tell you no group wants tax reform more than this country's small business owners.

As you move forward with the tax reform process, I would suggest two objectives for small businesses. The first obviously is a simpler code. The second is to improve cash flow for small businesses so that they can survive and grow. The tax code should not stand as an impediment

to starting a new business. I am pleased to say the core components of the Ways and Means Committee Discussion Draft is a positive move toward meeting these goals.

Over the years it has become clear to me that for most small entrepreneurs, the business checking account is the focal point for their bookkeeping. It is how they measure cash flow and profits, and to a great extent is the foundation for their tax accounting as well. Anything that moves them away from this simple, yet effective, approach creates complexity. Further, small start-up businesses live or die on their cash flow: anything that creates a mismatch between taxable income and cash-on-hand is not only adding complexity but creates the practical problem of how do you pay the taxes when there is no cash in the till. Finally, it is important to keep in mind that while lower rates are always welcomed by small businesses, a base broadening exercise can result in significant added complexity and accounting costs for this group. It is for that reason that I commend the Committee's Discussion Draft. Including its recommendations in a tax reform package will help move small businesses to a truer cash basis environment and will serve to inoculate the small business sector from potential complexity brought about by a base broadening approach to tax reform. At the same time, I believe the Committee should consider additional proposals to provide small businesses relief from complex rules governing inventory accounting. These areas are two of the more significant examples of current tax rules that prevent small businesses from operating as a true cash basis taxpayer.

I applaud the following recommendations in the Discussion Draft:

Permanent Section 179 Expensing, Including Leasehold Improvements and Computer Software. The fact that this proposal is permanent and includes leasehold improvements and computer software ensures that it will provide concrete benefits to small businesses in both simplification and cash flow. The current approach of annually extending – many times retroactively – provisions intended to spur investment and growth such as section 179, have had just the opposite effect. For tax reform to truly stimulate economic growth it needs to engender confidence that we can count on the rules not changing every year. In short, volatility of the tax laws increases risk and risk dampens investment. I have seen this firsthand. If Congress gives business some certainty in this area, it will pay dividends to the economy.

We must also recognize the contribution this proposal makes to simplification. Having the ability to deduct the cost of equipment eliminates the need to keep detailed depreciation schedules on all of these assets and calculate on an annual basis what we can deduct for that year. For Padgett, the $250,000 and $800,000 dollar levels, indexed for inflation, are sufficient for the vast majority of our clients. Finally, this proposal is a great add-on to the expanded use of cash accounting because for many small business owners, they will be able to deduct all of the costs of new equipment in the year it is paid.

Increasing the Cash Basis Threshold for Small Businesses to $10 million and Simplifying Its Application. This change will ensure that most small businesses will be covered by the general

cash basis exception. While the proposal also limits who receives this treatment, my experience tells me that the proposal will better target the benefit to the small business owners we all want to help survive and grow. Cash accounting allows a business to operate on the simple principle that money received is income, money paid out is an expense, and what's left is profit. This also has the effect of making cash flow and profits the same.

Today many small businesses have a hard time understanding why they must pay taxes on money they don't yet have or why they can't currently deduct money they just paid; therefore, resulting in a tax liability on money that is not in their bank account. To make matters worse, the business owner is required to keep more records to calculate this liability. At the end of the day the real difference between cash and accrual accounting is timing. Over time, the results are the same; it is just a matter of when it is reported.

Modification of Rules for Capitalization and Inclusion in Inventory Costs of Certain Expenses. A current area of complexity for many small business owners is inventory. Inventory issues are more complicated than just looking to see what is sitting on the shelves. How the inventory is valued, what to do with inventory that is yet to be paid for, what accounting method should be used to track inventory, and what other costs must be included? The Ways and Means Discussion Draft makes a modest improvement toward a true cash basis system. It is limited, however, to small businesses that produce tangible goods. My recommendation is that the Committee considers additional changes that would provide further relief from the uniform capitalization and inventory rules for small businesses. The inventory rules affect small retailers the most and almost always require expensive accounting advice and return preparation. So, while the businesses these rules affect are what you and I might consider unsophisticated, the tax laws treat them like a national retail business.

One possible reform would be to create safe harbor guidelines that establish a materiality bright line for a small business owner. Current law allows a deduction for inventory that is not material to the business. Under such a safe harbor rule, a business owner that otherwise meets the $10 million limit for cash basis could deduct increases in inventory as long as their inventory did not exceed a percentage of sales or a fixed dollar amount at the end of the year. Small business inventory meeting these rules would be deemed non-material. The Committee would need to consider special "smoothing out" rules for fast growing businesses to avoid a spike in income when the first year inventory must be reported. I believe something could be developed in this area that would not lose significant revenue to the Treasury but would further simplify the tax rules for the truly small, small business.

Combining Three Existing Provisions for Start-up and Organizational Expenses into a Single Provision Applicable to all Businesses and Increasing the Threshold to $10,000. The committee's Discussion Draft recognizes the value of new business startups by establishing a unified deduction for start-up and organization expenses. I applaud the committee's recommendations, which are an improvement over the current rules. I would suggest, however, an even more aggressive approach to start-up expenses for the small business owners

that qualify for use of cash accounting. I would suggest that all start-up expenses be allowed as a deduction in the year the business opens. The only carryover or capitalization required would be for expenses that were incurred in a year before the business was opened. Those expenses would be allowed in the year the business opens its doors.

Once again, this is an attempt to promote the simple concept that when money comes in it is income and when it goes out it is an expense. It would also minimize their tax liability in that critical first year of a business, when cash is usually very tight if non-existent. Here again I fall back on my experience of trying to explain to a small business owner that has just opened their business that the expenses that he paid in July are fully deductible but those same expenses when he paid them in February may not be currently deductible because he was still opening the business. When it comes to small business start-ups, we should be willing to do all we can to encourage that activity.

Ease Tax Compliance by Changing the Due Date for Business Tax Returns. One of the big headaches of tax filing season has become waiting for partnership K-1s. The main reason for the late availability of these K-1s is that the due date for the partnership return is April 15 which, as we all know, is the due date of the individual return as well. For this reason I commend the Committee's proposal to make the partnership return due on March 15. By moving the date to March 15 we will now have 30 days to complete the individual return. However, I do question why the proposal moves the due date of a S corporation return from March 15 to March 31. I believe all pass-through returns should have the same due date. If we believe that we should create a 30 day window between a partnership return and the partners return why would we not want to have that same window for an S corporation return and that shareholders return?

Pass-through Entity Reform Options. In regard to the two options presented in the Committee Discussion Draft, the changes proposed in option 1 are very beneficial to businesses that operate as S Corporations. For our customers, this is a very common business structure and these proposed changes would be welcomed. While few of our clients operate as partnerships those that do would also welcome most of the proposals. There are some proposed changes to payments made to partners that will require some different thinking but as a whole these too would be beneficial for our clients. As to option 2, I think it is important to say that this represents more of a radical change from the current tax structure. As we all know, change can be a scary thing for some people. I do have some concern about the proposal to require entity level withholding on income for the smallest of small businesses. For this group, withholding on payments to the partners instead of income would be simpler for them to comply. Also, option 2 could generate more need for transitional relief. Over all, though, this option would still be an improvement over the current system.

In conclusion, the Committee's Small Businesses Discussion Draft definitely heads in the right direction for entrepreneurs looking for a fairer system that simplifies their lives and lets them

just focus on running and building their business. Thank you for this opportunity to testify today and Padgett Business Services looks forward to working with the Committee on Ways and Means on this crucial area of the tax code.

Chairman TIBERI. Mr. Taylor, you are recognized for 5 minutes.

STATEMENT OF WILLARD TAYLOR, FORMER PARTNER, SULLIVAN & CROMWELL

Mr. TAYLOR. Thank you. Good morning. My name is——

Chairman TIBERI. Mr. Taylor, can you turn on the microphone?

Mr. TAYLOR. I am sorry.

Chairman TIBERI. That is all right. Perfect.

Mr. TAYLOR. Okay. Good. Thank you.

I am an adjunct professor at New York University Law School and I also teach at the Yale and the University of San Diego law schools, in each case, a course on the Federal income taxation of business pass-throughs. So it is a pleasure to be here to talk.

The committee discussion draft has two basic structural reforms: one is specific changes to Subchapter S and Subchapter K, that is option one; and the other is a more fundamental revision resulting in a single system of tax rules for all pass-through entities, whether incorporated or not.

I think what is proposed in option one is basically good. Many of the proposals have been around for a long time. I think you could add some to them, I think you could also expand them, but they are all basically good. However, they are really just improvements, if you will, to the system and not fundamental tax reform. So I think the focus ought to be on option two, the single pass-through regime.

And I think that the most compelling argument for that is that there really is no difference, apart from tax, between a limited liability company and a corporation. One's incorporated, the other is not, but the choice between the two has huge tax implications, including the treatment of foreign and tax exempt investors, the different treatment for payroll tax purposes, and we could go on and on about it.

Subchapter S came in in 1958 at a time when it was necessary to give limited liability to small businesses. That is not necessary today. You can form a limited liability company and not incorporate and get the same advantages.

Now, option two, then, offers the opportunity to address those differences. It also offers the opportunity for small businesses trapped in Subchapter C to move into Subchapter S, and it also provides a simplified regime.

There is a huge amount of work that has to be done if option two is going to be implemented, and the draft notes a lot of that, and I won't go over it, but I want to mention four items that I think in particular should be focused on. One is achieving parity among investors. There really should be no difference in the treatment of a foreign investor in a partnership and a foreign investor in a privately held corporation. And if you don't straighten that out, you distort investment decisions and capital raising. And the same is

true with respect to tax exempt investors. You should have a single set of rules.

Now, on tax exempt investors, inevitably you are going to hear from ESOPs, who love S Corporations, as to why they shouldn't get that treatment continued, both for S Corporations, or if you have a single regime, for Subchapter K. That is a different issue, but I don't think you ought to neglect it.

A second issue that deserves attention is payroll tax. If you have got a single regime for Federal income tax purposes, no difference between a partnership and a small privately held corporation, then why in the world would you have a difference in payroll taxes, but you do today, because the base for SECA, the self-employment tax, differs from the base for FICA. So you would have to address, how do we resolve that? How do we come to grips with it?

The third issue is determinations of tax liability and do you do that at the entity level with a withholding tax, as has been proposed in the draft, or do you let each owner make his or her own determination? I personally think doing it at the entity level makes sense, but, again, it is an issue that has to be come to grips with.

The fourth and final issue I would mention is foreign income. If you have a 95 percent dividends received deduction and a lower rate on dividends from the C Corporation, you are going to have to compare the effective tax rate for the pass-through entities, which may be higher if you don't do something about it.

So I will end there. I have sent in longer written comments. I agree with Chairman Tiberi that this is a hugely important subject, and that is the last word I will say on the subject. Thank you.

Chairman TIBERI. Thank you, Mr. Taylor.

[The prepared statement of Mr. Taylor follows:]

May 15, 2013

Testimony Before the Subcommittee on Select Revenue Measures of the Ways and Means Committee on the Discussion Draft Provisions To Reform the Taxation of Small Businesses and Passthough Entities

Good morning.

My name is Willard Taylor. I am an Adjunct Professor at New York University Law School and also teach at the Yale and University of San Diego Law Schools – in each case, a course on the Federal income taxation of business passthroughs. I am grateful the opportunity to testify on this subject today.

The Ways and Means Committee discussion draft on the reform of the taxation of passthrough entities, released in March, includes two options for structural change, one consisting of specific changes to the Subchapter S and partnership rules and the other, option 2, consisting of a fundamental revision of Subchapter S and of the partnership rules, resulting in a single set of rules for all non-publicly traded passthrough entities.[1]

The changes proposed in option 1 are, in my view, good – others could (and should) be added[2] and some of the issues could be addressed differently,[3] but the

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[1] The draft also includes items specifically directed at small business, such as the expensing of certain expenditures and the use of cash method accounting, and changes to the dues dates for business tax returns.

[2] Such as the repeal or modification of the technical termination rule in Section 708(b)(1); a more inclusive definition of "investment company" definition in Section 721(b); and the treatment of interests in a publicly-traded partnership as "securities" for purposes of Section 1058. With respect to the need for a more inclusive definition of a Section 721(b) investment company, *see* Report No. 1252 of the NYSBA Tax Section, Report on Investment Company Provisions: Sections 351(e) and 368(a)(2)(F) (December 28, 2011) at pages 1 (text at note 1) and 11-12.

[3] For example, the Administration's fiscal 2014 revenue proposals would change Sections 743(d), relating to built-in losses, and 704(d), relating to the basis limitation on losses, but in a different way than the changes in option 1. *See* Department of the Treasury, General

changes proposed by option 1 have been around for some time[4] and make sense. The option 1 changes, however, are "improvements," not basic tax reform, and so I feel strongly that Congress should focus on the option 2 proposal to have a single set of Federal income tax rules for all non-publicly traded passthroughs.

Why does it make sense to have a single set of rules for all non-publicly traded passthroughs?

To begin with, apart from tax, there is no longer any compelling legal distinction between a non-publicly traded corporation and a non-publicly traded partnership that justifies the different tax rules that apply under present law to S corporations and partnerships. There are many of these, including the different treatment of foreign and tax exempt investors, the different treatment for payroll tax purposes, the different treatment of property distributions and the different restrictions on allocations of items of a passthrough's income or loss.

Subchapter S was enacted in 1958 in order to allow "small" business owners to achieve limited liability by incorporating but without incurring corporate tax on the corporation's income. Limited liability companies have since eliminated the need for Subchapter S. The only non-tax difference today between an S corporation and a limited liability company is that one is incorporated and the other is not; but that difference, while unimportant as a

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Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013) at pages and pages 92 and 93.

[4] The S corporation changes in Option 1 come from H.R. 892, the S Corporation Modernization Act of 2013 (February 28, 2013). *See also*, the S Corporation Modernization Act of 2011 (April 12, 2011); and ABA Section of Taxation, Options for Tax Reform In Subchapter S of the Internal Revenue Code (April 10, 2013). In the case of the partnership changes, a number are proposals that were put forward in a 1997 Joint Committee paper but not enacted as part of the Taxpayer Relief Act of 1997 and others come from comments made over time by practitioners and academics. *See* Joint Committee on Taxation, Review of Selected Entity Classification and Partnership Tax Issues (JCX 6-97), April 8, 1997, and the sources cited by the Technical Explanation on pages 20, 22, and 29, including William B. Brannan, The Subchapter K Reform Act of 1997, 76 Tax Notes 121 (April 7, 1997).

practical matter, results in significant Federal income and payroll tax differences because of the different tax rules that apply to S corporations and partnerships. At the same time, the complexity of the partnership rules has grown exponentially over the last 50 years.

Option 2 offers the opportunity to address the Federal income tax aspects of this issue by putting in place a single set of tax rules for all non-publicly traded entities. It would also level the playing field by allowing non-publicly traded corporations that are now caught in Subchapter C (because, *e.g.,* they have foreign or other ineligible shareholders) to move into the new passthrough regime. And it would (because of its restrictions on allocations of a passthrough's items of income and loss and its treatment of property distributions by a passthrough) significantly simplify the present Subchapter K rules.

While there have been many proposals for reforming subchapter K, few are as straight-forward as option 2.[5]

Implementing Option 2 will require a lot of work and some difficult decisions. There are a number of issues that are explicitly "unaddressed" by option 2 (such as mergers, divisions and reorganizations; entity level determinations of a passthrough's income and loss; the treatment of foreign and tax exempt owners; and payroll taxes) or which need more clarity (such as the determination of when a corporation is publicly traded (and why the rule should differ from that which applies to partnerships), the "single distributive share" rules that applies to allocations of a passthroughs income or loss to the owners).

Let me quickly mention four that are important.

I: Parity between investors

It is important to provide the same tax treatment for investors in passthroughs that are corporations and passthroughs that are partnerships since

[5] While the Staff of the Senate Finance Committee has released a number of "Tax Reform Options for Discussion," those released so far do not include structural changes to Subchapters K or S.

otherwise the choice of a corporation or a partnership will distort investment decisions and access to capital.[6]

For example, it would make no sense for the rules that apply to foreign owners to differ depending on whether the passthrough was a corporation or a partnership. Foreign owners should be treated the same in either case. The choice here is between retaining and extending the existing partnership rule, which attributes partnership activities to the foreign partners for the purposes of determining whether the partner is engaged in a U.S. business and imposes the tax on the partner,[7] or replacing that rule by a withholding tax on distributions and an entity level tax on the foreign owner's share of undistributed income and gain recognized by a foreign partner on a sale of an ownership interest.

If there is tax exempt owner of a passthrough, there also should be parity between a passthrough corporation and a passthrough partnership. It seems clear under option 2 that the new passthrough rules would extend the tax on unrelated business taxable income to shareholders of a passthrough corporation, whether the income results from debt-financed income that would otherwise be excluded by the Section 512(b) "modifications" or from the other operations of the passthrough.[8] This is, of course, the rule that now applies to partners, and (although not in the same way)[9] to S corporation shareholders.

A related issue is the treatment of ESOP shareholders of an S corporation. Although not addressed by the draft, it would seem from what is there in the draft that the special rules for ESOP shareholders of an S corporation[10] may no

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[6] This is also an issue for investments in U.S. real estate made directly, through a partnership and through a real estate investment trust.

[7] New Section 711(b) provides for a passthrough of the character of items but this may fall short of attributing the activities of the corporation to its owners.

[8] Using the analysis of Rev. Rul. 74-197.

[9] The tax on unrelated trade or business income is applied to partners on a look through basis but Section 512(e)(1) treats all income of a tax-exempt shareholder of an S corporation as unrelated business income.

[10] In Section 512(e)(3).

longer apply, which will be an important issue for S corporations with ESOP shareholders – and there is an active ESOP lobby.[11] The effect of Section 512(e) is to eliminate any current tax on an ESOP shareholder's share of the income of an S corporation – that is, to defer any tax until there are distributions by the ESOP.

II: Payroll taxes

A second issue is the payroll tax.. The tax base for the self-employment tax that generally applies to partners in a partnership is net earnings from the trade or business carried on by the partnership; in the case of an S (or other) corporation, however, the FICA base is "wages", *i.e.*, remuneration for personal services. The difference is significant since the SECA base can both overstate and understate compensation for personal services, and the determination of what are reasonable "wages" is a complicated and much-litigated issue.

If there is a single passthrough system for Federal income tax purposes, it would certainly be odd to continue to have two rules for Federal employment tax purposes – that is, FICA for corporations and SECA for partnerships. And the Ways and Means Committee release that accompanied the draft seems to acknowledge this when it says (emphasis added) that Option 2 "requires *new* rules for the employment and self-employment taxes of owners."

This could, of course, be a major issue for S corporations since they are perceived as offering the opportunity to limit the FICA base.

Resolving the payroll tax issue may force a choice between applying the SECA base to *all* passthroughs or developing an administrable "reasonable

[11] *See, e.g.,* Comments submitted by The ESOP Association to the House Ways and Means Committee pension/retirement tax reform task force, Tax Notes Today, April 2, 2013; and S. 742, the Promotion and Expansion of Private Employee Ownership Act (April 17, 3013), supported by the Employee-Owned S Corporations of America.

compensation test" that could be applied to all passthroughs, as well as to C corporations.[12]

Related to the broad payroll tax question is the treatment of limited partners for self-employment tax purposes. There is now a rule, enacted in 1977 to address an issue that is no longer relevant, which allows an individual to exclude from the self-employment tax income derived as a limited partner unless it is a guaranteed payment for services actually rendered.[13] The draft does not seem to affect the exclusion. If the issue is addressed, which it should be, it seems self-evident that the exclusion should be limited to income derived for the use of capital invested as limited partner (and not apply to any other income).

III: Audits and determinations of taxable income or loss

A third issue is whether the final determination of an owners' items of income, gain, expense and loss from a passthrough will be made at the passthrough level or, as under present law (and subject to some restrictions), separately by each owner. The draft's proposed withholding tax points in the direction of an entity-level determination, which is a sensible way to reduce the complexity of present law and consistent with the purpose of the new withholding tax, which is to "Close the tax gap."[14] Thus, the owners' items of income, gain, expense and loss would be determined and audited at the passthrough level.

IV: Foreign income

Finally, the discussion draft does not address the disparity in the treatment of foreign income that will result if (as the Ways and Means Committee has

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[12] *See, e.g.*, Willard B. Taylor, Payroll Taxes – Why Should We Care? What Should be Done? , 137 Tax Notes 983 (2012).

[13] Section 1402(a)(13).

[14] *See* the Ways and Means Committee release. The reference to the tax gap is presumably a reference to underreporting of business income by individuals, which is consistently the largest component of the gap. *See* IR-2012-4, Jan. 6, 2012.

previously proposed) active foreign income of a C corporation's foreign subsidiaries is eligible for a 95% dividends received deduction – no dividends received deduction would be allowed to a passthrough.[15] This is a difficult issue since, if dividends to shareholders of a C corporation are taxed at capital gains rates, the effective U.S. tax on foreign earnings may be significantly less for a C corporation than for a passthrough, although that will of course depend on what happens to individual and corporate tax rates (and does not consider foreign taxes). The Ways and Means Committee release lists the taxation of foreign operations as a so-far-"unaddressed" issue.

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As Chairman Tiberi said in the release announcing this hearing, S corporations and partnerships are hugely important and need to be addressed. Passthroughs – whether S corporations or limited liability companies or partnerships – are a large and growing segment of the economy, and this is not likely to change.

In number, there were more than 4 million S corporations and 3 million partnerships (of which 1.9 million were limited liability companies) in 2008.[16] Between 1980 and 2007, passthroughs' percentages of business tax returns by number and of business receipts grew from 14.8% and 7.4%, respectively, to 22.8% and 34.1%, primarily because of the growth of S corporations (and notwithstanding the check-the-box regulations).

Will the enactment of option 2 slow the trend to passthroughs? Whatever the criticisms of option 2, a C corporation would not seem to be a better choice for small business. And S corporations, which have been the leading choice for privately held businesses, would likely find new Subchapter K more accommodating than Subchapter S. The complexity of new Subchapter K – *e.g.*,

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[15] Ways and Means Committee International Tax Reform Discussion Draft (October 26, 2011).

[16] There were 1.8 million C corporation returns filed for 2008, down from 2.2 million in 1980. The shift from C corporations has contributed to the decline to about 10% in corporate tax revenues as a component of Federal tax revenues.

the possibility of special allocations within the single distributive share rule – is purely optional and is unlikely to be a deterrent (and the view that option 2 will inevitably increase tax compliance costs is not supportable).[17] If small C corporations (those with less than $100 million of assets) were to become passthroughs, passthroughs would account for more than 50% of total business receipts. [18]

Thank you.

I have also submitted, as my written comments, an outline used in a presentation of the discussion draft at NYU Law School. This includes more detailed comments on the draft.

[17] What happens, of course, will depend on what happens to individual and corporate tax rates as well as other possible changes, such as to employment and self-employment taxes. The House-passed budget would reduce the corporate rate to 25% and have two individual brackets, 10% and 25%. H. Con. Res. 112 (March 2013).

[18] Congressional Budget Office, Taxing Business Through the Individual Income Tax (December 2012) at page 10.

Written Comments

1. Structure of the Ways and Means Committee Draft. The House Ways and Means Committee discussion draft of "Provisions To Reform the Taxation of Small Businesses and Passthough Entities," released on March 12, 2013, includes (apart from provisions directed at small businesses[19] and changes to the dues dates for business tax returns) two options for structural reform. One would make specific changes to the S corporation and the Subchapter K partnership rules (Option 1); and the second, while incorporating the Option 1 changes, would go much further and fundamentally redo Subchapters K and S, resulting in a single set of rules for all non-publicly traded passthroughs (Option 2) and publicly-traded partnerships that met the "good" income exception to the rule that generally treats publicly-traded partnerships as corporations.[20] There is no revenue estimate for either option. The changes would take effect in 2014, without any grandfathered exceptions (although the Ways and Means Committee release lists "Transition rules... with a goal of minimizing disruption" as a so-far-"unaddressed" issue).
2. Option 1. The specific changes in Option 1 are now new – they are essentially items that have been put forward for some time. In the case of S corporations, Option 1 would make most of the industry-backed changes that are in the S Corporation Modernization Act of 2013 and its predecessors.[21] In the case of

[19] Such as the expensing of certain expenditures and the use of cash method accounting.

[20] In Section 7704 of the Code.

[21] H.R. 892, the S Corporation Modernization Act of 2013 (February 28, 2013), which would (1) permanently reduce to 5 years the gain recognition period for built-in gain, (2) eliminate the rule that disqualifies an S corporation if has accumulated earnings and profits and its passive income is more than 25% of its gross receipts for 3 consecutive years, (3) raise from 25% to 60% of gross receipts the threshold for taxing an S corporation that has accumulated earnings and profits on net passive income, (4) allow and electing small business trust that is an S corporation shareholder to have a nonresident alien as a potential current beneficiary, (5) allow an electing small business trust to take a charitable deduction under the rules that apply to individuals, (6) make permanent the reduced basis adjustment to a shareholder's shares resulting from a charitable contribution by an S corporation of appreciated property, and (7)

partnerships, Option 1 would make more significant changes, although still largely clean ups. They are set out at the end of this outline. There is no single source for the partnership changes -- a number are proposals that were put forward in a 1997 Joint Committee paper but not enacted as part of the Taxpayer Relief Act of 1997 and others come from comments made over time by practitioners and academics.[22]

3. Option 2 – Fundamental Reform. Option 2 would be much more significant, both for partnerships and S corporations, and its economic importance should not be underestimated. Passthroughs – whether S corporations or limited liability companies or partnerships – are a large and growing segment of the economy, and this is not likely to change.[23]
    a. In 1980, C corporations accounted for 16.6% in number of business tax returns and 86.2% of business receipts; S corporations accounted for 4.2% in number of business tax returns and 3.2% of business receipts; and partnerships accounted for 10.6% in number of business tax returns and 4.2% of business receipts. By 2007, S corporations accounted for 12.8% of business tax returns and 19.8% of business receipts; partnerships accounted for 10% of business tax returns and 14.3% of business receipts; and C corporations accounted for 5.62% of business tax returns and 72.1% of business receipts.

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extend the time for making an S corporation election to the due date for the filing of the corporation's return. *See also*, the S Corporation Modernization Act of 2011 (April 12, 2011); and, ABA Section of Taxation, Options for Tax Reform In Subchapter S of the Internal Revenue Code (April 10, 2013).

[22] *See* Joint Committee on Taxation, Review of Selected Entity Classification and Partnership Tax Issues (JCX 6-97), April 8, 1997 (hereafter, "JCX-6-97"), and the sources cited by the Technical Explanation on pages 20, 22, and 29, including William B. Brannan, The Subchapter K Reform Act of 1997, 76 Tax Notes 121 (April 7, 1997). On the fate of the Joint Committee proposals, *see* John S. Pennell and Philip F. Postlewaite, Subchapter K - Have The Joint Committee Proposals and TRA '97 Given It A New Look?, 87 J. Tax'n 325 (1997).

[23] The numbers in the text below are largely taken from the IRS Statistics of Income. Measuring entity selection by business returns filed and business receipts reported seems more informative than focusing on S corporations as a percentage of the returns and receipts of all corporations.

b. Thus, passthroughs' percentages of business tax returns by number and of business receipts grew from 14.8% and 7.4% to 22.8% and 34.1%, primarily because of the growth of S corporations (and notwithstanding the check-the-box regulations).

c. In number, there were more than 4 million S corporations and 3 million partnerships (of which 1.9 million were limited liability companies) in 2008. There were 1.8 million C corporation returns filed for 2008, down from 2.2 million in 1980. The shift from C corporations has contributed to the decline to about 10% in corporate tax revenues as a component of Federal tax revenues.

4. What Does Option 2 Do? Option 2 would replace Subchapters K and S with a new Subchapter K that would apply to partnerships that were not publicly-traded (or, if publicly-traded, were still partnerships because of the "good" income exception in Section 7704(c) to the rule that generally treats publicly-traded partnerships as corporations) and be available to any corporation, other than one not eligible to be an S corporation under present law,[24] if it was not publicly traded and elected to be taxed under the new rules.[25] This would (outside of subchapter M, *i.e.*, RICs and REITs) then be the exclusive passthrough regime for corporations and partnerships.

   a. Option 2 would generally not change the definition of a partnership, the definition of what is an "entity" that is subject to classification as a partnership or a corporation (such as a "cell" company), or the treatment of "disregarded" entities.[26] Foreign corporations would be eligible to be passthrough entities, if not publicly traded, even though

[24] An insurance company, a bank that uses the reserve method of accounting for bad debts, or a DISC or former DISC. It would, however, be available to foreign corporations.

[25] An existing S corporation would be deemed to elect unless it affirmatively elected not to be a passthrough corporation. A passthrough election by a corporation can be revoked only with IRS consent.

[26] This may be an issue because of the ease with which a disregarded entity could be turned into a partnership. *See* Monte A. Jackel, A Short Journey Into Some Needed Reforms in the Partnership World, Tax Notes Today, October 22, 2012.

per se corporations sunder the Section 7701 regulations. [27] Option 2 keeps the statutory exclusions from partnership classification that are in Section 761,[28] and it would also keep Section 704(c), relating to "family partnerships," but only in a case where an individual (as opposed to, *e.g.*, a corporation) acquired a capital interest in a passthrough from another family member. [29]

5. When is a corporation publicly-traded? The Technical Explanation says that, in the case of a corporation, the definition of publicly-traded is "intended to be broader than the definitions under present law," and the proposed definition refers specifically to Section 1273(b), as well as to Section 7704.[30] The Section 1273(b) regulations treat instruments as publicly traded if there is a sale, a firm quote or an indicative quote. The rules focus on whether there is a reasonable basis to determine value and are inclusive.[31] The focus of the

[27] This may (like the check-the-box regulations) increase international arbitrage – that is, situations in which an entity is a corporation for foreign tax purposes but a passthrough in the US.

[28] As under present law, partnerships would not include unincorporated entities described in paragraphs (a), (b), or (c) of Section 761(a) – *i.e.*, at the election of all the members, an organization availed of for investment purposes only, for the joint production, extraction or use of property or by dealers in securities for a short period for the purpose of underwriting or distributing a particular issue of securities. The Section 761(f) exclusion for joint ventures between a husband and wife remains.

[29] Thus putting to rest the taxpayer's argument in TIFD III-E, Inc. v. U.S., 666 F. 3rd 836 (2d Cir. 2012).

[30] The Technical Explanation refers both to the Section 1273(b) and Section 7704 regulations. Under Regs. §1.7704-1(c)(1), interests not traded on an established securities market are publicly traded (as a general rule, and subject five safe harbors) if "taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market." Trading on a secondary market or its equivalent generally requires readily available, regular and on-going opportunities to sell. Regs. §1.7704-1(c)(2).

[31] Under the Section 1273(b) regulations, for example, debt can be publicly-traded if at any time in a 31 day period beginning 15 days after its issuance "There are one or more indicative quotes," defined as being the case "when a price quote is available from at least one broker, dealer, or pricing service...for the property and the price quote is not a firm quote," or if there is a sale of the instrument within that period. Regs.§ 1.1273-2(f).

Section 7704 regulations is different, *i.e.*, not on determining value but on whether there are readily available, regular and on-going opportunities to sell. The broader definition will limit the population of corporations that can move into Subchapter K, possibly even excluding some existing S corporations.

6. Moving In and Out of New Subchapter K. Under Option 2, an election by an corporation (whether a C or formerly an S corporation) to be a passthrough would not be a taxable event (although the special rules that apply to built-in gains and to passive income of, or distributions by, corporations with accumulated earnings and profits would, as modified under Option 1, remain).[32] Thus, an S corporation could generally move into new Subchapter K without interrupting its passthrough treatment. Nor would there be a taxable event if a passthrough corporation or partnership no longer qualified as a passthrough (*e.g.*, it became publicly-traded) and moved out of new Subchapter K – *i.e.*, was henceforth treated as a corporation. Whether a partnership that was or became publicly traded would be classified as a C corporation or not would continue to depend on whether it met the "good" income exception in Section 7704(c) to the rule that generally treats a publicly-traded partnership as a corporation. Unless it ceased to be publicly-traded, an existing publicly-traded corporation could not move into new Subchapter K without a taxable liquidation since the passthrough election is available only if the corporation is not publicly traded; and, if it did liquidate, it would of course have to meet the "good" income exception in Section 7704(c) to be classified as a partnership.[33]

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[32] That is, the rules that (1) tax passive income if the passive income of such a corporation is more than 60 % of its gross income, (2) tax such a corporation on built-in gain if the property is disposed of within 5 years, (3) require a former C corporation to keep an accumulated adjustments account in order to segregate C corporation earnings and profits (and tax distributions out of that account as dividends), and (4) require the recapture of LIFO reserves when a C corporation becomes a passthrough entity. In addition there would be no carryover of C corporation losses to the passthrough entity or from a passthrough entity to a C corporation.

[33] And thus publicly-traded partnerships that wanted to be passthroughs would, as today, choose to become real estate investment trusts if able to qualify.

7. Impact of Option 2. The effect of Option 2 would be to change significantly the treatment of partnerships and of non-publicly traded corporations that elect to be passthroughs. While there have been many proposals for reforming subchapter K, few are as straight-forward as this.[34]
    a. Thus, in case of S corporations, the one-class-of-stock and shareholder-level eligibility rules (not more than 100 shareholders, consisting of specified trusts and estates and exempt organizations, but otherwise only individuals who are residents or citizens) are eliminated, as is the "back-to-back" loan issue (since debt of a corporations that was a passthrough is treated in the same way as debt of a partnership passthrough and thus can be included in the owner's basis).[35] There would be no more QSubs (although disregarded entities would be available, as would passthrough corporations if treated in effect as disregarded entities); no ability to use an S corporation as a "mixing bowl;" no Section 338(h)(10) elections; and no more tax-free reorganizations or spin offs, except to the extent feasible under new Subchapter K (as opposed to Subchapter C).
    b. In the case of a partnership, the most significant changes are (1) new restrictions on allocations of passthrough items to owners and (2) importing the S corporations rule, the recognition of gain by the passthrough and gain (and sometimes loss) by the owner on a distribution of property.
8. New Subchapter K. The Option 2 rules for passthroughs include all of the changes to present Subchapter K, *i.e.*, to partnerships, that would be made by Option 1 (as set out at the end of this outline), and in addition the following:

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[34] As one exception, *see* Walter D. Schwidetzky, Integrating Sub-chapters K and S - Just Do It, 62 Tax Lawyer 749 (2009). While the Staff of the Senate Finance Committee has released a number of "Tax Reform Options for Discussion," those released so far do not include structural changes to Subchapter K or S.

[35] *See* the Ways and Means Committee release stating that Option 2 will "Conform [S corporations] to the basis rules that currently apply to partnerships".

a. Single Distributive Shares. While the passthrough rules (*i.e.*, what passes through to an owner, the retention of its character and source, etc.) are not changed,
   i. an owner's distributive share will henceforth be determined on the basis of its "economic interest" in the partnership;
   ii. separately and regardless of whether an allocation is consistent with the owner's "economic interest", there can be only be a single distributive share of items within each of three categories – ordinary items, capital gain rate items (which will include "qualified" dividends) and tax credits (other than the foreign tax credit); and
   iii. an owner's distributive share of foreign income taxes (and thus the related deduction or credit) will be based on the owner's share of the passthrough items on which the foreign taxes were imposed.[36]
   iv. The statute contemplates that regulations will prevent the avoidance of the restriction on distributive shares through, *e.g.*, the use of passthroughs under common control.

b. Impact on partnerships. The single distributive share rule (which is intended to "Reduce the use of complex structures to engage in tax avoidance")[37] will, for example, prevent the splitting between owners of ordinary deductions, such as depreciation, and ordinary income; of capital losses and capital gains; or of foreign and domestic source ordinary income.[38] That is a major change for partnerships – many of

[36] This seems to be more or less the same as the rule now in Regs. §1.704-1(b)(4)(vii)(a); and it puts to rest foreign tax credit structures like that in Pritired 1, LLC v. U.S., 816 F. Supp. 2d 693 (S.D. Iowa 2011).

[37] From the Ways and Means Committee release that accompanied the draft.

[38] *See* the one example in the Technical Explanation -- "Assume passthrough AB has 2 owners, A and B. The passthrough has the following items related to its leasing activities: $ 100 of rental income and depreciation expense of $ 50, for a net income of $ 50 from the leasing activity. The passthrough also receives $ 50 royalty income. A's economic interest in the passthrough is with respect to the leasing activity, while B's economic interest in the passthrough is with respect to

the illustrations in the current Section 704(b) regulations would be closed down before being evaluated to determine whether they have "substantial economic effect".[39] Conversely, it may restrict the flexibility that partnerships now provide – for example, where a professional services firm has nonresident alien and US partners and allocates foreign source income to the foreign partners.[40]

c. Impact on S corporations. The single distributive share rule is obviously much less important for passthrough corporations, since (under Subchapter S) they are now limited to one class of stock. With the changes made by Option 2, a corporation that elects into Subchapter K will be able to have more than one class of stock. This is important – S corporation banks, for example, have urged that they be able to issue preferred stock and that would be feasible under Option 2.

d. Are there are holes and/or unresolved issues in the single distributive share rule?

   i. For example, where is tax-exempt interest? Possibly in the ordinary income share, since that is "any passthrough item which is not in" another share – but does it make sense to combine tax-exempt interest with other ordinary items?

   ii. The distributive shares focus on individual tax rates – do they make sense for corporate partners? For example, in the case of a corporate owner, does it make sense to group dividends that are eligible for the dividends received deduction with net capital gain, which is taxed at the same rate as ordinary income?

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the intellectual property giving rise to the royalty income. Thus, of the $ 100 total passthrough net income, A and B each have $ 50, or 50 percent each. For purposes of applying this section, A's and B's distributive shares of $ 50 are each comprised of 50 percent of each ordinary passthrough item, specifically, $ 50 of rental income (50 percent of the $ 100 of rental income), $ 25 depreciation expense (50 percent of the $ 50 depreciation expense), and $ 25 royalty income (50 percent of the $ 50 royalty income)."

[39] *E.g.*, Examples (1), (3), (10) and (12) of Regs. §1.704-1(b)(5).

[40] Example (10) of Regs. §1.704-1(b)(5). The release notes, however, that the "proper treatment of ...foreign partners" is a so-far-"unaddressed" issue.

iii. Is the single distributive share rule for each year or for longer? Shifting, or transitory, allocations that change from year to year are, of course, an important focus of the "substantial economic effect" rules.

iv. Why are credits a separate distributive share, at least if (like the research expenditure credits, for example) they are based on expenditures that are included in the ordinary items distributive share?

v. And, out of curiosity, where did the single distributive share rule come from? [41] Is it in part a product of the proposed withholding tax?

9. Other allocation rules? It is unclear to what extent, apart from the single distributive share rule, there will be a change in the present partnership allocation rules – the distributive shares still have to be tied to something, such as capital accounts, which is presumably what the "economic interest" rule will require. On the other hand, "substantial economic effect" is eliminated; and, without elaboration of what "economic interest" means (beyond that it is to be determined on the basis of "all the facts and circumstances"), the effect of this is uncertain. Liabilities are not mentioned in the Technical Explanation (and Section 752 is not changed).

10. Gain or Loss on Property Distributions by a Passthrough. Gain (but not loss) is recognized by a passthrough entity on a distribution of property to the owners, and gain or loss is recognized by an owner on the receipt of property distributed by the passthrough (but with the loss deferred until the termination of all of the owner's direct or indirect interest in the passthrough). The basis in loss property to the owner cannot exceed the owner's basis in the owner's interest in the passthrough. The Ways and Means Committee release describes these changes as intended to "Prevent owners from gaming the tax

[41] *See*, as one possibility, the default rule (all "tax allocations ratably based on [the] partners' relative capital account balances") suggested by Andrea Monroe, Too Big To Fail: The Problem of Partnership Allocations, Virginia Tax Review, Winter 2010, available on SSRN, and the other proponents of similar rules listed in footnote 168 of that article.

system by using losses to reduce tax liability," to "Ensure that taxes are paid on real, economic gains," and to "Prevent the use of pass-through entities to shift gains and losses amongst owners with different tax profiles."

a. Mergers, divisions and reorganizations. How will the gain/loss recognition rules affect passthrough mergers, divisions and reorganizations?

   i. "Mergers, divisions, and reorganizations" is listed as a so-far-"unaddressed" issue. The need to do so is evident – whether a passthrough is a corporation or partnership, a merger (whether, in the case of a partnership, it is an "assets over" or "assets up" transaction), division or reorganization may involve transfers of assets, exchanges of ownership interests and/or distributions of property. Under the general rules of new Subchapter K, some of these, including distributions of property,[42] will result in the recognition of gain unless there are separate rules.

   ii. Section 708 of the draft provides (as before in the case of a partnership) that, in the case of a merger or consolidation, a passthrough will continue if its owners have more than 50% of the survivor and that a passthrough resulting from a split up or division will continue if more than 50% is owned by the prior owners. Does this imply that the effect of a merger, division or reorganization is limited to a non-continuing passthrough and its owners? That subchapter K will be the starting point for dealing with mergers, divisions and reorganizations?

b. Other Changes. Leaving aside the changes that would be made by Option 1 and are also included in Option 2, most of the other rules in new subchapter K are described by the Technical Explanation as "similar to," "consistent with," or "as in present law," with those in existing subchapter K .[43]

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[42] The draft also provides that a distribution of a partnership interest is an exchange.

[43] For example, the exclusions from passthrough classification in Sections 761(a) and (f), the Section 704(c) rules for contributed property, the basis limitation on an owner's share of a

11. Withholding Tax on an Owner's Distributive Share and the Determination of a Passthrough's Income. Under Option 2, a passthrough will be required to withhold tax, at a rate to be specified, on an owner's distributive share of the entity's net income (treating ordinary income and capital gain items separately) unless the income is subject to withholding under Section 1446, which imposes withholding tax on foreign partners in a partnership. It seems unlikely that the intention is to apply Section 1446 only to foreign partners in a partnership passthrough, as opposed to foreign owners of a passthrough, whether it is a corporation or a partnership, but this is not clearly stated.
    a. The new withholding tax is intended to "Close the tax gap"[44] – presumably a reference to underreporting of business income by individuals, which is consistently the largest component of the gap.[45].
    b. The new withholding tax will be treated as a distribution for the purpose of determining the owner's basis in the owner's interest and as tax paid by the owner. The credit allowed to the owner for the tax withheld is refundable. The tax is treated as imposed on the passthrough entity under Section 11 and the failure to pay the tax is treated as a failure to pay estimate corporate income tax.
12. Entity level determinations? New subchapter K does not include the electing large partnership provisions of subchapter K[46] (or the Administration's

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passthough's loss, the nonrecognition of gain or loss on a contribution of property to a passthrough, the basis of the contributed property to a passthrough, the basis of the contributing owner's interest when there is a contribution of property, the character of gain or loss on contributed receivables, etc., the Section 707(a) and (b) rules on transactions between passthroughs and owners, the closing of a passthrough's taxable year, and the determination of an owner's distributive share when the owner's interest in the passthrough changes. Likewise, the passthrough rules relating to built-in gain or accumulated earnings and profits of a C corporation that becomes a passthrough are described as similar to those that apply when a C corporation becomes an S corporation.

[44] *See* the Ways and Means Committee release.

[45] See IR-2012-4, Jan. 6, 2012.

[46] Sections 771-76.

proposals with respect to audits, etc. of large partnerships).[47] Because the new withholding tax is determined at the level of the passthrough entity, however, there is an entity level determination of that tax and of the items that make up the amount subject to withholding. This would seem to eliminate any owner participation in the determination of the base for the withholding tax.[48] The Ways and Means Committee release asks, nonetheless, whether the IRS should "be permitted to audit and assess tax liability at the entity level."

13. Will Passthrougths Continue to Grow? Would the enactment of Option 2 slow the trend to passthroughs? Whatever the criticisms of Option 2, a C corporation would not seem to be a better choice for small business. And S corporations, which have been the leading choice for privately held businesses, would likely find new Subchapter K more accommodating than Subchapter S. The complexity of new Subchapter K – *e.g.*, the possibility of special allocations within the single distributive share rule – is purely optional and is unlikely to be a deterrent. What happens, of course, will depend on what happens to individual and corporate tax rates as well as other possible changes, such as to employment and self-employment taxes. (The House-passed budget would reduce the corporate rate to 25% and have two individual brackets, 10% and 25%.)[49] If small C corporations (those with less than $100 million of assets) were to become passthroughs, passthroughs would account for more than 50% of total business receipts.
14. Regulated Investment Companies, Real Estate Investment Trusts, and Publicly-Traded Partnerships. Option 2 would not affect regulated investment companies or real estate investment trusts (except in so far as it makes permanent the 5 year gain recognition period for built-in gain) or, generally,

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[47] *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013) at 188. Nor does it mention the TEFRA partnership audit provisions.

[48] It is not clear whether this would extend to the Section 1446 withholding tax.

[49] H. Con. Res. 112 (March 2013). These are the rates targeted by the Ways and Means Committee.

the status of publicly-traded partnerships that are treated as partnerships for tax purposes because of the "good" income exception in Section 7704(c) to the rule that generally treats publicly traded partnerships as corporations. The draft does not address those publicly traded partnerships but, unless the rules were changed, their operations would henceforth be subject to the rules of new Subchapter K (and no changes are made to rules that publicly-traded partnerships may find annoying, such as the rule in Section 708(b)(1)(B) which terminates a partnership if there is a sale or exchange of 50% or more of the ownership interests during the year).[50] RICs, REITs and publicly-traded partnerships that are shareholders of a passthrough corporation would seem to be treated no differently than if they were partners in a non-publicly traded partnership. Since passthrough treatment of a corporation is elective, however, they could continue to have corporate subsidiaries, including taxable REIT subsidiaries, as "blockers." Taxable mortgage pools may have to be addressed if Option 2 moves forward.[51]

15. Attribution To Owners of a Passthrough's Activities. Will a passthrough's activities be attributed to the owners (as is now the case for partnerships) if the passthrough is a corporation?[52] This is important in a number of contexts, including where there are foreign or tax exempt owners.
    a. Foreign owners. If there are foreign owners, for example, the present partnership rules (1) treat a foreign partner in a partnership as engaged in a US trade or business if the partnership is so engaged,[53] and (2) treat a sale of an interest in a partnership as a sale of the partner's share of the assets of the partnership that are effectively connected, whether

[50] The partnership allocation rules of Option 2 may affect iShare structures that some publicly traded partnerships use to attract tax exempt investors – *i.e.*, the partnership allocations between the issuer of the iShares and the partners in the publicly traded partnership.

[51] A taxable mortgage pool is *per se* a corporation, under Section 7701(i), but may not be publicly-traded.

[52] New Section 711(b) provides for a passthrough of the character of items but this may fall short of attributing the activities of the corporation to its owners.

[53] Section 875(1).

because of FIRPTA or otherwise.[54] The Ways and Means Committee release lists the treatment of foreign owners as a so-far-"unaddressed" issue. It would be odd, however, if the rules differed for a passthrough corporation and a passthrough partnership, and aligning the rules would offer an opportunity to achieve parity between foreign partners and foreign shareholders by, for example, making the withholding tax a definitive tax.

b. Tax exempt owners. If there are tax exempt owners of a passthrough, it seems clear that the new passthrough rules would extend the tax on unrelated business taxable income to shareholders of a passthrough corporation, whether the income results from debt-financed income that would otherwise be excluded by the Section 512(b) "modifications" or from the other operations of the passthrough.[55] This is, of course, the rule that now applies to partnerships. The Ways and Means Committee release asks whether the withholding tax should be applied to "tax-indifferent owners, such as pension funds" -- it would seem that it should (although possibly in a modified form), so long as there is a tax on unrelated business taxable income.

    i. ESOPs, etc. The special rules in Sections 512(c) and 512(e) that apply to tax exempt and ESOP shareholders of an S corporation may no longer apply, which will be an important issue for S corporations with ESOP shareholders – and there is an active ESOP lobby.[56] The effect of Section 512(e) is to eliminate any current tax on an ESOP shareholder's share of the income of an S

[54] Rev. Rul. 91-32, which would be codified by the Administration's fiscal 2014 budget proposals. *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013) at 57.

[55] Using the analysis of Rev. Rul. 74-197.

[56] *See, e.g.,* Comments submitted by The ESOP Association to the House Ways and Means Committee pension/retirement tax reform task force, Tax Notes Today, April 2, 2013; and S. 742, the Promotion and Expansion of Private Employee Ownership Act (April 17, 3013), supported by the Employee-Owned S Corporations of America.

corporation – that is, to defer any tax until there are distributions by the ESOP.

16. What's Left Out? There have been from time to time other proposals to change specific Subchapter K rules that are not included in Option 2, such as to repeal or modify the technical termination rule in Section 708(b)(1),[57] to eliminate the anti-abuse regulations and to take a consistent approach to the aggregate-or-entity issue,[58] to make more inclusive the "investment company" definition in Section 721(b),[59] and to accommodate some of the problems faced by publicly-traded partnerships covered by the "good" income exception in Section 7704(c) (such as the determination of distributive shares when interests are regularly purchased and sold and the treatment of interests in a publicly-traded partnership as "securities" for purposes of Section 1058). Nor does Option 2 does address the hot-button issue of carried interests and, since subchapter K is the starting point for new Subchapter K, it might be interpreted as expanding the issue to include interests in passthrough corporations.[60]

17. Other questions. Option 2 leaves open a large number of questions, apart from those mentioned above, such as the application of the partnership anti-abuse rules and the circumstances in which a partnership will be treated as an entity or an aggregate – without more, it would be logical to assume these rules now apply to passthrough corporations. It also leaves open a number of matters not as such addressed by subchapters K or S, other than those mentioned above, including

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[57] *E.g.,* Monte A. Jackel, *supra* note 7; JCX-6-97 at 40. This would be repealed by the Administration's fiscal 2014 budget proposals. *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013) at 231.

[58] Id.

[59] See NYSBA Tax Section, Report No. 1252, Report on Investment Company Provisions: Sections 351(e) and 368(a)(2)(F) (December 28, 2011).

[60] This is addressed by the Administration's fiscal 2014 budget. *See* Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013) at 159.

a. Employment Taxes and Related Matters. The different treatment of partnerships and corporations under SECA and FICA,[61] and for purposes of provisions such as Section 469 or 1411, are not addressed. The SECA/FICA divergence is noted in the Technical Explanation and listed as a so-far-"unaddressed" issue in the related Ways and Means Committee release. If there is a single passthrough system for Federal income tax purposes, it would certainly be odd to have two rules for Federal employment tax purposes -- that is, FICA for corporations and SECA for partnerships. And the Ways and Means Committee release that accompanied the draft seems to acknowledge this when it says (emphasis added) that Option 2 "requires *new* rules for the employment and self-employment taxes of owners." This could, of course, be a major issue for S corporations since they are perceived as offering the opportunity to limit the FICA base.

    1. Limited partner exclusion. Absent new rules, because of the draft's repeal of the guaranteed payment rule, the exception to the Section 1402(a)(13) exclusion for limited partners will, under the draft, be for payments made to an owner for services rendered by the owner in a non-owner capacity. The Section 1402(a)(13) exclusion from the SECA base will otherwise remain, and the draft is also clear that an owner may be an employee of a passthrough partnership and thus earn "wages" subject to FICA.[62]

b. Foreign Operations. The discussion draft does not address the disparity in the treatment of foreign income that will result if (as the Ways and Means Committee has previously proposed) active foreign income of a C

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[61] Since Section 706(c) is repealed, the reference to guaranteed payments in Section 707(c) would be replaced by a reference to Section 707(a) payments for services actually rendered to the passthrough other than in the owner's capacity as an owner.

[62] *See* the Ways and Means Committee release ("Provide certainty with respect to owners who actively participate in the business by allowing owners to be treated as employees of the business.")

corporation's foreign subsidiaries is eligible for a 95% dividends received deduction – no dividends received deduction would be allowed to a passthrough.[63] This is a difficult issue since, if dividends to shareholders of a C corporation are taxed at capital gains rates, the effective U.S. tax on foreign earnings may be significantly less for a C corporation than for a passthrough, although that will of course depend on what happens to individual and corporate tax rates (and does not consider foreign taxes). The Ways and Means Committee release lists the taxation of foreign operations as a so-far-"unaddressed" issue.

c. Tax treaties. Treating US corporations as passthroughs is consistent with the right of the US to use its definitions in applying US tax treaties; and, in the case of inward investment, more recent US treaties (and, in any event, Section 894) apply uniform rules to fiscally transparent entities, whether incorporated or not.

d. State and local income taxes. Many states (including New York) have specific rules for S corporations (which sometimes include entity level taxes) and partnerships; and, if there is to be parity between non-publicly traded corporations and partnerships for State and local tax purposes, these rules would have to be conformed to new Subchapter K. In any event, the terms used in many state and local tax statutes (*e.g.*, references to S corporations) would have to be changed.

18. Conclusion. Subchapter S was enacted in 1958 in order to allow a "small" business owner to achieve limited liability by incorporating but without incurring corporate tax on the corporation's income. Limited liability companies have since eliminated the need for Subchapter S. The only non-tax difference today between an S corporation and a limited liability company is that one is incorporated and the other is not; but that difference, while unimportant as a practical matter, results in significant Federal income and payroll tax differences because of the different rules that apply to S corporations and partnerships.

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[63] Ways and Means Committee International Tax Reform Discussion Draft (October 26, 2011).

a. Is Option 2 the solution?
b. Would it also level the playing field, *i.e.*, address the problems of small businesses caught in subchapter C?
c. Or, because it does not involve the complexity of addressing so many issues, would Option 1 be a better choice?

Option 1

These changes made to partnership taxation by Option 1 (and which are also included in Option 2) are

1. Guaranteed payments. On the basis that Section 707(a), relating to payments to partners not acting in that capacity, is sufficient, repealing Section 707(c), relating to guaranteed payments for services or the use of capital (because it has "created a great deal of uncertainty, confusion, and controversy").[64] Payments would simply be distributions to a partner unless covered by Section 707(a).
2. Mandatory adjustment to partnership property basis. Eliminating the elections in Sections 734 and 743, so that an adjustment to the basis of partnership property to reflect a sale of a partnership interest by a partner or the distribution of property by a partnership is mandatory, not elective or dependent on the built-in loss in partnership property after the distribution being "substantial";[65] and applying these rules to tiered partnerships. [66]
3. Eliminate time restrictions on mixing bowl provisions. Eliminating the 7 year restrictions on the "mixing bowl" rules (*i.e.*, the 7 year restrictions in Sections 704(c)(1)(B) and 737(b)(1)) on the allocation of pre-contribution gain or loss of property when the contributed property is distributed to another partner or other property is distributed to the contributing partner.
4. Hot asset rules. Broadening the "hot asset" rule in Section 751 so that it treats a distribution of inventory to a partner as a sale, whether or not the inventory has appreciated "substantially" and simplifying the

[64] See JCX-6-97 at 45.

[65] See JCX-6-97 at 27.

[66] See JCX-6-97 at 42.

definition of an "unrealized receivable" so that it includes any property to the extent of the amount that would be ordinary income on a sale. [67]

5. Deceased or retired partners. Repealing, as "obsolete," Sections 736 and 753, relating to payments in the liquidation of a retiring or deceased partner's interest and the treatment as income in respect of a decedent of amounts received as a successor in interest to a deceased partner.
6. Limiting a partner's loss. Extending the rule that limits a partner's loss to the partner's basis in the partnership interest to deductions for charitable deductions and foreign taxes taken as a deduction (which is the rule that applies to shareholders of an S corporation).

[67] See JCX-6-97 at 43.

Chairman TIBERI. Mr. Rubin, you are recognized for 5 minutes.

STATEMENT OF BLAKE RUBIN, PARTNER, MCDERMOTT WILL & EMERY

Mr. RUBIN. Thank you. Chairman Tiberi, Ranking Member Neal and distinguished Members of the Subcommittee, thank you for the opportunity to testify today. My name is Blake Rubin, and I am global vice chair of the U.S. and International Tax Practice at

McDermott, Will & Emery, a law firm of approximately 1,100 lawyers.

I support the effort to reform the Internal Revenue Code and also applaud the committee for the robust and transparent process that it is following. I also congratulate the committee leadership and staff for producing a detailed and thoughtful set of options.

I will focus my comments primarily on the proposed changes to the taxation of partnerships. I support most of the changes in option one. As detailed in my written statement, however, I believe that three of the changes in option one are unwarranted: eliminating the 7-year period for application of the so-called partnership anti-mixing bowl rules, making upward basis adjustments in the context of partnership interest transfers and distributions mandatory, and eliminating the substantial appreciation requirement in the partnership hot asset rules.

Option two proposes much more sweeping changes, merging the current tax regimes for partnerships and S Corporations. This is an approach that has been proposed by some academic commentators primarily for reasons of simplicity. There is no denying the conceptual appeal of a single unified regime for pass-through entities. If one were designing a tax system from scratch rather than reforming a tax system that is now 100 years old, a single unified regime might well be the way to go. Given where we are today, however, I believe that option two would significantly increase complexity, upset settled expectations of taxpayers and cause substantial economic dislocations.

Current law provides taxpayers with a choice. Businesses that want a relatively simple pass-through regime and can tolerate a certain amount inflexibility can operate as S Corporations. Other businesses need greater flexibility, perhaps because debt is a bigger part of their capital structure, or because they anticipate the need to distribute property in kind, or they want a more complicated economic sharing arrangement. For those businesses, the partnership tax rules provide the needed flexibility to operate without incurring an entity level tax, but at the cost of greater complexity and compliance burdens.

Option two would eliminate this choice. Worse, it would do so by creating a single unified regime that effectively combines the complexity of the current partnership regime with the inflexibility of the current S Corporation regime.

Many of the provisions of the current partnership tax regime that create the greatest complexity are retained and even expanded in option two. At the same time, option two imports inflexibility from the S Corporation regime by restricting the ability to effectuate complex economic sharing arrangements and triggering gain on distributions of property in kind, even though the taxpayer receives no cash.

I would like to briefly address two of the most significant changes proposed by option two. The first is the three-basket rule under which an owner is restricted to a single percentage share of all items in each of three baskets: ordinary income items, capital gain items and tax credit. The summary states that the reason for this rule is to reduce the use of complex structures to engage in tax avoidance.

I believe that the existing regulations governing allocations of partnership income and loss adequately police this area. I also believe that this change would create unwarranted restrictions on the ability of taxpayers to effectuate non-abusive commercial arrangements. For example, as detailed in my written statement, it is not clear that one pass-through owner could have a common interest akin to common stock and another, a preferred interest akin to preferred stock, because of the requirement that items of profit and loss in each basket be allocated in the same percentage.

The second change I would like to focus specifically on is the recognition of gain on the distribution of appreciated property. This is, of course, the current rule in the context of corporations, including S Corporations, but extending that rule to partnerships would undeniably result in the taxation of non-economic gains in many cases. To take an example, assume a partner has a 50 percent interest in a partnership that has property with a $200 value and a zero tax basis. The partner's interest is worth $100 and has a zero tax basis. The partnership distributes property worth $50, also with a zero tax basis, to the partner in redemption of his interest. Under option two, the partnership recognizes $50 of gain on the distribution and the distributee partner recognizes an additional $25 of gain on the distribution.

So a distribution of property with a zero tax basis and $50 of value triggers not $50 of gain, but instead $75 of taxable gain. In this and many other common transactions, option two would create taxable gain that exceeds actual economic gain.

I thank you again for the opportunity to present my views today and commend the committee leadership and staff for advancing the debate in this area. I look forward to answering your questions now and in the future.

Chairman TIBERI. Thank you, Mr. Rubin.

[The prepared statement of Mr. Rubin follows:]

Testimony Before the

Subcommittee on Select Revenue Measures

Committee on Ways and Means

United States House of Representatives

Blake D. Rubin

May 15, 2013

Introduction

Chairman Tiberi, Ranking Member Neal, and distinguished Members of the Subcommittee, thank you for the opportunity to testify today regarding the recently released Ways and Means Committee Discussion Draft on the Reform of the Taxation of Small Businesses and Passthrough Entities (the "Discussion Draft").

My name is Blake Rubin, and I am Global Vice-Chair of the U.S. & International Tax Practice at McDermott Will & Emery LLP. McDermott is a law firm of approximately 1100 lawyers with 18 offices in the United States, Europe and Asia. I have been a practicing tax lawyer for 33 years. Early in my career, I worked at the U.S. Treasury Department Office of Tax Policy, where I worked on the Tax Reform Act of 1986 and the Treasury Department proposals that preceded it. Apart from that, I have worked in the private sector, and have spent a substantial portion of my time working with the tax rules affecting passthrough entities. The views I express here today are my own and do not necessarily represent the views of McDermott or any of its clients.

General Observations

I would like to start by saying that I support the effort to reform the Internal Revenue Code to make it simpler and more rational, and to lower tax rates and broaden the base. I also applaud the Committee for the robust and transparent process that it is following in developing a tax reform bill, including working groups, hearings, discussion drafts and substantial stakeholder input. Finally, I congratulate the Committee leadership and staff for producing a detailed and thoughtful set of options in a difficult and important area of the tax law.

I will focus my comments primarily on the proposed changes to the taxation of partnerships.

Option One

Option 1 sets forth proposed targeted changes to the existing partnership tax rules. I believe that many of the changes to the taxation of partnerships proposed in Option 1 of the Discussion Draft

will help simplify and rationalize the partnership tax rules and should be enacted. Specifically, I believe that the proposed repeal of the guaranteed payment rule of section 707(c) and the rules relating to the liquidation of a retiring or deceased partner's interest in sections 736 and 753 are sensible changes that further the goal of simplification. Indeed, I would go a step further and adopt the proposed change from Option 2 that would overrule the IRS's position in Revenue Ruling 69-184[1] and allow a partner to be treated as an employee of the partnership for withholding, FICA and FUTA tax purposes.

I also believe, however, that some of the proposed changes are not warranted because they will add additional complexity in many cases where the existing rules serve their intended purpose. I focus on these changes below.

- **Mandatory Adjustments to Basis of Partnership Property (Secs. 242 and 243 of the Discussion Draft and Secs. 734 and 743 of the Code)**

Sections 242 and 243 of Option 1 would require adjustments to the tax basis of partnership property under sections 734(b) and 743(b) for all partnership distributions and transfers of partnership interests regardless of whether the partnership makes an election under section 754 to adjust the basis of its property under these provisions. The Summary accompanying the release of the Discussion Draft states that the intended purpose of this provision is to prevent abuses that occur when (1) property distributions shift the character of gains and losses among partners, and (2) acquisitions result in the duplication of gains or losses.[2] I believe that current law satisfies these goals while avoiding the unwarranted imposition of significant complexity and expense on partners and partnerships that choose not to take advantage of a step-up in the basis of partnership property. As a result, I do not think that the proposed changes to sections 734(b) and 743(b) should be enacted.

Prior to 2004, in some cases, the failure to make a section 754 election could have resulted in the duplication of a loss recognized by a distributee partner or a transferor partner because a corresponding downward adjustment would not be made to the tax basis of the partnership's remaining property. In order to prevent this potential abuse, the American Jobs Creation Act of 2004 (the "Jobs Act") generally provided for mandatory downward basis adjustments to partnership property in cases where the potential basis adjustment would exceed $250,000 regardless of whether the partnership makes an election under section 754.

A section 734(b) or section 743(b) adjustment to partnership property can impose a substantial administrative burden and expense on a partnership, particularly a partnership that holds many assets. In order to implement the adjustment, the partnership must value its property, allocate the adjustment and keep track of the adjustment in future years in order to compute the depreciation, amortization and gain or loss on disposition of its assets. As a result, in a significant number of cases, a partnership will decline to make a section 754 election and forgo the benefit of a positive basis adjustment because of this administrative burden and expense. This is particularly true when the adjustment is small or would benefit only a minority of the partners. The $250,000

[1] 1969-1 C.B. 256.

[2] *See* http://waysandmeans.house.gov/uploadedfiles/small_biz_summary_description_03_12_13_final.pdf (hereinafter the "Summary").

threshold for mandatory downward basis adjustments provided in the Jobs Act acknowledges this burden and prevents the imposition of a mandatory basis adjustment in cases where the adjustment would be small. In addition, by not requiring a positive basis adjustment to partnership property, the Jobs Act maintained the flexibility to forgo such a positive adjustment if it is determined that the associated complexity is not commensurate with the benefit.

Because the mandatory downward basis adjustment under existing law already addresses the potential for abuse that could result from the failure to make a section 754 election, the burden that would be imposed on partnerships by the proposed imposition of basis adjustments in all cases is unwarranted and would result in more complexity for partnerships than exists under current law.

- **Revisions Related to Unrealized Receivables and Inventory Items (Sec. 246 of the Discussion Draft and Sec. 751 of the Code)**

Section 246 of Option 1 would eliminate the requirement that inventory items be substantially appreciated in order for such items to be subject to section 751(b).

Section 751(b) is intended to prevent a partner from in effect exchanging a share of ordinary income property held by the partnership for a share of capital gain property held by the partnership, or vice versa. To achieve this goal, if a partner receives a disproportionate distribution of capital gain or ordinary income property, section 751(b) creates a dizzyingly complex constructive exchange of assets between the distributee partner and the partnership, potentially triggering gain or loss for both the distributee partner and the partnership. There are many uncertainties regarding exactly how the provision applies in particular fact patterns, and it is widely acknowledged that the existing regulations are seriously flawed. In 2006, the IRS itself acknowledged the serious problems in the section 751(b) regulations in Notice 2006-14, which proposed various alternative approaches that might be taken in revised regulations and solicited public comments. Seven years later, the IRS is continuing to work on new regulations under section 751(b).

The saving grace under current law is the requirement that "inventory items" (which are broadly defined to include all ordinary income property) be "substantially appreciated" in order for section 751(b) to apply. For this purpose, "substantially appreciated" means that the inventory items have value in excess of 120 percent of adjusted tax basis. The proposed elimination of this requirement would dramatically expand the number of transactions that would be subject to this burdensome provision.

I have sometimes heard elimination of the substantial appreciation requirement in section 751(b) advocated on grounds of simplicity, because it would conform the section 751(b) rule to the section 751(a) rule. Section 751(a) generally treats gain or loss on the sale of a partnership interest as ordinary to the extent it is attributable to ordinary income property held by the partnership. Until 1997, section 751(a), like current section 751(b), applied only to a partnership's inventory items were substantially appreciated. In 1997, section 751(a), but not section 751(b), was amended to eliminate the substantial appreciation requirement. Section 751(a) is a much simpler rule in both theory and application than section 751(b), and the elimination of the "substantial appreciation" requirement in that context has not created any

particular compliance issues. Repealing the substantial appreciation requirement in the context of section 751(b), however, would require application of this enormously complex provision to every distribution of property or cash by a partnership, greatly expanding its scope.

In addition, there are many cases where the application of this complex rule is simply not justified from the government's perspective. For example, if a partnership has only C corporation partners, the abuse that section 751(b) is targeting is not at issue because there is no rate differential between ordinary income and capital gain for C corporations. Similarly, to the extent all of the partners of a partnership are individuals with similar tax profiles, the partners have no incentive to shift ordinary income and capital gains among themselves, and any such shift will not reduce the aggregate amount of taxes collected from the partners. In order to avoid subjecting taxpayers to the complexity of section 751(b), I believe the provision should be amended so that it applies only when there is a likelihood that a disproportionate distribution of ordinary income or capital gain property will result in an aggregate reduction in tax liability among all of the partners.

- **Repeal of Time Limitation on Taxing Precontribution Gain (Sec. 247 of the Discussion Draft and Secs. 704(c) and 737 of the Code)**

Section 247 of Option 1 would eliminate the seven-year period for the application of section 704(c)(1)(B) and section 737, the so-called "anti-mixing bowl rules," with respect to built-in gain property contributed to a partnership. I believe this change should not be enacted because the current rules adequately police the abuse that the anti-mixing bowl rules are intended to address.

Currently, under the anti-mixing bowl rules, if a partner contributes built-in gain property to a partnership, such property is deemed to be sold and the built-in gain is recognized if such partner receives a distribution of other property from the partnership, or the contributed property is distributed to another partner, within seven-years of the contribution. Prior to June, 1997, the anti-mixing bowl rules applied for the five-year period following the contribution of built-in gain property to a partnership.

The anti-mixing bowl rules are intended to prevent a property owner from avoiding the recognition of gain by exchanging the property for other property through a partnership where the exchange could not otherwise qualify for non-recognition treatment. The current seven-year post-contribution period for the application of the anti-mixing bowl rules achieves this goal. In my experience, property owners simply do not structure contributions to partnerships with the intent to exchange that property for different property seven years later. In addition, a permanent application of the anti-mixing bowl rules would impose a significant burden on partnerships because they would be required to track the acquisition history of all of their property and analyze the potential application and consequences of the anti-mixing bowl rules whenever a property distribution is contemplated.

Option Two

Option 2 provides a single unified set of rules for "passthrough corporations" and partnerships, in effect merging the current law tax regimes for partnerships and S corporations. This is an

approach that has been championed by a number of academic commentators over the years, primarily for reasons of simplicity. There is no denying the conceptual appeal of a single unified regime for passthrough entities, and if one were designing a tax system from scratch rather than reforming a tax system that is now 100 years old, a single unified regime might well be the way to go. Given where we are today, however, I believe that Option 2 would significantly increase complexity, upset settled expectations of taxpayers and cause substantial economic dislocations.

Under current law, businesses that want a relatively simple passthrough regime and that wish to avoid the complexity of partnership capital accounts, basis adjustments, the inclusion of debt in the basis of the ownership interest, "hot assets" and the like can operate as S corporations. In the main, the S corporation rules allow businesses to operate without incurring an entity level tax and without a great deal of complexity – but without the flexibility that the partnership regime provides.

Other businesses need greater flexibility – perhaps because debt is a bigger part of their capital structure and it is important to have it included in the basis of the ownership interest, perhaps because the owners want a more complicated economic sharing arrangement such as different classes of ownership interests, perhaps because they anticipate the need to distribute property in kind, perhaps because they foresee transfers or redemptions of ownership interests. For those businesses, the partnership tax regime provides the needed flexibility and allows them to operate without incurring an entity level tax – but at the cost of greater complexity and compliance burdens.

Option 2 would eliminate this choice. Worse, it would do so by creating a single unified regime that effectively combines the complexity of the current partnership regime with the inflexibility of the current S corporation regime. Thus, businesses currently operating happily as S corporations would have to master the complexity of capital accounts, mandatory basis adjustments, the inclusion of debt in the basis of the ownership interest, "hot assets" and the like. Businesses currently taxable as partnerships would continue to have to deal with the complexity occasioned by those provisions but would have reduced flexibility: distributions of property in kind would trigger taxable gain without receipt of cash, and significant restrictions would be placed on the ability to effectuate complex economic sharing arrangements. In many respects, from the practitioner and taxpayer perspective, Option 2 seems to combine the worst of both regimes.

I also believe that any simplification benefit from Option 2 is illusory. As noted above, many of the provisions of the current partnership tax regime that create the greatest complexity are retained and even expanded, including the need to maintain and adjust capital accounts, mandatory basis adjustments, the inclusion of debt in the basis of the ownership interest, allocations with respect to contributed property, the "anti-mixing bowl" rules and rules relating to "hot assets." Moreover, if the policy choice in Option 2 to trigger gain on the distribution of appreciated property is adopted, a complex set of reorganization provisions will need to be

developed and added to Option 2 to allow tax-free mergers, divisions, subsidiary liquidations and the like.[3] This will add further to the complexity, as will the need for significant transition rules.

I would now like to address some of the most significant changes proposed by Option 2.

- **Pass-thru of Items to Owners (Sec. 231 of the Discussion Draft and New Sec. 711 of the Code)**

The Summary suggests that the reason for the proposed rule is to "reduce the use of complex structures to engage in tax avoidance." As I understand the provision, most of the principles of current section 704(b) and the regulations thereunder would be retained, with an additional restriction overlaid that would require that the passthrough owner's distributive share of items in each of the three "baskets" be the same as its share of other items in the same "basket" for the taxable year. I believe that the existing regulations under section 704(b) adequately police this area, and that this change would create unwarranted restrictions on the ability of taxpayers to effectuate non-abusive commercial arrangements.

It appears that the "three basket" restriction is intended to disallow changes in the percentage interest from year to year. Thus, in theory, an owner could be allocated 20% of all items in Year 1 and 50% of all items in Year 2.

However, it may be difficult to effectuate such an economic sharing arrangement under Option 2 if the increase in percentage interest is not attributable to an additional capital contribution that increases the partner's interest in capital to 50%. For example, assume Partner A contributes 20% of capital and receives 20% of all profits and losses until Partner B receives a specified return on capital, at which point Partner A's interest in all profits "promotes" to 50%. Assume the "promote" is a "carried interest" attributable to the performance of services. Regardless of one's view on whether carried interest ought to be taxed as ordinary income or capital gain, my point here is that it will be difficult to effectuate this economic deal under the new regime. That is because under existing partnership tax allocation principles that presumably would carry over under the Option 2 regime, Partner A generally cannot be allocated more than 20% of the losses after the "flip," but is supposed to be allocated 50% of profits. That apparently would violate the requirement that items of profit *and loss* in each basket be allocated in the same percentage. In order to validate the 50% allocation of profit, Partner A would have to be allocated 50% of losses, which would require a "capital account deficit restoration obligation" and would expose Partner A to additional economic risk.

To take an even simpler case, assume a key employee of a partnership is granted a 1% profits interest in exchange for services. Again, putting aside the carried interest debate regarding whether the service partner should have ordinary income or capital gain from the interest, it appears that the economic arrangement cannot even be effectuated under Option 2 unless the service partner is willing to fund 1% of potential losses through the mechanism of a deficit restoration obligation.

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[3] The Committee acknowledged the need for reorganization rules in the Summary at page 7

Another possible unintended consequence relates to real estate partnerships. It is reasonably common in real estate partnerships to have special allocations of depreciation deductions that are in a different percentage than other ordinary items. The existing regulations under section 704(b) allow and even facilitate such allocations, which presumably are viewed as non-abusive. This kind of allocation would be prohibited under Option 2.

- **Extent of Gain or Loss on Distribution (Sec. 231 of the Discussion Draft and New Sec. 731 of the Code)**

Certainly, this would be a sea change in the taxation of partnerships. The recognition of gain on the distribution of appreciated property is, of course, the current rule in the corporate context, including for S corporations. I believe, however, that the rule makes more sense in the context of enforcing a double tax regime for C corporations than it does in the passthrough context. I believe it should not be extended to partnerships.

In the partnership context, distributions of property have historically been treated as a "mere change in form" rather than as an occasion to impose tax. Part of the rationale for this treatment is that the distribution of property does not result in the receipt of any cash with which to pay tax on the gain. That rationale is as valid today as it was when the partnership tax rules were enacted in 1954.

One can, perhaps, legitimately debate whether a distribution of property is an appropriate occasion on which to impose a tax. However, it is beyond debate that in many cases, the Option 2 approach will result in the taxation of non-economic gains.

To illustrate, assume that Partner C is a 50% partner in a partnership that has property with a $200 value and a $0 adjusted tax basis. Partner C has a $0 adjusted tax basis in his interest, and it is worth $100. The partnership distributes property with a $50 value and $0 adjusted tax basis to Partner C in redemption of half his interest. Under the provision, the partnership recognizes $50 of gain on the distribution, of which $25 is allocated to Partner C, increasing the adjusted tax basis of his interest to $25. Partner C recognizes an additional $25 of gain on the distribution (the excess of the $50 value of the distributed property over Partner C's adjusted tax basis in the interest of $25). Thus, a distribution of property with a $0 adjusted tax basis and $50 value triggers $75 of taxable gain. C and his partners have to pay tax on $25 of noneconomic gain.

In addition, the most mundane partnership restructuring transactions would generate gain without receipt of cash. For example, assume the DE Partnership owns a 99% interest in the FG Partnership. In order to reduce the number of tax returns required to be filed, DE Partnership liquidates and distributes out the 99% interest in FG Partnership. Gain is recognized at both the DE Partnership level and by D and E. Alternatively, assume that the DE Partnership causes the FG Partnership to liquidate and distribute 99% of its assets and liabilities to the DE Partnership. Gain is recognized at the FG Partnership level and at the DE Partnership level.

Similarly, under existing principles, a merger of Partnership HI into Partnership JK is generally treated as an "assets over" transfer of HI's assets into JK in exchange for an interest in JK, followed by a distribution of the JK interest in liquidation of HI. Again, gain will be recognized at the HI level and then by H and I. Likewise, a "division" of a partnership (the partnership

analogue of a corporate spin-off) will involve a distribution of appreciated property and gain recognition. As noted above, the Summary acknowledges the need for reorganization rules, but the difficulty of crafting them and their complexity should not be underestimated.

- **Adjustments to Basis of Undistributed Property (Sec. 231 of the Discussion Draft and New Secs. 734 and 743 of the Code)**

For the reasons discussed above in the context of Option 1, I do not think that the proposed changes to sections 734(b) and 743(b) should be enacted.

- **Unrealized Receivables and Inventory Items (Sec. 231 of the Discussion Draft and New Sec. 751 of the Code)**

For the reasons discussed above in the context of Option 1, I do not think that the proposed elimination of the substantial appreciation requirement in section 751(b) should be enacted. Indeed, taking into account the proposal in Option 2 to trigger gain on the distribution of appreciated property, the expansion of section 751(b) is even more unwarranted.

- **Withholding on Distributive Share of Passthrough Income (Sec. 231 of the Discussion Draft and New Secs. 33A and 3411 of the Code)**

Although styled as a "withholding tax," the provision as described does not require withholding on distributions to owners, but rather requires payment of tax at the passthrough level coupled with a credit on the owner's return for the tax paid by the entity. In that respect, it appears similar to the regime under section 1446, which requires payment by the partnership of tax on income attributable to a foreign partner, together with a credit allowable to the foreign partner.

It appears that the tax payment required from the passthrough would be based on a uniform percentage of the amount allocable to the owner, possibly taking into account any applicable rate differential between capital gains and ordinary income. Any separate tax attributes of the owner apparently would not be taken into account.

The provision is presumably intended to ensure that passthrough owners report their distributive share of income. As described, the provision would require tax-exempt charities and pension funds that invest in passthroughs to file income tax returns in order to obtain refunds of the tax paid at the entity level. A similar issue would arise with respect to RICs and REITs, which typically do not pay Federal income tax because of the dividends paid deduction that they receive. Moreover, taxpayers with other tax attributes that offset passthrough income would be subject to "withholding" and would be required to wait until after the end of the tax year to receive a benefit from the credit. While certification procedures similar to those contained in the current regulations under section 1446 could be developed to address these issues, those procedures would likely be complex and not entirely efficient.

The withholding requirement is particularly problematic when viewed in conjunction with the Option 2 proposal to trigger tax on the distribution of appreciated property. Taking into account both provisions, the passthrough would incur an obligation to pay tax on behalf of its owners as a

result of the distribution in kind, but would have no cash proceeds from the transaction with which to do so.

An alternative to the proposed withholding regime that would ensure that passthrough owners report their distributive share of income is matching by the IRS of Schedule K-1 filed by the passthrough with respect to each owner with the tax reporting at the owner level. It is not self-evident why a Schedule K-1 matching program could not be implemented, and of course such document matching has been extremely effective in ensuring reporting of interest income and other items reflected on IRS Form 1099.

Transition Rules Under Option 2

Given the sweeping changes proposed in Option 2, transition rules will be extremely important if Option 2 is adopted. Many existing partnerships have contractual restrictions on their operations including restrictions on investment types, time horizons and the like. These partnerships and contractual restrictions were structured with certain legitimate expectations regarding current law, for example assuming the continued ability to distribute assets or liquidate in kind without triggering taxable gain. The fairest transition rule would be to permanently grandfather existing partnerships from at least the most far-reaching changes in Option 2, such as the restrictions on allocations and the recognition of gain on distributions of property. Of course, the need to have the Option 2 regime operating side-by-side with existing law for grandfathered entities for an extended period of time would further undermine the goal of simplifying the tax rules in this area.

Conclusion

I thank you again for the opportunity to present my views on this important subject, and I again commend Committee leadership and staff for advancing the debate in this area. While I have offered much constructive criticism in this testimony, I would like to reiterate my appreciation and respect for the impressive work that the Discussion Draft represents. I would be pleased to answer any questions you may have at this time or in the future.

Chairman TIBERI. Mr. Nichols, you are recognized for 5 minutes.

STATEMENT OF THOMAS NICHOLS, MEISSNER TIERNEY FISHER & NICHOLS

Mr. NICHOLS. Chairman Tiberi, Ranking Member Neal and other members, thank you very much for the opportunity to testify today.

I have been representing closely held businesses ever since I began practicing tax and business law in 1979. I have been a member since 1986, and am a past chair of the ABA Tax Sections Committee on S Corporations and am currently chairman of the Board of Advisors of the S Corporation Association.

The views expressed today are informed by and benefit from all of these relationships. I will focus my comments primarily, though, on S Corporations.

Let me begin by saying that I sincerely appreciate your ongoing bipartisan efforts to enact genuine tax reform. Seeking public comment on discussion drafts takes substantially more time and effort, but this more open and transparent process is much more likely to result in a long-lasting consensus on tax policy that will truly benefit our economy.

Chairman Camp has identified several fundamental principles to help shape the course of tax reform, namely leveling the playing field for all U.S. employers, while at the same time ensuring that low income and middle income Americans pay no more in taxes than they do today. In this regard, the bipartisan Tax Reform Act of 1986 stands out as an excellent template. It expanded the tax base by eliminating numerous preferences and privileges, thereby creating room to dramatically decrease tax rates for C Corporations, pass-through businesses and individuals alike.

As others have noted, the discussion draft before us today has three principle components: a more limited option one to address limitations of the existing S Corporation and partnership rules, a more aggressive option two that would replace the existing S Corporation and partnership rules with a new uniform set of rules; and finally, a set of core provisions that would apply to either option.

I will begin with the core provisions and work from there. Generally speaking, the core provisions, such as establishing a higher permanent threshold for expensing equipment, are reforms that have been considered and vetted for years and should be included in any tax reform effort.

One core provision that might not fit that description is the proposed mandatory use of accrual method for businesses with gross receipts of more than $10 million.

S Corporations and partnerships that don't have C Corporation partners are currently entitled to use cash basis accounting. This makes sense, because closely held businesses do not have access to the public markets to monetize illiquid assets on their balance sheets, so requiring them to pay tax on income they have not yet collected could create cash flow challenges where none exists today.

For S Corporations, option one includes many provisions contained in the bipartisan S Corporation Modernization Act, introduced by Congressman Reichert and Kind, which are consistent with the goals of tax reform stated above.

The discussion draft would make permanent the shorter 5-year built-in gains tax recognition period. The built-in gains tax was initially intended to prevent C Corporations from electing S status simply to avoid double tax in connection with the sale of a business, but a 10-year period is much longer than necessary. Five years is much more appropriate.

Other positive provisions in option one relate to the passive investment income tax, electing small business trusts, and charitable contributions.

From the S Corporation perspective, option two would establish a better line of demarcation between pass-through businesses and those subject to the corporate tax, namely whether a business has chosen to access the capital markets and public ownership, and would bring this demarcation in line with the corresponding cut-off for partnerships.

Updating the current limitations on types of shareholders eligible for S Corporation ownership as contemplated by option two also makes real sense.

My basic concern with option two is that it would take two significantly different business structures, the simple and easily administered S Corporation structure, and the more flexible but also more complicated partnership rules, in attempts to meld them under a single unified regime.

The details of option two are well thought out, but I am concerned that the benefit of a single unified regime may not be worth the cost. Option two would add additional complexity to existing partnership rules and then apply them to S Corporations. This means imposing new rules and compliance burdens on the more than 4.5 million S Corporations in existence today.

As for new entities, S Corporation status is the most popular tax entity choice today, thus eliminating this structure could impede business formation. A better approach might be to take the positive reforms included in option two and combine them with the more modest ambitions of option one.

Once again, I would like to thank Chairman Tiberi and the ranking member for inviting me to testify. I look forward to questions.

[The prepared statement of Mr. Nichols follows:]

TESTIMONY BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES

COMMITTEE ON WAYS & MEANS UNITED STATES HOUSE OF REPRESENTATIVES

Thomas J. Nichols, J.D., CPA[1]
May 15, 2013

Chairman Tiberi, Ranking Member Neal and other members of the Subcommittee on Select Revenue Measures, thank you very much for the opportunity to testify today regarding the Small Business and Pass-Through Entity Tax Reform Discussion Draft (the "Discussion Draft").

I have been representing closely held businesses ever since I began practicing tax and business law in 1979. I have been a member (and a past Chair) of the ABA Tax Section's Committee on S Corporations since 1986 and am currently Chairman of the Board of Advisors of the S Corporation Association. The views expressed today are informed by and benefit from all of those business and professional relationships. Although in my practice I have represented all forms of closely held business entities, I understand that there are other witnesses here today with specific expertise in the partnership and C corporation areas. Therefore, I will focus my comments primarily on the impact of the Discussion Draft on S corporations.

A. Overview

Let me begin by saying that I am sincerely appreciative of the ongoing bipartisan efforts of the Ways & Means Committee to enact genuine Tax Reform in this country. There is no question that preparing and seeking public comment on Discussion Drafts, such as the one we are addressing today, takes substantially more time, patience and effort than other more cloistered forms of decision-making. However, this more open and transparent process is much more likely to result in a long-lasting consensus on tax policy that will truly benefit our economy over the short and long term.

Chairmen Camp has identified three fundamental principles to help shape the course of Tax Reform, namely leveling the playing field for US employers (by lowering the top corporate tax rates and refraining from picking winners and losers within the American economy) and providing for parity for small businesses, while at the same time ensuring that low income and middle income Americans pay no more in taxes than they do under current law.

In this same spirit, I would like to reiterate the following three basic principles that have been adopted by the S Corporation Association and several dozen other national business organizations to guide the Tax Reform process:

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[1] President and Shareholder, Meissner Tierney Fisher & Nichols S.C.

1. Tax Reform needs to be comprehensive and address the individual, passthrough, and corporate tax codes at the same time;
2. Congress should continue to foster progress toward a single level tax system for all businesses; and
3. Congress should continue to strive to keep the tax rates paid by businesses and individuals as low as possible.

In this regard, the bipartisan Tax Reform Act of 1986 stands out as an excellent template for Tax Reform. It expanded the tax base by eliminating numerous preferences and privileges for specific taxpayer groups, thereby creating room to dramatically decrease the tax rates for C corporations, passthrough businesses, and individuals alike. This approach allowed many, if not most, owners and managers to get out of the tax planning business and immerse themselves in the operations of their real businesses instead. It is my hope that the current Tax Reform effort will build on the policies and lessons learned in 1986.

As others have noted, the Discussion Draft before us today has three principal components – a more limited Option 1 to address limitations of the existing S corporation and partnership rules, a more aggressive Option 2 that would replace the existing S corporation and partnership rules with a new, uniform set of rules, and, finally, a set of Core Provisions that would apply to either option.

My testimony will begin with the Core Provisions and work from there.

B. Core Provisions

Generally speaking, the Core Provisions in the Discussion Draft (Subtitle B) are reforms that have been considered and vetted for years and should be included in any Tax Reform effort. Provisions to establish permanent higher thresholds for the section 179 expensing rules (Section 211), to expand the exemption from the uniform capitalization rules (Section 214), to make uniform the treatment of organizational and startup costs (Section 215), and to integrate the compliance dates of businesses, trusts, and their shareholders and beneficiaries (Part 2) are all laudable improvements.

One Core Provision change that might not fit that description is the provision to amend the cash basis accounting rules. Sections 212 and 213 of the Discussion Draft would make several changes to the rules regarding accrual versus cash basis accounting for tax purposes. In general, they would allow all businesses (except those maintaining inventories, such as manufacturers and retailers) with gross receipts of less than $10 million (an increase from $5 million) to utilize the cash basis method of accounting for tax purposes.

However, they would expand the application of the mandatory accrual provisions to S corporations and all partnerships (not just partnerships with C corporations as partners), as well as eliminate exceptions for farming businesses and qualified personal service corporations with gross receipts in excess of the preferred amount. The net effect of this change would be to limit the ability of S corporations and partnerships with receipts above the new threshold to use cash

basis accounting, something that they are currently able to do. In this regard, it is worth noting that closely held businesses do not have access to the public markets to "monetize" illiquid assets on their Balance Sheets.

In this context, it is not clear that requiring farms, S corporations, service businesses and non-C corporation partnerships to pay tax on income that they have not yet collected is necessarily consistent with the overall goals of Tax Reform.

C. Subtitle C [Option 1]

For S corporations, Option 1 in the Discussion Draft includes many provisions that are contained in the bipartisan S Corporation Modernization Act (H.R. 892) introduced by Congressmen Reichert and Kind, which are consistent with the goals of Tax Reform stated above.

Section 231 would make permanent the reduction in the built-in gains tax recognition period to five years that is currently in place through the end of calendar years 2013. The built-in gains tax was initially intended to prevent C corporations from electing S status simply to avoid double tax in connection with the sale of the business. However, as Congress has recognized in a series of amendments that were initially effective in 2009 and have been in continuous effect ever since, a ten-year period is much longer than necessary to accomplish this purpose. Very few business owners can afford to wait even 5 years after they have decided to sell their business.

Moreover, this unduly long period unnecessarily froze capital in place, because corporation owners were very reluctant to sell assets subject to the punitive built-in gains tax regime, which triggers double tax at both the corporate and shareholder levels. These tax consequences are significantly more costly than those that apply to C corporations where the proceeds are to be reinvested in the business, or to S corporations that have not previously been C corporations. In this regard, it is important to note that the gains on assets sold after the expiration of the 5-year recognition period do not escape tax. They merely get taxed once, rather than being subjected to the punitive two-tax regime.

Section 232 would increase the threshold for triggering the tax on passive investment income for S corporations from 25% to 60%. It would also eliminate the complete termination of S status for corporations exceeding that threshold for three consecutive years. The increase in the percentage to 60% would bring this threshold in line with the corresponding percentage in the C corporation personal holding company rules. This change makes sense because both the C corporation personal holding company tax and the S corporation passive investment income tax are designed to address the same issue, namely so-called "incorporated pocketbooks". Elimination of the S corporation status termination provision is also good policy that is consistent with recommendations made by the Joint Committee on Taxation. These termination provisions constitute a significant trap for the unwary, because the passive investment income tax can usually be avoided with proper and sophisticated tax planning.

Section 233 would expand the eligible current beneficiaries for electing small business trusts to include nonresident alien individuals. In addition to allowing for foreign family members to benefit from estate planning trusts, this provision would also enable S corporations to procure capital from individuals outside of the country. It is also unlikely to result in a meaningful loss of revenue to the federal government, inasmuch as income passed through from an S corporation to an electing small business trust is automatically taxed at the highest individual income tax rate. In fact, expanding upon this provision to allow C corporations, partnerships and other currently ineligible shareholders to become owners of S corporations on these terms would seem to be good policy for the same reasons. As long as the income attributable to these new owners would automatically be taxed at the highest individual rate, enabling S corporations to tap these additional sources of capital would appear to entail no significant countervailing policy considerations.

Sections 234 and 235 contain two provisions designed to facilitate charitable contributions by S corporations by making the rules for them more consistent with those that apply to individuals. As such, they certainly seem consistent with the goals and policies of Tax Reform.

Section 236 would enable newly-electing S corporations to make that election on the tax return for the taxable year for which it is to be effective, rather than during the first 2 ½ months of the taxable year itself. Although most sophisticated taxpayers are well aware of the earlier date by which such elections need to be made under current law, the proposed provision would enable start-up and other small business entities to make that election as part of the process of preparing income tax returns for that initial year, which may be the only time that such owners have outside accounting help to assist in making those determinations. Again, this provision is consistent with the goals of facilitating proper tax planning and compliance by smaller closely held business entities.

As mentioned earlier, I am focusing my comments primarily on the impact of the Discussion Draft on S corporations, and so I will not go into comparable detail with respect to the proposed partnership provisions contained in Part 2 of Option 1. However, I note that several of the changes outlined in Part 2, including the mandatory adjusted basis changes and the expanded "hot asset" rules, could be potentially problematic if applied to S corporations as proposed in Option 2.

D. Subtitle C [Option 2]

As I mentioned, Option 2 would repeal Subchapters S and K (S corporations and partnerships) and replace them with a single, unified passthrough structure. In general, Option 2 of the Discussion Draft would significantly relax (though not eliminate) certain S corporation eligibility and tax provisions, while further restricting the partnership tax rules and requiring all S corporations to comply with those newly-revised rules.

From the S corporation perspective, there are certain features of Option 2 that are beneficial and should be considered under any Tax Reform effort. To start with, Option 2 embraces a new, superior line of demarcation between passthrough businesses and those subject

to the corporate tax – namely whether a business has chosen to access the capital markets and public ownership.

The current limitations on both the number and types of shareholders eligible for S corporation ownership are wholly arbitrary and have been eclipsed by the advent and increased utilization of limited liability companies and other forms of partnerships. These forms of business enjoy passthrough tax treatment, the same as S corporations, but without similar limits on the number of shareholders or partners or restrictions on the permissible types of such shareholders or partners.

There is a sound policy rationale for distinguishing among entities based on public versus privately held status. For example, in my experience privately held companies typically sell for somewhere in the range of 5 to 12 times earnings, whereas publicly held companies often trade at multiples of 10 to 20 times earnings. As a practical matter, making this change may not dramatically expand the number of corporations electing passthrough corporation status, given that the vast majority of S corporations currently have only a small number of shareholders and there are also provisions for treating members of the same family as only one shareholder for this purpose. However, this is a more logical cutoff point for S corporation status, and would bring it in line with the corresponding cutoff for partnerships. *See* Code § 7704.

As the Draft notes, there are also several outstanding issues not addressed in the Discussion Draft, including the appropriate treatment of payroll taxes in the new passthrough structure and the future of special business structures such as REITS, MLPs and ESOPs. As an advisor to the S Corporation Association, I would be remiss if I didn't mention the tremendous success of the S corporation ESOP structure and its contribution to the economic participation and retirement security of ESOP company employees.

Regarding the correct treatment of payroll taxes, I do not have a silver bullet solution that would address everyone's concerns, but I do have a couple of rules that I believe should apply to any proposed solution. First, any change in the current rules should be easier, not more difficult, to comply with and enforce than the existing rules. My analysis is that the proposals considered by Congress in recent years would fail that test, making compliance and enforcement more, rather than less, difficult. And second, any solution should strive to continue the bright line between a compensation-based, contributory system and a welfare system funded by general revenues. Applying payroll taxes to what is legitimate business income would simply layer yet another tax on business income and move the tax code in the wrong direction.

With regard to the specifics of Option 2, here is a more detailed analysis:

1. <u>Enhanced S Corporation Provisions</u>.

New section 703 of the Code would create a new type of tax entity, namely the "passthrough corporation". The eligibility restrictions for this new type of tax entity would not be as restrictive as the current S corporation rules. For example, as noted earlier, in lieu of the current somewhat arbitrary 100-shareholder restriction, this new provision would merely prohibit publicly held corporations from electing S status.

New section 703 also would eliminate the rule limiting eligible shareholders to citizen or resident individuals, estates and certain trusts and exempt organizations. As noted earlier, this could open up new avenues for raising capital to current and future S corporations.

The last change reflected in new section 703 is the elimination of the current single-class-of-stock rule. This could also open up new sources of capital for S corporations. However, as explained in more detail later, new section 712 of the Code would adopt a provision designed to limit the flexibility of special allocations in all passthrough entities, including former S corporations.

New section 721 of the Code would allow the tax-free contribution of property to a passthrough corporation irrespective of the 80% control requirement that currently applies to S corporations. However, again as explained in more detail later, new section 731 of the Code would require the recognition of gain at both the entity and owner levels upon distributions of property by all passthrough entities.

Finally, new sections 773 and 774 of the Code would enact the five-year built-in gains and 60% passive investment income tax reforms described earlier with respect to Option 1.

2. Application of C Corporation Rules to Partnerships.

As noted earlier, new section 731 of the Code would require gain to be recognized by the entity upon all distributions of appreciated property, as well as requiring gain to be recognized by an individual owner whenever the fair market value of cash or other property distributed to that owner by the entity exceeds his or her basis. Although corporations (including S corporations) are currently subject to comparable tax treatment on distributions, eliminating the possibility of tax-free distributions of property for passthrough entities would mean that what is generally considered to be the most significant advantage of partnership tax treatment would no longer be available.

New section 771 of the Code would appear to preclude tax-free reorganization treatment for S corporations, something for which they are currently eligible. However, it is unclear whether this particular result was intended, inasmuch as there is no reference to it in the Technical Explanation for the Disclosure Draft.

3. More Restrictive Partnership Rules.

New section 712 of the Code would constrain special allocations for partnerships (including passthrough corporations) by requiring all such allocations to be in the form of a flat percentage of three separate categories of tax incidents, namely ordinary income, capital gains and tax credits. These provisions are likely to be less restrictive than the current S corporation single-class-of-stock rules. However, just how much less restrictive will not be clear unless and until regulations and other administrative guidance are promulgated pursuant to this provision.

Also under Option 2, new section 734 of the Code would create a complicated new regime designed to equalize gain among all owners in connection with all distributions of property by the entity. Similarly, since the partnership rules would now be applicable to S corporations, the rules relating to tracking pre-contribution gain and loss on contributed property under current section 704(c) of the Code would need to be contended with. These changes would all require detailed and ongoing calculations that are currently not necessary for S corporations.

New section 740 of the Code would preclude the recognition of loss on the sale of a partial interest in a passthrough entity, another difference from current S corporation treatment. Also, just as under Option 1, new section 742 of the Code would require mandatory basis adjustments to equalize internal and external basis on all sales of partnership interests.

Finally, new section 751 of the Code would still require the bifurcation of all sale and distribution transactions to account for disproportionate distributions and/or sales of so-called "hot assets," a category which would be expanded to include all inventory property, as well as cash basis accounts receivable and depreciation and other recapture.

In sum, under Option 2, S corporations would now be subject to a whole new regime of taxation – a more rigorous version of the current partnership rules. This would unavoidably impose transition costs, as well as an ongoing and substantial additional compliance burden.

4. Withholding.

Under Option 2, new section 3411 of the Code would impose a new withholding requirement on all income passed through by partnerships or passthrough corporations. The statutory language appears to contemplate varying percentages, based on type of income. However, it is unclear whether a passthrough entity would be entitled to take into account an individual shareholder's or partner's tax situation. For example, would an owner that is in a lower tax bracket be entitled to have less withheld from his or her passthrough income? Alternatively, would an owner who is experiencing substantial losses through a different passthrough entity be entitled to avoid having tax withheld at the source in light of the fact that no income tax will ultimately be due?

While many S corporations and partnerships do currently deal with similar withholding mechanisms for out-of-state business operations, the withholding rates are typically quite small and home state withholding and tax are typically adjusted to account for these out-of-state taxes. It is possible that such a regime might be appropriate or necessary at the federal level for compliance purposes. However, it is important to recognize that it would entail significant initial compliance costs and could create an ongoing business burden if not designed to avoid disrupting the operations of taxpayers currently complying with the tax deposit rules.

E. Summary

In summary, the S corporation enhancements contained in Option 1 would indeed encourage and foster additional economic activity in the American economy and I strongly support them.

The provisions contained in Option 2 are more aggressive and deserve closer scrutiny. Certain aspects of Option 2, particularly the new bright line between corporate and passthrough treatment, are extremely valuable and should be made part of any Tax Reform effort.

The advantages of other aspects, including the need for S corporations to comply with a new and much more complicated tax regime, however, may not justify the substantial costs involved in requiring them to convert and comply with that new system. One goal of the Discussion Draft appears to be to restrict partnership flexibility so as to reduce the potential for abusive tax structures. The partnership tax structure has always been much more flexible than the S corporation structure, and hence more subject to potential abuse. In fact, much of the complexity of the partnership regime is attributable to Congress's efforts to eliminate this abuse potential.

But for the 4.5 million existing S corporations accustomed to dealing with the restrictions applicable to S corporations, forcing them to comply with these old and new compliance-focused partnership provisions would likely impose a substantial cost with little offsetting economic benefit. New start-up owners are likely to be similarly discouraged. I am supportive of Congress's efforts to rein in tax shelters and other perceived tax abuses, but disrupting the tax mechanics for tax-compliant S corporations is unlikely to further that goal.

Once again, I would like to thank the Chairman and Ranking Member for holding this hearing and inviting me to testify. As someone on the front lines of business taxation, I sincerely hope that the Tax Reform effort is productive and successful, and results in improved rules for all businesses and individuals alike. It is a tremendous undertaking, but done right, well worth it.

CURRICULUM VITAE

Thomas J. Nichols is a shareholder in the Milwaukee law firm of Meissner Tierney Fisher & Nichols S.C., where he has been practicing corporate and tax law since 1979. The firm itself is over 160 years old, and is the second oldest firm in the state of Wisconsin. Mr. Nichols represents a wide array of clients ranging from start-ups, physician groups, software, publishing, sales, restaurant, real estate and other closely-held concerns to insurance company, manufacturing and mutual fund advisory clients.

Mr. Nichols is Chairman of the Board of Advisors of the S Corporation Association and a recent Chair of the S Corporations Committee of the ABA Section of Taxation, on which he has been active since 1987. In this capacity, Mr. Nichols has participated, as primary draftsperson or otherwise, in the preparation of the Committee's comments on the large majority of regulations that have been promulgated by the Treasury to implement the current S corporation provisions enacted in the Subchapter S Revision Act of 1982 and subsequent legislation, including those concerning pass-through income and loss, adjusted basis, corporate accounts, the single class of stock requirement, open account indebtedness, qualified subchapter S subsidiaries, the built-in gains tax, passive income, self-employment tax, back-to-back loans, the new net investment income tax and other S corporation rules. Mr. Nichols has also worked with the House and Senate legislators and staff personnel on pending Tax Reform efforts, and has been a member of various ABA Tax Section Task Forces dealing with tax reform, including assisting in the preparation of its August 3, 2006 Comments on Additional Options to Improve Tax Compliance Prepared by the Staff of the Joint Committee on Taxation (for which he was listed as the contact person for S corporations). Mr. Nichols also participated extensively in Wisconsin's federalization of its S corporation statutes, where a number of his recommendations were adopted as statutory amendments. In addition, at the request of the Wisconsin Department of Revenue, Mr. Nichols reviewed and revised drafts of the Department's Publication 102, "Wisconsin Tax Treatment of Tax Option (S) Corporations and Their Shareholders," both in 1987 and again in 1998.

Mr. Nichols has also been and is actively involved in the development and updating of Wisconsin's business entity statutes, including the adoption of provisions on cross-species mergers and conversions between corporations, partnerships, limited liability companies and non-profit corporations, as well as updating Wisconsin's partnership statutes to reflect the Revised Uniform Partnership Act. He is a member of the Board of Directors of the Business Law Section of the State Bar of Wisconsin and Chair of its Partnerships Committee, as well as a Member and Past Chairman of the Wisconsin Taxation Committee of the Wisconsin Institute of Certified Public Accountants. Mr. Nichols is also the columnist for The Choice of Entity Corner for the Journal of Passthrough Entities published by CCH, Incorporated; a member of the National Health Lawyers Association and a Fellow of the American College of Tax Counsel.

Mr. Nichols has spoken and written extensively on tax and business entity topics, including testimony before the U.S. House of Representatives Ways & Means Committee, the ABA Tax Section, the New York University Institute on Federal Taxation, the American Law Institute–American Bar Association (ALI-ABA), the Accounting Continuing Professional Education Network (ACPEN), the Tulane Tax Institute, the State Bar of Wisconsin, the Wisconsin Institute of Certified Public Accountants, the Corporate Practice Institute and numerous other groups and institutions. Mr. Nichols is AV-rated by Martindale-Hubbell, and has been selected for inclusion in the *Best Lawyers in America®* and *Super Lawyers®* publications.

Chairman TIBERI. Well, thank all of you on behalf of the committee and the committee staff for being here today, for your written testimony, which I said would be part of the record. I don't know about you, but I was excited that you were going to be here, and that we were having this hearing today. Unfortunately, most of Washington, including the press corps, I think is more excited about the hearing in 48 hours in this room, but this is pretty important, and this is going to be part of the process, the transparent process that Chairman Camp has had, and so your testimony is very, very helpful.

Mr. Nichols, I want to start my questioning with you. As you know, for the last 12 years, S Corps and pass-through entities have had a statutory top rate of 35 percent. In January that changed, and we saw the top rate rise to 39.6 percent, but with the addition of the 3.8 percent tax from ObamaCare on investment income, the Pease Limitation, which adds another 1.2 percent, you have a reality of a tax rate much higher than that.

But something that I didn't realize until recently that I would like you to comment on is that that 3.8 percent tax on investment income that—I didn't realize actually falls on something much broader than investment income. So if I were selling—my understanding, if I were making widgets and then selling widgets, that 3.8 percent investment tax would fall on the making and selling of those widgets as well.

So in essence, this means that the top rate on an S Corp manufacturer in my home State of Ohio is now 44.6 percent and not 35 percent; so a pretty large tax increase that is not just investment income. Can you expand upon that and expand upon how much broader this 3.8 percent tax is than many of us thought or think?

Mr. NICHOLS. Yes. I would be happy to. Essentially what happens is there are two things at play here. One is if you have got any passive investors in the S Corporation itself, then that passive investor is going to require distribution of money to pay taxes based on the top rate, so you have got the 39.6 percent rate, you add on to that the Pease reduction another 1.2 percent, then you add on the 3.8 percent tax, you get up to approximately 45 percent, as you point out.

And essentially what happens for S Corporations is that if you have got, let's say, a 10 percent shareholder, let's say a father who is no longer involved in the business that ends up paying that tax, most S Corporations have an obligation under shareholder agreements to distribute out an amount to pay the tax attributable to pass-through income. The combination of having one shareholder subject to that tax, that 45 percent tax rate, and the fact that the S Corporation rules require a single class of stock means that if you are going to distribute out 45 percent to one of the shareholders, you are going to have to distribute out 45 percent of the income to all of the shareholders, even though some of them may not have to pay that additional tax. All of that will have to come out of the corporation and won't be available obviously for future use inside the corp.

Chairman TIBERI. Thank you. So as you know, the 1986 Act reduced the top rate from 50 to 28 percent, and now we see the rate essentially going up to almost 45 percent; not quite 50, but 45. So over the last 27 years, we now have, since 1986, the highest rate, statutory rate for S Corps and pass-through entities, correct?

Mr. NICHOLS. That is correct.

Chairman TIBERI. And what do you see as the—as a practitioner, what do you see the reaction to that on the ground?

Mr. NICHOLS. Well, realistically, very many, in fact, I would venture to say most closely-held businesses, they essentially earn their income; if they are pass-through business, they reserve to pay for the tax and then the vast majority of what is earned is essentially rolled back into the business.

Essentially what happens if the tax rate goes up, and essentially it has gone up now potentially by a 10 percent increment from 35 percent to 45 percent, and that is without taking State taxes into account, essentially that 10 percent used to stay inside the company and used to be reserved and used, either reserved for capital or used to actually grow the business, hire people, do whatever the business needs, that 10 percent is effectively just an additional

slice out of the capital that would otherwise be used in the business, for most of them.

Chairman TIBERI. One last question, because I have taken almost all my time, is a fascinating point you made in your written testimony that a clearer—I am trying to get this right—a clearer demarcation between who may be an S Corp and who may be a C Corp is whether they are publicly traded, which is kind of a line of demarcation that is proposed in option two for pass-through entities.

Can you elaborate on why you think a publicly traded, privately owned line is conceptually a correct way to distinguish between the two?

Mr. NICHOLS. Well, it is a difference—it is a distinction that makes a difference. Unlike the fairly arbitrary 100-person limit that currently exists, it is a distinction that makes a difference.

There are a number of things that are different about a publicly held entity. They are treated differently. And essentially, what the point I made in the written testimony is that essentially, if I am selling a closely held company, a privately held company, I am likely to get multiples, let's say, you know, maybe in the neighborhood of 5, maybe 12 times earnings if you are lucky, whereas publicly traded companies regularly trade at 10 to 20 times earning. So that is a big difference, and it is something, frankly, I have to explain to some of my closely held clients that there is a difference being closely held. And so as a consequence, that and the other thing that is significant for a closely held clients, and that is, they don't have the opportunity to turn around and go to the public markets. They don't have that automatic price that they can sell stock for and they don't—it is not easy for them to go to the public markets to borrow money, either, for publicly held securities, and so as a consequence, that demarcation line is one that does have some policy significance, and to the extent possible, the demarcation lines in the Code should reflect, you know, significant differences between the business entities, and that one does.

Chairman TIBERI. Thank you.

Mr. Neal is recognized for 5 minutes.

Mr. NEAL. Thank you for your indulgence earlier today, Mr. Chairman, as well. And Mr. Nichols, if you can help to explain some of these things to us, too, it would be helpful.

Mr. Rubin, could you describe for me the tax consequences for both partners involved and the partnerships of a merger of two partnerships, each of which contains appreciated property under current law? And can you describe the tax consequences for both partners involved and the partnerships under option two of Chairman Camp's draft? Any potential administrative burden of the merger under option two as relative to current law.

Mr. RUBIN. Sure. Under current——

Mr. NEAL. And this is very helpful, incidentally, to us, very, very helpful.

Mr. RUBIN. Great. Under current law, if two partnerships want to merge, first under State law and Uniform Limited Partnership Act, the General Partnership Act, the LLC Act, that can be accomplished by filing articles of merger; so relatively convenient way to combine two companies operating in partnership form.

From a tax perspective, let's say you have got the AB partnership merging with the CD partnership. For tax purposes, that is generally treated under current law when they file articles of merger as if the AB partnership contributed its assets into the CD partnership in exchange for an interest in the CD partnership and then the AB partnership liquidated and distributed the interest in the CD partnership out to the partners.

What is important about that is that under current law, all of those deemed transactions are generally tax free, the transfer of the assets into the combined entity, if you will, that is deemed to occur and then the transfer of the interest in the combined entity that goes out.

Under option two, that would no longer be the case, because when the AB partnership that is going out of existence, is deemed to distribute the interests in the CD partnership out to its partners, that is a distribution of appreciated property, it would trigger gain both at the AB partnership level, and then potentially a second gain at the AB partner level.

So what can be consummated tax free under a carryover basis regime so that the built-in gain is taxed in the future on a disposition to a taxable disposition to a third party is taxed immediately under option two.

Mr. NEAL. In Massachusetts, 92 percent of the firms are structured as pass-through entities, and there are nearly 90,000 businesses structured as S Corporations. The level of choice is pretty unique to the United States.

Mr. Nichols, in your testimony, you indicated that there are benefits to offering entrepreneurs multiple options when choosing a business structure. On the other hand, option two of Chairman Camp's draft proposes moving most S Corporations and partnerships into a single uniform structure. Could you go into a little bit more detail on what you see as the benefits of sticking with the current set of options of business entities as well as the potential costs of moving all of these businesses to a single new entity?

Mr. NICHOLS. I would be happy to. Well, currently you have approximately 4.5 million S Corporations. It is the most popular format, it is the most popular tax structure for closely held businesses. You have got, well, a little more than 3 million partnerships also. But the S Corporation structure has the advantage of being simple and being easy to administer, and that is something for many, many corporations. They are not interested in sophisticated and flexible capital-raising mechanisms. All they want to do is make widgets. And when given a choice to simply have a simple structure, not do any sophisticated transactions, but just focus on their business, they like that.

The partnership structure is much more flexible and as a consequence, it is much more complicated, and some of that complication is imposed by Congress in order to essentially rein in the flexibility so that abusive transactions don't occur.

What happens in option two potentially is the partnership rules are made somewhat more complicated and more restrictive, and all of the S Corporations that currently exist today essentially are being forced into that structure. And what happens then, you have got an unavoidable cost for a lot of just day-to-day businesses that

have been S Corporations for many times many years. They are forced into that new structure. They need to deal with both the transition, but they also need to deal with the ongoing complexity of the partnership rules. For example, under the proposal, and even under the current law, there are changes and adjustments that potentially need to be made whenever there is a sale of any interest in the business, even a minority interest. There is also the need to bifurcate transactions for distributions on sales to determine whether hot assets are applicable and treating that as a separate transaction.

All of that complexity, it may be appropriate in the partnership regime, which is much more flexible; on the other hand, it has not been found necessary in the S Corporation regime, but you would be essentially requiring all of the current 4.5 million S Corporations to switch to that more complicated regime and the compliance costs, but also there would be ongoing compliance costs. And what I don't see as a countervailing economic benefit, I don't see any S Corporations engaging in more economic activity as a consequence, and so as a consequence, I see a cost, but I don't see the benefit of that forced conversion.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman TIBERI. Thank you.

Mr. Young is recognized for 5 minutes.

Mr. YOUNG. Thank you, Mr. Chairman. I appreciate you and Ranking Member Neal for holding this hearing. Very important to all of my colleagues, really to the country.

Each of us has a plenitude of pass-through entities in our districts. I would like to begin just with a remark, respectfully reminding my colleagues and those who are paying attention, that we need to be attentive to one type of pass-through entity that has not been addressed yet, at least not in a specific way in some of the discussion drafts, and that is ESOPs, the employee stock ownership entities. And I do believe there will be consideration of this as we move forward, but I think we should strive to avoid any inadvertent damage we might do, as Mr. Taylor indicated, to these entities, seeing as they empower employee ownership. And per my briefing, they are four times less likely during a recession to lay off employees, so that is something for us to consider.

My first question relates to withholding, something Mr. Nichols—we have got a sound issue here. There we go. Relates to with—it is not working.

Chairman TIBERI. One, two.

Mr. YOUNG. One, two.

Chairman TIBERI. Why don't you try another microphone.

Mr. YOUNG. Here we go. I am Mr. Young. Thanks. As we say in the Marine Corps, adapt, improvise and overcome, so here we go.

My question relates to withholding. Mr. Nichols, you touched on this briefly in your testimony, and I believe each of you are aware that in option two of the discussion draft, we suggest an entity level withholding rather than our current practice.

Now, as practitioners that deal with small businesses every day, can you talk a little, either Mr. Nichols, perhaps others have thoughts, about the negative impacts as well as the positive out-

comes that this change might create? Specifically, I am interested in how the provision might impact cash flow, whether it might create cash flow problems for any type of existing pass-through entity.

Mr. NICHOLS. Yes. There are a number of considerations here. Obviously one is compliance. And the withholding system that is proposed is not a completely new item. There are a lot of S Corporations that have out-of-state operations. They actually have a withholding system that they need to deal with in order to withhold taxes for their out-of-state operations in the various states that they are operative in.

Now, the withholding system at the Federal level potentially creates more of a cash flow situation. The amounts for the State systems are typically smaller. And the other thing that would need to be factored in, and I am not sure the proposal contemplates it, or I am not sure it does, I am not sure it doesn't, but the other thing that would need to be factored in is the fact that tax rates at the corporate level, if they are to be uniform, are unavoidably going to impact cash flow. And I can give you two examples. One example would be if the taxpayers are in a lower tax bracket and you have got a mandated withholding rate that is above that tax bracket, obviously there is going to be an amount that is going to need to be withheld, and then the taxpayers are going to have to wait till next year to get that refunded to them. It is like any other withholding. You don't get it until you file the return at the end of the year.

The second one that I think is potentially more problematic, but maybe it could be dealt with, and that is the idea that you have got a taxpayer that runs or has interest in two different businesses, and they have got $100,000 of income in one business, and $100,000 of loss in the other business, but they are in two separate entities.

Under the withholding regime, unless you can take into account the individual taxpayer's facts, you would end up having to have withholding occur on the $100,000 from the profitable business, notwithstanding the fact that that shareholder, that owner is doing exactly what we hope they do in today's economy: use those profits in another business, hire people and use that. Well, you can't do that if you—some of those monies are siphoned off in the form of the withholding and you are not going to get them back until after the end of the year.

Mr. YOUNG. Any other quick thoughts here? We have about 30 seconds left.

Mr. TAYLOR. Yeah. I think you are missing something in this whole picture. You could take withholding tax and put it in option one, and apply it to S Corporations and partnerships.

The merit of option two is not the particular features, all of which can go in option one. The merit is it gets you to focus on the difference between the entities. I mean, take your ESOP point.

Mr. YOUNG. Yeah.

Mr. TAYLOR. You can have an ESOP as a shareholder of an S Corporation today. Okay? You cannot have an ESOP partner in a partnership and get the same tax consequences.

Your point about the net investment income tax. If you are an S Corporation, you can eliminate a large part of that 3.8 percent tax on your S Corporation earnings, assuming it is not a passive

activity. You cannot do that generally if you have got a partnership.

So the point here of option two and option one, I think, is option two forces you to ask the question, why is this different from the way it is here?

Mr. YOUNG. Right.

Mr. TAYLOR. And that is what you should be focusing on, I think, not the particular features, all of which, as I say, you could put in——

Mr. YOUNG. Great.

Mr. TAYLOR [continuing]. Option one if you wanted.

Mr. YOUNG. Thanks so much. I yield back.

And if you have further testimony, maybe you can submit it for the record.

Chairman TIBERI. Does someone else have a thought? Go ahead, Mr. Harris. I feel generous today.

Mr. HARRIS. Thank you.

Mr. YOUNG. Thanks, Mr. Chairman.

Mr. HARRIS. I think one thing in addition to what has been said when you get to entity level withholding, we have to consider the complexity on the small business owner of understanding what are we going to withhold on and what records are they going to have to keep and what efforts are they going to have to go through to calculate the number that we are going to withhold on.

So I think we have to be very cognizant of the fact that we could be adding complexity that may or may not benefit anyone for the other problems here, that it could be a wrong amount, it could be offset somewhere else, and yet we have imposed a burden. So I think we should always look, if we are going to look at entity level withholding, withholding on something that is easy to get to, perhaps like payments that are made to shareholders and partners, as opposed to a calculated income amount.

Chairman TIBERI. Thank you. Let me just tell you, I can tell the difference between someone who is trying to filibuster an answer and someone who is trying to be substantively helpful, and I think the four of you, your testimony, both written and your testimony today, is great, very helpful, very interesting. And so help us by being substantive in your answers, and don't feel pressure on the clock. Not everyone will always tell you that.

Mr. Gerlach, you are recognized for 5 minutes.

Mr. GERLACH. Thank you, Mr. Chairman. And, gentlemen, thank you for testifying today.

Mr. Harris—and I would like to get the other three gentlemen's thoughts on this as well—but I want to base my question on your testimony and in particular, your written testimony on the issue of the startup and organizational expense provisions that would increase the amount as a startup company you could deduct under the Code. And you approve of that proposed draft language, although you go on to say that you would suggest an even more aggressive approach to startup expenses for small business owners that qualify for the use of cash accounting.

Can you expand a little bit more, if you would, on your thoughts on how the current discussion draft language could be improved upon relative to that particular expensing that we would like to see

startups be able to have so that encourages them to move forward with that initial business activity?

Mr. HARRIS. Sure. I will be happy to, because I think one thing we can all agree upon, we want more businesses starting up.

Mr. GERLACH. Right.

Mr. HARRIS. And anything we can do to encourage that is going to benefit us all.

Mine is more of really expanding the cash accounting rules to say when you start a business, in the year that you actually open your doors, I believe we should allow them to deduct any expenses they incurred through that process. Again, if it started in a prior year and it rolled into a current year, then that would be carried forward, but as I said in my opening statement, it is very hard to explain to a small business owner that the expense you pay in July, you can fully deduct, but the exact same expense that you paid in February, because it happened to come prior to the opening of your doors, may not be deductible or has to be capitalized, depending on the amount.

And it really comes down to, again, the basic understanding, as I have heard a lot of discussions today, I think of it in terms of our clients and our small business owners, and they are sitting there going, this is what is wrong with the tax system. You know, if I paid the money and I started the business, why isn't it a deduction.

Mr. GERLACH. So if you start the business November 1st, but of course leading up to opening those doors on November the 1st, in February, March and April, you are incurring different organizational and other expenses that are justifiable for the startup of that entity on November 1st, all of that should be deductible for that tax year, is what you are suggesting?

Mr. HARRIS. Right. Because all that money is gone and they have expended the funds.

Mr. GERLACH. And it is out of the checkbook——

Mr. HARRIS. It is out of the checkbook.

Mr. GERLACH [continuing]. Which is the basis for which they make decisions.

Mr. HARRIS. Yes.

Mr. GERLACH. Yeah. Gentlemen, the other folks on the panel, do you have a thought on that same issue? Mr. Nichols.

Mr. NICHOLS. Well, I certainly agree. I would just add to that, and that essentially what you have got is the dichotomy between the accounting principles and the tax principles. And there are a number of provisions in the Code. I know over the course of its history, for example, for accounting purposes, you capitalize those startup costs because you want to communicate to your outside investors that it is not all wasted money, over time it is going to build up and you are going to have something of value, and it makes the first year not look as bad as it otherwise would.

And so you have got the accounting principles that go in one direction, but you have also got the tax principles that essentially say from the standpoint of tax policy, is this really a time in which we want to allow somebody—put somebody in a position of paying expenses and not give them the deduction? And when you look at it from the standpoint of tax policy——

Mr. GERLACH. Because the whole goal is you want them to be successful.

Mr. NICHOLS. Exactly.

Mr. GERLACH. And it is from a cash flow standpoint that they will or won't be successful.

Mr. NICHOLS. Exactly.

Mr. GERLACH. Is that—okay. Great. Mr. Taylor, Mr. Rubin, do you have a thought on that?

Mr. RUBIN. No.

Mr. TAYLOR. No comment.

Mr. GERLACH. Good. Well, thank you very much. I appreciate that. I yield back. Thank you, Mr. Chairman.

Chairman TIBERI. Thank you, Mr. Gerlach.

Mr. Larson, you are recognized for 5 minutes.

Mr. LARSON. Thank you, Mr. Chairman. And I want to thank our panelists as well for being here today. And, again, want to thank Chairman Camp for putting out his proposal.

And obviously in the case of small businesses, especially the notion of simplicity is something that we all want to strive for. In looking at the two options that are before you, and I would be interested in your responses, in real terms, real life, anecdotal or otherwise, how does this—what does simplicity mean to you and what could we best do to assist small business in the Tax Code? Is it, as my colleague often suggests, not having to have an accountant 12 months of the year, but only that 1 month when you actually need them? Is it the less reporting? What is it in the overall simplification that we could do to make you more entrepreneurial, as Mr. Harris said, and to grow businesses and encourage people to get involved? And we will start with Mr. Harris.

Mr. HARRIS. I think from the perspective of our clients, what simplicity means to them is that to the extent that it is possible, that the tax system can follow the records that they have to keep to run their business, that they aren't being forced to keep records solely to comply with the tax law, that the basic records that we all need to keep to run our business should be sufficient for filing taxes. It shouldn't require a lot of complexity.

And it should also, I think, allow them to operate in a real world. As I was listening to the example of partner A and B merging with partner C and D and all that, in the real world, those are just four guys that came together to start a business, and yet if they heard this discussion, their head would explode, because they are saying, what do you mean? I mean, we just decided to work together.

So I think what we have to do is we try to mirror the records they keep and recognize what they are doing every day to run a business, and try to make that our tax law as best we can.

Mr. LARSON. Thank you, Mr. Harris. Mr. Taylor.

Mr. TAYLOR. Let me just add one thing without disagreeing in any way with what you said. It seems to me——

Mr. LARSON. Could you speak into the mic?

Mr. TAYLOR. Yeah. I am sorry. Thank you. It seems to me great simplicity would be that you did not need to come and talk to us before deciding whether you were going to be a partnership or an S Corporation.

And that is the merit of option two, you know, there is only one system. And we can disagree as to what the features of that system should be, and I think there is disagreement, but, you know, not having your fundamental choice being something that is dictated can only be sensibly made from a tax point of view if you have an accountant or a lawyer, you know, that is crazy.

And the differences between limited partnerships—I am sorry—limited liability companies and S Corporations from a tax point of view are huge and pervasive. And so if you could get to a single regime where you didn't need that accountant or lawyer upfront, that would be simplicity, I think.

Mr. RUBIN. And I guess I would argue that that is only conceptual simplicity rather than practical simplicity; that under current law, the regime really provides a choice, that people who want greater simplicity and less flexibility can achieve that through an S Corporation, people who need greater flexibility to distribute properties, need to have debt included in basis and so forth, they can deal with the more complicated rules.

You know, again, in concept, combining them means you don't have a choice, and maybe that is simple in a way, but I think as a practical matter, it means that a lot of people who currently are happy with the S Corp regime have to deal with a much more complicated set of rules.

Mr. NICHOLS. And actually I would agree with Mr. Rubin. I guess if you look at this from the standpoint of the small business owner, watch what they do, what they want to do and what they have done. And 4.5 million of them, the plurality of them have chosen to be S Corporations. Don't disrupt what they are doing unless there is good reason to do so. And moving that—changing—what one of the things that does keep lawyers and accountants busy and employed is changes. And if you have got a system that seems to be working and seems to satisfy the needs of both the—the revenue needs and the needs of the individual businesses, and they have grown accustomed to it, don't change that without, you know, solid underpinning of reasons to do so, just because the disruption alone slows business down.

Mr. LARSON. Thank you.

Chairman TIBERI. Thank you. Mr. Schock is recognized for 5 minutes.

Mr. SCHOCK. Thank you, Mr. Chairman, and thank you to the witnesses. A couple quick follow-up questions, one on cash accounting. I am pleased that the chairman included the framework of Mr. Thompson in my bill that increased the threshold from $5 million to $10 million permanently, however, I am aware of specific groups in my district who were exempted from current law that allow for unlimited amounts to be used on cash accounting, particularly in the ag industry. I have got some large pork producers that currently are allowed to use cash accounting.

So I am wondering, from your perspective, if you are aware of other folks who may be exempted currently that will not be exempted under the chairman's proposal, and if you could talk a little bit about what effect this will have on perhaps accountants or others in the service sector, or a large pork producer like the ones in my district that have to go from an accrual basis to a cash basis

if, in fact, there are no exemptions for folks over $10 million. Mr. Nichols?

Mr. NICHOLS. I am assuming people being forced to essentially go from a cash basis to an accrual basis?

Mr. SCHOCK. Correct. I am sorry. Yes.

Mr. NICHOLS. And that—well, one of the big exemptions that currently exists in that is closely held—S Corporations are exempt currently, and this essentially would eliminate that exemption for all S Corporations below the $10 million level, and so as—and that—I think any time you vary from the cash being in the door to pay the tax and you are requiring tax to be paid perhaps before it—in this case, before it is collected, you should take into account that you are creating a cash flow situation that is potentially problematic.

Under the current rules, there are a number of corporations, S Corporations and partnerships that don't have C Corporations as partners that are eligible for the cash basis method of accounting. This would eliminate that. It would essentially create another one of these demarcation lines that is somewhat arbitrary, unavoidably. If it is, you know, $10 million, you know, if they move $1 million above $10 million for 3 years in a row, then suddenly they are on a completely different system.

And there I would focus on is there a policy reason that is important enough to require enterprises that haven't collected the cash right away, they haven't collected the cash already, is there a policy reason important enough to require them to pay the tax on that income that they haven't received yet. And that is—if there is—it is kind of if it is not broken, don't fix it. Be careful if you change things so as not to disrupt the business.

Mr. SCHOCK. Mr. Harris.

Mr. HARRIS. Just to add to that, I think we have to understand that the only real difference between cash and accounting is when the income shows up, not if it shows up. So to his point, what is the incentive to require the perhaps accelerated reporting of the income, what is the benefit of doing that, as opposed to waiting until it actually shows up, because it will eventually show up and be income when the money is paid.

So unless there is a real policy reason, as he said, to force that acceleration into income, I don't know why we don't just wait until they actually have it.

Mr. SCHOCK. Okay. It may have something to do with the CBO score.

The second question really is just genuinely interested in your view on this effect on small businesses. A lot of times we focus on the big C Corp guys. We have got a few of those important ones in my district. But we also recognize that the majority of Americans work for small companies. And it is the startups, really, who are the engine of our economy. And some of the things we do, like 179, raising that threshold to 250, making that permanent, is there anything else you guys are aware of that maybe we aren't doing that we should be doing, or perhaps we should look at, particularly for small startup companies? You think about the Apples, the Microsofts. They started in garages. They didn't have your traditional framework. You are not going to use R&D incentives for a

small startup like that. Are there other things that we could be looking at for some of those organic startups?

Mr. HARRIS. I think we have discussed a lot of the things that we should do. Again, when you are starting up at the smallest of small businesses, cash flow is of critical importance. They don't have access to capital. They are probably doing it from maybe even credit cards or living on a spouse's salary.

So we should do everything we can to allow them to keep as much of their cash as they can and not get into complicated, broadening base exercises, if you will, which is basically saying something you spent can't be reported yet, can't be deducted yet, is to allow them to keep the money in their startup years when it is the most critical. Because if they can get through those 1 or 2 startup years, they tend to have a chance to survive.

So we should be very careful to do everything we can in a startup mode to allow their tax return to mirror their cash flow as closely as possible. Because cash is at a premium at that point.

Mr. SCHOCK. Anyone else?

Mr. Nichols.

Mr. NICHOLS. Well, I am finding myself agreeing with Mr. Harris more and more. But, essentially, to a great extent what I am going to do is repeat what he just said, but essentially there are two ways; one is by recognizing income only when it is collected, and the other is by giving the benefit of deductions to startup businesses when they actually pay it as opposed to over time. And both of those, frankly, help small businesses, especially startups, who are cash starved.

Mr. SCHOCK. And what is proposed in the rough draft you feel is sufficient.

Mr. NICHOLS. It is an improvement. I don't disagree with Mr. Harris that the idea of allowing startups to actually expense, at least maybe up to a cap, actually expense immediately startup expenses. I am not sure that is bad policy. I understand cost revenue, but it is putting the incentives towards starting up businesses right where they should be. At least, I am going to get my deduction when I am paying the cash out.

Mr. SCHOCK. Okay. Thank you guys.

Chairman TIBERI. Thank you, Mr. Schock.

Mr. Marchant, you are recognized for 5 minutes.

Mr. MARCHANT. Thank you, Mr. Chairman.

I would like to follow up on some of the chairman's earlier questions. Partnerships draw their earnings through K1s, don't they? And Sub-S. Basically, it is a straight pass-through. So going back to the ObamaCare tax and the Pease tax that is attached to that, is it going to provide a disincentive for an investor to look at a small business, a Sub-S or a partnership, and know that they possibly could get a K1 or pass-through income, that there will be no cash following those documents, so that they can be taxed? Normally, in small businesses there is no requirement, is there, that the amount of income that you have to show on your income taxes as a pass-through is followed by any cash. Is that correct?

Mr. TAYLOR. That is correct. You would normally make sure that it was followed by cash as a contractual matter. If you were

just an investor, you would make sure the cash distributions were at least equal to what you thought the tax liability was.

Mr. MARCHANT. But in a C Corp, you can have earnings——

Mr. TAYLOR. In a C Corp, you are perfectly right. You can have earnings and nothing to report. Unless you get a distribution, you just report your distribution. If you are in an S Corp or a partner in a partnership, you report your share of the income or loss of the S Corporation or partnership, whether or not you got it, on the one hand. On the other hand, typically you would make sure that, either because you were part of the management or you thought about this in advance, that they did make distributions sufficient to cover your liability.

Mr. MARCHANT. Well, if you are a passive investor in a partnership, then you usually don't have a lot to say about the general day-to-day——

Mr. TAYLOR. Okay, fine. But would have a lot to say about the terms of your investment. You want my money, here's the circumstances under which I will make it.

Mr. MARCHANT. In the discussion draft, it sets a $250,000 limit on the cost of new property and equipment that a small business can expense during the tax year, and immediate expense begins to phase out once the taxpayer places more than $800,000 of that property into service in a year. These levels parallel those that were in effect prior to the stimulus. Do you think that these levels reasonably reflect the need of small businesses?

Mr. HARRIS. Well, as I said in my opening statement, from our client perspective, it is going to get most of them. Those limits would be sufficient for most. But it is very clear you can go buy a printing press if you are in a printing business that is going to exceed $800,000, or it can be $1 million. So no matter what the limits are, there is always going to be someone who wants more. And I guess that is the beauty that we have on this panel. We don't have to consider revenue impacts. In a perfect world, I would say let everybody write off their equipment no matter how much they buy in a year. But we can just say that because we don't have to balance a budget in Washington. But I think that is going to depend on the kind of business you are in. But I can say for a lot of our clients, $250,000 and $800,000 would cover most of our clients' acquisitions in a year.

Mr. MARCHANT. Mr. Chairman, in the spirit of the Chairman Camp's intent that the Tax Code be simplified and that the rates get lowered and that we encourage formation of small business, I think this is a very important hearing. I do think that the whole issue of the additional 5 percent tax on the K1 and the Sub S income is a very significant thing in this whole formula. And I don't want to see us do anything in the Tax Code that will encourage people to go into C Corps instead of partnerships and Sub S's, because in my district probably three-quarters of the businesses organize at that level.

Thank you.

Chairman TIBERI. Ditto. Thank you, Mr. Marchant.

Mr. Young brought up earlier ESOPs. And I know Mr. Neal is a big supporter of ESOPs as well. And you all know that in the draft, option two, going to a single entity, we don't address the

issue of S Corp ESOPs in terms of how we go forward on that. Have any of you thought of a way to do that? The reason why I ask is what we don't want to do is have a detrimental impact on something that I think there is bipartisan agreement on that it has been successful in our communities and in our districts.

Mr. Nichols, do you want to start?

Mr. NICHOLS. I would be happy to. S Corporation ESOPs have actually been very successful in essentially expanding the base of ownership, essentially, and moving, frankly, both the profit and loss and risk to the business among the entire employee base, which from the standpoint of inclusion in the American economy, has a pretty fundamental function. And so as a consequence, doing what can be done in order to encourage that, it doesn't surprise me that there is bipartisan support.

You are right, I am not sure I read anything in one way or another in the proposals. I am not quite sure I would tinker with that. In order to have an ESOP, you would have to have a corporation. But the proposals don't seem to change that. So if the policy is along the lines of if it is not broke, don't fix it, it seems to be working very well. I am not quite sure I would try to change that as part of these proposals.

Chairman TIBERI. Mr. Rubin, anything to add?

Mr. RUBIN. I guess I would say that I agree that in general S Corp ESOPs have certainly broadened ownership of S corporations and allowed employees to participate in that. I guess, with a nod to Mr. Taylor, I would say there is probably no conceptual reason why you couldn't craft a regime that allowed an ESOP to own interest in an LLC. But on the other hand, I don't think that there is a great need to do that, given where we are today.

Chairman TIBERI. Mr. Taylor.

Mr. TAYLOR. To just reiterate what I said, if you have a special rule for ESOPs, it ought to be across the board. You shouldn't have people saying well, I have got to form an S Corporation because it is the only way I can do an ESOP, as opposed to setting up a limited liability company. So it ought to be across the board.

I do think there is a fundamental issue about ESOPs. You give them treatment that you do not give to other tax exempts, including regular pension plans. Because there you would have so-called unrelated business income for many of these investments, and you do not when it is done through an ESOP. So you have another issue not related to this small business reform, if you will, about whether or not you are not giving ESOPs an advantage from a tax point of view that should not be given to other tax exempt organizations, including other benefit plans.

Chairman TIBERI. Mr. Harris.

Mr. HARRIS. I really don't have much to add to what has already been said other than, again, if we have got something that is working, the last thing we want to do is do anything to make it not work. So I would defer to their judgment. But I think it is working, so let's just don't hurt it.

Chairman TIBERI. Okay. Any other members have any questions with our expert witnesses here?

You want to ask us a question? I defer to Mr. Neal.

Mr. TAYLOR. I don't have the courage to do that. But I would make one point here; that it is not working, to start right there. The system is conceptually enormously messed up. I am not talking specifically about ESOPs or anything like that.

Chairman TIBERI. You are talking about the Tax Code?

Mr. TAYLOR. The Tax Code and the particular provisions we are talking about, they don't work. And you ought to start from the assumption that there are serious flaws in them. And that is why, as I said, there is great deal of merit in focusing on option two. Even if you decide in the end you are not going to do it, you are just going to take the ideas and build them into option one, it has the merit of making you focus on what is wrong.

Chairman TIBERI. Thank you. Anybody else want to add a comment? That is why we are having this hearing. That is why the chairman has decided to do these drafts. And we appreciate you four being here today and adding your input to this process. I appreciate the time that you have taken.

That concludes today's hearing. Please be advised that members may submit written questions to the witnesses. Those questions and the witnesses answers will be made part of the record.

Again, thank you all for your time for appearing today, for the thoughtfulness and for our wonderful, educational discussion that we have had. I think this helps us continue to move the ball forward. Thank you.

This hearing is adjourned.

[Whereupon, at 11:12 a.m., the subcommittee was adjourned.]

[Public Submissions for the Record follows:]

AdvaMed

House of Representatives Committee on Ways and Means
Subcommittee on Select Revenue Measures

Small Business and Pass-Through Entity Tax Reform Discussion Draft
May 15, 2013

Testimony for the Record
Ashley Wallin, Executive Director, Emerging Growth Company Council
On behalf of
Advanced Medical Technology Association (AdvaMed)

Advanced Medical Technology Association
701 Pennsylvania Avenue, NW, Suite 800
Washington, D.C. 20004
awallin@advamed.org
(O) 202.434.7221
(F) 202.783.8750

The Advanced Medical Technology Association (AdvaMed) appreciates the opportunity to provide written testimony for today's hearing on simplifying the tax code in support of small businesses, as described in the Committee on Ways and Means discussion draft released March 12, 2013. AdvaMed represents approximately 400 of the world's leading medical technology innovators and manufacturers of medical devices, diagnostic products and medical information systems. AdvaMed members range from the smallest to the largest medical technology innovators and companies – nearly 80 percent of our members are small companies in a pre-revenue state or with annual domestic sales of less than $100 million. AdvaMed is dedicated to the advancement of medical science, the improvement of patient care, and in particular, to the contribution that high quality health care technology can make toward achieving those goals. We believe that changes to the tax code are essential to support continued creation and growth of the small start-up companies that are critical to the future of our industry and to other knowledge-based, high technology industries.

About the Medical Device Industry

The medical technology industry is an American success story. The industry directly employs more than 400,000 workers nationwide. Typically, for every worker our industry directly employs, another four workers are employed by businesses supplying components and services to our industry and our employees, so that the total numbers generated by our industry nears two million.

The jobs our industry provides are good jobs—the kinds of jobs that allow employees to live the American dream. Industry pay levels are 38 percent higher than average pay for all U.S. employment and 22 percent higher than other manufacturing employment. While the number of manufacturing jobs was plummeting across the larger economy, even before the recent economic downturn, employment in our industry was expanding. Between 2005 and 2007, medical technology employment grew 20.4 percent, adding 73,000 jobs. During the recession, between 2007 and 2008, MedTech employment dropped 1.1 percent, compared to 4.4 percent for manufacturing as a whole.

What the Subcommittee may not know is that the medical technology industry is heavily skewed toward small companies—the kind of companies that begin with a scientist or doctor with an idea to improve patient care. Almost two-thirds of the 7,000 medical technology firms in the U.S. have fewer than 20 employees – the majority of these companies being in pre-revenue or early revenue stages. A high proportion of the breakthrough products in our industry come from these small, often venture-capital funded companies. The long-term health of the whole industry depends on the continued success of these small firms and their access to the capital necessary to develop the breakthrough products of the future.

With this being said, these emerging and early-growth companies are facing extreme drought in terms of required capital to develop new technologies and create new jobs. In 2012, venture capital investments in the Medical Device industry fell by 13 percent in dollars and 15 percent in deals – with a total of $2.4 billion going into 313 deals. Much of

the decline occurred in first-time financings, where Medical Devices saw the lowest number of deals since 1995[i]. Prior to the financial crisis of 2008, the industry began experiencing a significant decline in the number of first-time financings, as shown in Figure 1[ii]. Total investments have also declined to levels below those present prior to the financial crisis (Figure 2).

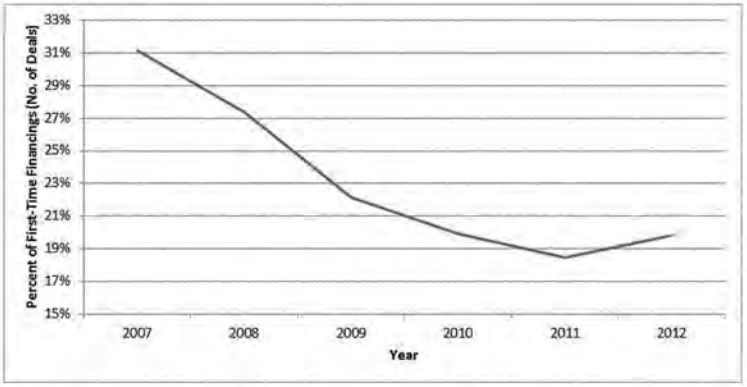

Figure 1. First-Time Investment Decline since 2007 (based on number of deals)[ii] – Medical Device Industry

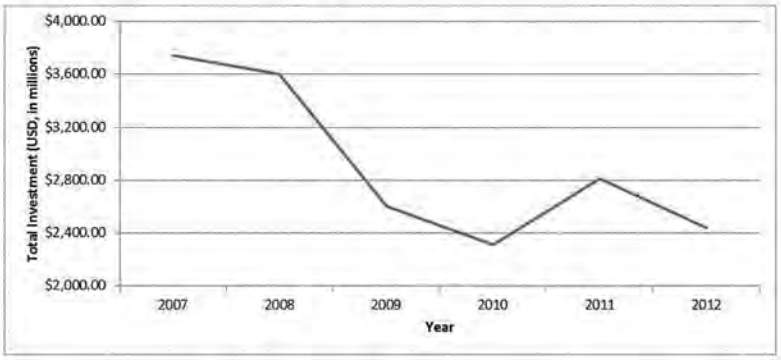

Figure 2. Total Venture Capital Investment in the Medical Device Industry[ii]

[i] Pricewaterhouse Coopers and NVCA, "MoneyTree Report," January 2013.
[ii] Thomson Reuters, MoneyTree Report Aggregate Data Q1 1995 – Q4 2012.

Whether a firm is large or small, success in our industry comes only from innovation—the creation of diagnostics, treatments and cures that extend and enhance lives. Our industry's investment in research and development is more than twice the national average. Our product life-cycle is typically only 18-24 months, so being able to invest in R&D is essential to creating the next generation of treatments and cures.

With $33 billion in total exports in 2008, medical technology ranks eleventh among all manufacturing industries in gross exports. Notably, unlike virtually every other sector of U.S. manufacturing, medical technology has consistently enjoyed a favorable balance of trade.

While we are very proud of our contributions to the U.S. economy, we are even more proud of our contributions to improving patient care. For patients, medical progress has been remarkable. Between 1980 and 2000, medical progress added more than three years to life expectancy. The death rate from heart disease was cut in half; the death rate from stroke was cut by one-third, and the death rate from breast cancer was cut 20 percent. Medical technology has been a major driver of this progress.

We have been able to make these contributions while helping to keep overall health care costs from growing. Our industry is so competitive that increases in costs for our products have averaged only one-quarter the rate of other medical goods and services and just one-half the general CPI for almost 20 years. Many of the devices produced by our companies help reduce hospital readmissions or address chronic disease, and in the long-term can provide cost-savings for the health care system through better patient outcomes.

But the continued success of our industry depends on the continued success of a vibrant and supportive environment for small companies, especially small, start-up companies that have not yet attained profitability.

Tax Reform: An Opportunity to Promote Innovation and Stimulate Investment in Emerging Companies

AdvaMed applauds Ways and Means Committee Chairman Camp and Chairman Tiberi, Ranking Member Neal, and the Select Revenue Measures Subcommittee for their consideration of small businesses as the tax code is reformed. Lowering the overall tax rate can make a vital contribution to the health and competitiveness of a small business. Simplifying the tax code to allow these small businesses to better leverage their capital in investment and job creation rather than tax preparation is also commendable. For the start-up small businesses that are so important to our industry, however, access to capital in the pre-profit stage is also crucial. Development of a new breakthrough product to point of FDA approval and marketing typically requires years and close to $100 million in investment, and companies generally do not reach profitability until they achieve annual revenues exceeding $100 million. We urge you to consider ways of adjusting the tax code to address the needs of these small, innovative, research-intensive businesses through incentives that encourage investments from other companies, individuals, and funds. Providing additional incentives for investment in these pre-profit companies is

critical to encouraging their ultimate success and their ability to create new jobs and commercialize life-changing technologies.

"Broadening the base and lowering the rate," while desirable, is not by itself sufficient to support the establishment, survival, and growth of these companies, especially those not yet realizing a revenue stream. We commend Chairman Camp for his proposal to increase the threshold for the deductibility of start-up expenses. While this will be helpful to some small companies, the need to raise capital in a very challenging regulatory and economic environment and to compete globally will require the enactment of some of the proposals that are set out in this testimony.

We also commend the Chairman for his commitment to simplify the tax system; start-ups should focus as much as they can on the challenges of developing and marketing new products instead of dealing with a confusing and over-complex federal tax system. In addition to simplifying the tax code, comprehensive tax reform should also encourage current – and new – investors to finance companies sooner. With the new challenges posed by an increasingly demanding regulatory and payment environment, incentives in the tax code to encourage availability of capital for companies developing the life changing innovation and great products of the future are essential. To achieve this objective, AdvaMed believes that the following policies should be part of tax reform:

Device Tax Repeal
The 2.3% Medical Device Excise Tax poses an enormous burden for small companies – in terms of capital and compliance. From their first sale, these companies are subject to the tax, even with millions of dollars in net operating losses incurred over years of development. AdvaMed continues to advocate for full repeal of this detrimental tax burden.

Section 469 R&D Partnership Structures (Attachment 1)
AdvaMed, along with the Coalition of Small Business Innovators (CSBI), supports a limited exception from the passive activity loss (PAL) rules for R&D-focused pass-through entities. Relaxing the PAL rules will incentivize investors to finance companies at an earlier stage when capital is most needed – and where current investments in the Medical Device industry have dried up most since 2007.

Section 382 Net Operating Loss (NOL) Reform (Attachment 1)
AdvaMed, along with CSBI, supports the exemption of NOLs generated by qualifying research and development conducted by a small business from Section 382. Currently, the usage of NOLs by companies who have undergone an "ownership change" is restricted. Such reform would encourage additional outside financing and help make such businesses more attractive to investors.

Section 1202 Capital Gains Reform (Attachment 1)
AdvaMed, along with CSBI, supports changing the qualified small business (QSB) definition to include companies with gross assets up to $150 million (from $50 million), with that cap indexed to inflation. This change would also include S-Corps and LLCs in

the definition of a QSB. Furthermore, AdvaMed and CSBI support excluding the value of a company's IP when calculating gross assets. These changes would also encourage investment into emerging and early-growth medical device companies.

Permanent Extension of Section 179 Depreciation Deduction

AdvaMed also supports the permanent extension of the Section 179 expense, which allows qualifying small business owners to deduct the cost of depreciating business assets on their tax returns at a limit of $500,000. Furthermore, AdvaMed supports the permanent extension of bonus depreciation in Year 1 (50% of cost) of a qualified business asset purchase. Such incentives allow companies to invest more heavily in their businesses and encourage job creation and growth. We commend Chairman Camp for including a permanent extension of Section 179 in his small business discussion draft. We believe, however, that the higher $500,000 limit we are proposing is needed given the high cost of equipment needed to start a new business in today's economy, especially in the capital-intensive medical device and diagnostic industries.

Permanent Extension of Sections 992-996 IC-DISC Status

AdvaMed supports the permanent extension of IC-DISC status for qualified small companies exporting to other countries. Many medical device companies are forced to commercialize their products first overseas. The tax rate reduction to 15% provides these companies with capital to fuel organic growth, finance clinical studies and regulatory approvals in the United States, and develop new technologies.

Conclusion

In closing, we would like to thank Chairman Tiberi and Ranking Member Neal for their interest in the tax code's impact on small businesses and consideration of the proposals contained herein to support research and development-intensive firms. Our industry stands ready to work with the Ways and Means Committee and Subcommittee on Select Revenue Measures as you continue your efforts to reform the tax code, which will help provide the medical device and diagnostics industry the opportunity to continue be the world leader in the development of new technologies that allow patients to lead longer, healthier, and more productive lives.

Attachment 1. Promoting Innovation Through Tax Reform

The Coalition of Small Business Innovators (CSBI) supports a U.S. tax code that recognizes innovation as a crucial part of the 21st century American economy. By itself, a lower corporate tax rate will not support growth and innovation in America's small businesses, many of which are pre-revenue. Comprehensive tax reform should go further than "broadening the base and lowering the rate." Instead, policymakers should specifically promote innovative research-intensive businesses through incentives for other companies, individuals, and funds to invest in small companies and support their research.

Section 469 R&D Partnership Structures

Background: Prior to 1986 tax reform, many growing companies attracted investors by using R&D Limited Partnerships, in which individual investors would finance R&D projects and then utilize the operating losses and tax credits generated during the research process. These structures gave investors a tax incentive to support high tech research, which is entirely dependent on outside investors but often too risky or expensive to attract sufficient investment capital. The enactment of the passive activity loss (PAL) rules in 1986 prevented investors from using a company's losses to offset their other income, thus removing the incentive to support vital research.

Proposal: CSBI supports a limited exception from the PAL rules for R&D-focused pass-thru entities. Under this proposal, small companies would be able to enter into a joint venture with an R&D project's investors. The losses and credits generated by the project would then flow through to the company and investors, who would be able to use the tax assets to offset other income. Relaxing the PAL rules to allow investors to enjoy a more immediate return on their investment, despite the long and risky timeline usually associated with groundbreaking research, would incentivize them to invest at an earlier stage, when the capital is most needed.

Section 382 Net Operating Loss (NOL) Reform

Background: Innovative companies often have a long, capital-intensive development period, meaning that they can undergo a decade of research and development without any product revenue prior to commercialization. During this time period, companies generate significant losses, which can be used to offset future gains if the company becomes profitable. However, Section 382 restricts the usage of NOLs by companies which have undergone an "ownership change." The law was enacted to prevent NOL trafficking, but small high tech companies are caught in its scope – their reliance on outside financing and deals triggers the ownership change restrictions and their NOLs are rendered useless.

Proposal: CSBI supports reform of Section 382 to exempt NOLs generated by qualifying research and development conducted by a small business from Section 382. This change would allow small companies the freedom to raise capital for innovative research without fear of losing their valuable NOLs. Additionally, the ability of a small business to maintain its NOLs makes it more attractive to investors and purchasers looking to take its research to the next level.

Section 1202 Capital Gains Reform

Background: Section 1202 allows investors to exclude from taxation a portion of their gain, temporarily set at 100%, from the sale of a qualified small business (QSB) stock if they hold the stock for five years. This provision was designed to promote investment in growing businesses, but its overly restrictive size requirements prohibit innovative companies from accessing valuable investment capital. Currently, QSBs must have gross assets below $50 million. The high costs of research, coupled with valuable intellectual property and successive rounds of venture financing, often push growing innovators over the $50 million gross assets limit and out of the QSB definition.

Proposal: In addition to making the 100% capital gains exclusion permanent, CSBI supports changing the QSB definition to include companies with gross assets up to $150 million, with that cap indexed to inflation. CSBI also supports excluding the value of a company's IP when calculating its gross assets. These changes would allow more growing innovators to attract investors to fund their vital research. Providing incentives to invest in high tech research will increase the innovation capital available to research-intensive businesses and speed the development of groundbreaking technologies.

AIA

AIA

The American Institute of Architects Statement for the Record

"Ways and Means Small Business and Pass-through Entity Tax Reform Discussion Draft"

U.S. House of Representatives
Committee on Ways and Means
Subcommittee on Select Revenue Measure
May 15, 2013

The American Institute of Architects (AIA) appreciates the opportunity to provide a statement to the Subcommittee on the impact of tax reform proposals on small businesses, and we commend the Committee for discussing this important issue.

The AIA has been the leading professional membership association for architects and allied partners since 1857. The AIA represents more than 81,000 architects and emerging professionals nationwide and around the world.

The AIA supports comprehensive tax reform that lowers marginal tax rates for individuals, pass-through entities, and corporations, while broadening the tax base and simplifying the tax code. We recognize that tax reform is a balancing act. Lowering tax rates will require curtailing or discarding many tax expenditures, while maintaining and improving a limited number of tax policies that support important policy objectives. We are hopeful that, at the end, tax reform is an opportunity to provide taxpayers with much-needed certainty, simplicity, and fairness, while at the same time encouraging economic growth and job creation.

U.S. architects are the leading edge of a design and construction industry that accounts for one in nine dollars of Gross Domestic Product. Every $1 billion invested in design and construction creates 28,500 full-time jobs in a wide range of industries. In 2011 alone, the 17,500 architecture firms owned by AIA members grossed billings of $26.0 billion, driving economic activity and job growth.

Architecture is by-and-large a small-business industry: most architecture firms at which AIA members work are small businesses. Approximately 97 percent of firms meet the Small Business Administration's size standard definition of a small business and have fewer than 50 employees. Moreover, a significant portion of these firms are organized as pass-through entities, including partnerships and S corporations. Many architects operate as sole proprietors, including a large number who lost their jobs in the recent economic crisis and set up shop on their own.

The American Institute of Architects
1735 New York Avenue, NW
Washington, DC 20006
www.aia.org

In addition to architects, every day, nearly 70 million Americans go to work at small businesses organized as something other than a C corporation. These "flow-through" businesses, structured as S corporations, partnerships, LLCs, or sole proprietorships, represent 95 percent of all businesses, and they contribute more to our national income and our job base than all the C corporations combined.

Despite these contributions, recent press reports suggest that the Administration and some Members of Congress support budget-neutral legislation that would reform the tax code for C corporations only. The proposal would be to reduce the tax rate on C corporations and offset those lower rates by eliminating or reducing tax deductions and credits used by all businesses.

Two years ago, Ernst & Young studied what "budget neutral, corporate-only" tax reform would mean to pass-through businesses. According to the Ernst & Young study, this approach would increase taxes on pass-through job creators of all sizes by at least $27 billion per year. In other words, corporate-only tax reform means lower taxes for large multinational corporations and higher taxes for small businesses like architecture firms.

"Corporate-only" tax reform would leave pass-through entities at a severe disadvantage, harming small businesses, including architecture firms. As Congress moves forward with tax reform, tax policies aimed at strengthening small businesses-- including tax policies that maintain the ability of businesses to choose pass-through forms of entities -- should be preserved.

We appreciate the House Ways and Means Committee's release of the Small Business Tax Reform Discussion Draft ("the Draft"). We continue to analyze the impact that the Discussion Draft's proposals would have on AIA members.

In the meantime, we associate ourselves with the analysis of the Draft by the American Bar Association dated April 12, 2013 and echo its concerns over the implications of the proposed Option 2. Particularly, we are concerned that this new structure would burden our small businesses with paperwork and compliance costs. Also, the most likely result will be a general confusion over whether their firms are compliant with the new rules. Most small architecture firms do not have tax experts on staff, and would have to incur additional fees to comply. Adding more confusion to the code in this way runs counter to the goal of tax simplification.

The AIA urges Congress to preserve tax policies that are aimed at strengthening small businesses, reducing compliance burdens, and providing certainty. Such policies would help spur economic activity by helping small businesses expand operations and drive job creation by allowing small businesses to hire new workers and increase wages and benefits.

To that end, the AIA is very concerned that past proposals aimed at closing loopholes used by some lawyers and celebrities to avoid paying payroll tax, would force a massive tax increase on legitimate small businesses who file taxes as Subchapter S corporations.

The AIA vigorously opposes proposals that would wind up punishing the honest small businesses that follow the rules, reinvest their profits and create jobs. A much better way to stop abuse would be to have the IRS issue clearer guidance for S Corporation filers and give the agency broader authority to go after abusers.

We welcome the opportunity to provide this statement to the Committee and look forward to working with the Committee to foster an economic environment that helps small businesses grow our economy.

AICPA

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

WRITTEN STATEMENT
OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

For the Record of the
May 15, 2013 Hearing
of the

HOUSE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

on

SMALL BUSINESS AND PASS-THROUGH ENTITY
TAX REFORM DISCUSSION DRAFT

May 17, 2013

AICPA

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

WRITTEN STATEMENT
For the Record of the
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May 17, 2013

As Congress considers tax reform this year, the American Institute of Certified Public Accountants (AICPA) offers the following comments on the House Ways and Means Committee Chairman Camp's small business tax reform discussion draft, Proposed Tax Reform Act of 2013, Title II – Tax Reform for Businesses (March 12, 2013). These comments are submitted for the record of the May 15, 2013 hearing of the House Committee on Ways and Means Select Revenue Subcommittee on Small Business and Pass-Through Entity Tax Reform Discussion Draft. The comments were drafted in response to the House Ways and Means Committee's request for such comments and focus on simplification.

The AICPA plans to further consider and analyze Option 2 (Proposed Tax Reform Act of 2013, Title II – Tax Reform for Businesses, Subtitle C – [Option 2] Unified Rules for Passthroughs) and will likely submit further comments on Option 2 in the coming months. The AICPA is available to discuss with Members of Congress and their staff the various issues involved.

The AICPA commends Chairman Camp and the House Ways and Means Committee on your continued attempts to simplify the tax Code and your responsiveness to taxpayer concerns that the Code as written is currently too complex for taxpayers. The AICPA appreciates the opportunity to provide comments as part of the tax reform process.

The AICPA is the world's largest member association representing the accounting profession, with nearly 386,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We welcome the opportunity to discuss these comments on the discussion draft legislative proposal or to answer any questions.

T: 202.737.6600 | F: 202.638.4512 | aicpa.org

AICPA Written Statement for May 15, 2013 Hearing
House Ways and Means Committee Select Revenue Subcommittee
Small Business and Pass-Through Entity Tax Reform Discussion Draft
May 15, 2013

These AICPA comments relate to the House Ways and Means Committee Chairman Camp's March 12, 2013 small business tax reforms discussion draft legislative text ("Proposal"). These comments are in response to the House Ways and Means Committee's request for such comments and focus on simplification. Unless section references are noted as being from the Internal Revenue Code (IRC or "Code"), the section references are to the proposed legislative text in the draft bill, Tax Reform Act of 2013, Title II – Tax Reform for Businesses.

Our comments are on:

Subtitle B Tax Reform for Small Businesses, Part 1 General Provisions

- Section 211 - Expensing Certain Depreciable Business Assets for Small Businesses.
  - AICPA strongly supports this provision.
- Section 212 - Limitation on Use of Cash Method of Accounting.
  - AICPA strongly opposes the limitation on use of cash method of accounting imposed on non-natural persons under this provision of the Proposal, and the AICPA strongly opposes the elimination of exceptions for personal service corporations and farmers. Separately, the AICPA supports the availability of the cash method for an increasing level of gross receipts for small businesses.
- Section 213 - Repeal of Required Use of Accrual Method for Corporations Engaged in Farming.
  - AICPA supports this provision but opposes the elimination of the exception to use the cash method of accounting for farmers under section 212 the Proposal.
- Section 214 - Modification of Rules for Capitalization and Inclusion in Inventory Costs of Certain Expenses.
  - AICPA supports and provides a recommendation to modify this provision of the Proposal to exempt businesses with less than $5 million of average annual inventory from the section 263A requirements, rather than utilize average annual gross receipts.
- Section 215 - Unification of Deduction for Start-Up and Organizational Expenditures.
  - AICPA supports this provision.

Subtitle B Tax Reform for Small Businesses, Part 2 Tax Return Due Date Simplification

- Section 221 - New Due Date for Partnership Form 1065, S Corporation Form 1120S, and C Corporation Form 1120.
  - AICPA strongly supports this provision.
- Section 222 - Modification of Due Dates by Regulation.
  - AICPA strongly supports this provision.

- Section 223 - Corporations Permitted Statutory Automatic 6-Month Extension of Income Tax Returns.
    - AICPA strongly supports this provision.

Subtitle C [Option1] Passthrough Entities

- Section 231 - Reduced Recognition Period for Built-In Gains Made Permanent.
    - AICPA supports this provision.
- Section 232 - Modifications to S Corporation Passive Investment Income Rules.
    - AICPA strongly supports this provision.
- Section 233 - Expansion of Qualifying Beneficiaries of An Electing Small Business Trust.
    - AICPA strongly supports this provision.
- Section 234 - Charitable Contribution Deduction for Electing Small Business Trusts.
    - AICPA supports this provision.
- Section 235 - Permanent Rule Regarding Basis Adjustment to Stock of S Corporations Making Charitable Contribution of Property.
    - AICPA supports this provision and requests consideration of our proposed treatment.
- Section 236 - Extension of Time for Making S Corporate Election.
    - AICPA supports this provision.
- Section 241 - Repeal of the Rules Relating to Guaranteed Payments and Liquidating Distributions.
    - AICPA supports this provision; notes further clarification is needed.
- Section 242 - Mandatory Adjustments to Basis of Partnership Property in Case of Transfer of Partnership Interests.
    - AICPA opposes this provision as drafted and requests de minimis rules be included due to the added complexity for small taxpayers; AICPA suggests de minimis thresholds to exempt small partnerships and small transfers from mandatory adjustments to basis
- Section 243 - Mandatory Adjustments to Basis of Undistributed Partnership Property.
    - AICPA opposes this provision as drafted in general because of the gain triggering rule and requests the addition of de minimis rules due to complexity and gain implications for continuing, non-distributee partners; AICPA suggests de minimis thresholds to exempt small partnerships and small transfers from mandatory adjustments to basis.
- Section 244 - Corresponding Adjustments to Basis of Properties Held by Partnership where Partnership Basis Adjusted.
    - AICPA opposes this provision due to complexity; suggests further clarification.
- Section 247 - Repeal of Time Limitation on Taxing Precontribution Gain.
    - AICPA opposes this provision due to complexity; suggests a de minimis rule be included.

AICPA Written Statement for May 15, 2013 Hearing
House Ways and Means Committee Select Revenue Subcommittee
Small Business and Pass-Through Entity Tax Reform Discussion Draft
May 15, 2013

and

Other Issues For Consideration

- Repeal Technical Terminations of Partnerships and Repeal the Anti-Churning Rules of Section 197
    - AICPA supports the Administration's Fiscal Year 2014 Revenue Proposals provisions concerning repeal of the rules for technical terminations of partnerships and the anti-churning rules of IRC section 197.

- Self-Employment Taxation
    - AICPA asks for guidance; provides comments.

Specific Comments

Title II Tax Reform for Businesses, Subtitle B Tax Reform for Small Businesses, Part 1 General Provisions

1. Section 211 – Expensing Certain Depreciable Business Assets for Small Business.

The AICPA strongly supports section 211 of the Proposal.

The provision provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2013, is $250,000 of the cost of qualifying property placed in service for the taxable year. The $250,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $800,000. The $250,000 and $800,000 amounts are indexed for inflation for taxable years beginning after 2014. In addition, the AICPA supports making permanent, for taxable years beginning after 2013, the treatment of off-the-shelf computer software as qualifying property, the treatment of qualified real property as eligible IRC section 179 property, and the special rule allowing an election or specification under IRC section 179 to be revoked by the taxpayer without consent of the Commissioner.

The IRC section 179 deduction provides many small business taxpayers opportunities to increase their investment in capital assets by lowering their after-tax acquisition costs via a current tax deduction for 100 percent of the acquisition costs. The expanded IRC section 179 deduction that has been available in recent years has encouraged even greater capital investments by small businesses. We believe the IRC section 179 deduction gives many small businesses incentives and opportunities to continue their capital expenditures to grow their businesses, often expanding the employment base. Therefore, we strongly support section 211 of the Proposal.

2. Section 212 - Limitation on Use of Cash Method of Accounting.

The AICPA strongly opposes the limitation on the use of the cash method of accounting imposed on non-natural persons under the Proposal, and the AICPA strongly opposes the elimination of exceptions for personal service corporations and farmers. Separately, the AICPA supports the availability of the cash method for an increasing level of gross receipts for small businesses.

Congress previously recognized when enacting the Tax Reform Act of 1986 that the cash method is generally a simpler method of accounting and that simplicity justifies its continued use by certain types of taxpayers and for taxpayers engaged in certain types of activities. At that time, Congress believed that small businesses should be allowed to continue to use the cash method of accounting in order to avoid the higher costs of compliance which would result if they are forced to change from the cash method. Given there has been no change that would reduce the costs of compliance, indeed if anything costs of compliance would have increased since 1986, we are concerned that certain aspects of section 212 of the Proposal may create additional administrative burden.

Section 212 of the Proposal currently provides that the cash method of accounting can be used only by a natural person and any other taxpayer who meets the $10 million gross receipts test. This inability to use the cash method of accounting would create an artificial obstacle to joint ventures, which may be necessary for small business growth and job creation, and would create significant administrative burdens as a result of the more complex requirements of the accrual method of accounting. Consider, for example, a sole proprietor operating a successful business with more than $10 million of gross receipts. If the sole proprietor adds a new partner to the business, the business is no longer operating as a natural person (sole proprietor), creating a disincentive to expand the business. Furthermore, section 212 of the Proposal provides for (i) the elimination of the exceptions for personal service corporations (PSCs) and farming businesses that exceed the proposed $10 million threshold, and (ii) subjecting passthrough entities to a gross receipts test. As currently drafted, section 212 of the Proposal would require virtually all service companies with gross receipts greater than $10 million currently using the cash method of accounting to change to the accrual method of accounting, which would increase administrative and recordkeeping burdens on such taxpayers, especially those that are growing service companies. For example, the accrual method of accounting for tax purposes imposes additional rules when compared to either the cash method of accounting or the accrual method of accounting that many business entities must use for Generally Accepted Accounting Principles (GAAP) (e.g., the all-events test). The AICPA believes section 212 of the Proposal, as drafted, would impose undue burdens on many of these taxpayers by requiring significant additional planning to prepare for, and comply with, the new requirements.

Congress has previously noted that individuals engaged in professional activities traditionally have used the cash method of accounting in the operation of their trades or businesses and should be eligible for the continued use of the cash method. For certain fields, such as law, it could be years before the account receivable is actually collected. Paying the taxes on this income years in advance would be a hardship on the taxpayer.

The potential hardship from restrictions on the use of the cash method by partnerships would be increased for those professional firms that are subject to state regulations restricting ownership to individuals who actively participate in the business. For example, in many states, a firm engaged in the practice of accountancy may not have any passive (investor) ownership and a majority of the owners must hold active CPA licenses. We believe that similar restrictions also exist for firms engaged in the practice of law. As a result, many accounting and law firms must be capitalized solely by the individual professionals, who together own the firm, and cannot raise capital from outside investors. Because of these restrictions, an acceleration of tax on income that has not actually been collected in cash would place a significant strain on the ability of such professional owner-operators to properly capitalize their firms. In summary, the AICPA strongly opposes the limitation on the use of the cash method of accounting for non-natural taxpayers. The AICPA proposes an expansion of the eligible taxpayers to include qualifying passthrough entities.

The AICPA strongly opposes the elimination of exceptions for personal service corporations and farmers noted above.

3. Section 213 – Repeal of Required Use of Accrual Method for Corporations Engaged in Farming.

The AICPA supports section 213 of the Proposal, which would repeal the required use of the accrual method for corporations engaged in farming, but the AICPA opposes the elimination of the current exception to use the cash method of accounting for farmers under section 212 of the Proposal. If section 212 of the Proposal does not continue to exempt farmers, farmers operating their business as a sole proprietor would be able to use the cash method of accounting, but farmers operating as partnerships or corporations would be required to use the accrual method of accounting. This appears to be an inequitable result.

Treas. Reg. § 1. 162-12(a) allows cash method farmers to deduct costs incurred in raising crops and animals. The cash method of accounting presents simpler recordkeeping for most farmers. The repeal of the required use of the accrual method by corporate farmers would alleviate the burden imposed on these farming businesses.

However, we believe the repeal should only be passed with the cash method farmer exception in place. As noted above, section 212 of the Proposal provides for eliminating an exception allowing the use of the cash method for farmers, and the AICPA strongly opposes the elimination of this exception. If the repeal provision (section 213) remains in the Proposal with the elimination of the farmer exception (section 212), the special method of accounting rules for corporations and partnerships with a corporate partner who engages in farming under IRC section 447 should be retained to provide those entities with an unchanged (IRC section 447) threshold on gross receipts for a farm corporation.

4. Section 214 – Modification of Rules for Capitalization and Inclusion in Inventory Costs of Certain Expenses.

The AICPA supports modifying the rules for capitalization and inclusion of certain expenditures in inventory. The AICPA recommends modifying the Proposal to provide an exception for businesses with less than $5 million of average annual inventory from the IRC section 263A requirements, rather than utilize average annual gross receipts. Section 214 of the Proposal would provide that a taxpayer that produces tangible personal property and has $10 million or less of average annual gross receipts would not be subject to IRC section 263A.

We believe the proposal provides small manufacturers with simplification by removing the burden of complying with the complex Uniform Capitalization (UNICAP) rules. However, we believe that a more appropriate measure for a small taxpayer exemption from IRC section 263A would be the average aggregate value of average ending inventory and other property otherwise subject to IRC section 263A. This is a more appropriate measure for an IRC section 263A small taxpayer exemption because there is a direct correlation between the value of property subject to IRC section 263A and the amount of costs capitalized to such property under IRC section 263A. Therefore, we suggest that the Proposal be revised to provide that taxpayers (both producers and resellers) would be exempt from IRC section 263A when the average aggregate value of ending inventory and other property otherwise subject to IRC section 263A for the three previous taxable years does not exceed $5 million. For this purpose, the value of ending inventory would be determined under the taxpayer's methods of accounting for inventory for Federal income tax purposes, except that, for those taxpayers using the last in, first out (LIFO) inventory accounting method, the value of ending inventory would be the prior year cost of inventory, including any adjustments for trade discounts, cash discounts, and inventory shrinkage. We also suggest the $5 million threshold be indexed for inflation.

5. Section 215 - Unification of Deduction for Start-Up and Organizational Expenditures.

The AICPA supports section 215 of the Proposal, which consolidates IRC sections 195, 248, and 709 into one provision.

Section 215 of the Proposal would allow a taxpayer to elect to deduct (up to $10,000, from $5,000) such expenditures that are allowed in the taxable year in which the active trade or business begins. In addition, section 215 of the Proposal would increase the phase-out amount from $50,000 to $60,000. The $10,000 amount would be reduced (but not below zero) by the amount by which the cumulative cost of the sum of start-up and organizational expenditures exceeds $60,000. The AICPA suggests that for simplification reasons, there should be no phase-out as the total amount allowable as a deduction is only $10,000 and mostly small businesses would be the start-up businesses utilizing this benefit. The Proposal states that pursuant to such election, the remainder of such start-up expenditures and organizational expenditures could be amortized over a period of not less than 180 months, beginning with the month in which the trade or business begins. We suggest that Congress reconsider the amortization period to be 60 months, similar to the period when this provision was first enacted, rather than 180 months, to

simplify the tracking and administrative burden. We believe section 215 of the Proposal would provide simplification and reduce administrative burden for small businesses.

The AICPA notes that section 215 of the Proposal eliminates section 709 in its entirety and asks for clarification on the capitalization and amortization of expenditures that would constitute syndication costs, as defined in current section 709.

Title II – Tax Reform for Businesses, Subtitle B – Tax Reform for Small Businesses, Part 2 – Tax Return Due Date Simplification

1. Section 221 – New Due Date for Partnership Form 1065, S Corporation Form 1120S, and C Corporation Form 1120; Section 222 – Modification of Due Dates by Regulation; and Section 223 – Corporations Permitted Statutory Automatic 6-Month Extension of Income Tax Returns.

The AICPA strongly supports the tax return due date simplification in the Proposal. We note that this provision is the same as the proposal contained in the March 21, 2013 Senate Finance Committee Tax Reform Options paper on Simplifying the Tax System for Families and Businesses.[1] As the AICPA has suggested to Congress, the Proposal changes to the current schedule for filing tax returns will address many of the problems currently facing taxpayers and tax professionals by creating a logical flow of information.[2] It will assist taxpayers and tax professionals in filing timely and accurate tax returns. Currently, taxpayers and practitioners have insufficient time to prepare accurate returns because required information from a business is not available under the current due-date schedule, requiring extensions to accommodate the current deadlines.

The due dates in the Proposal would allow for a more logical and chronologically-correct flow of information as data from flow-through entities is filed before the individuals and corporations that are invested in the flow-through entities. The Proposal simplifies and aligns other types of tax return and information return reporting due dates. The Proposal should increase the accuracy of tax returns and reduce the need for extended or amended corporate and individual income tax returns, resolving many of the current due date problems.

The AICPA supports the due dates provision in the Proposal because it would:

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[1] See March 21, 2013 Senate Finance Committee Tax Reform Options paper on Simplifying the Tax System for Families and Businesses, Part II. Filing Process, 1. Enable the IRS to Verify Information on Taxpayer Returns Against Third-Party Information as Returns are Processed, a. Establish a System of Filing Deadlines that Ensures Timely Receipt of Reliable Third-Party Information by Taxpayers and the IRS, for Example by Changing Due Dates for Returns

[2] See http://www.aicpa.org/InterestAreas/Tax/Resources/Partnerships/Advocacy/DownloadableDocuments/Due%20Date%20Letter%20and%20Bill%20-%20Final.pdf

- Improve the accuracy of tax and information returns by allowing corporations and individuals to file using current data from flow-through returns that have already been filed rather than relying on estimates.
- Better facilitate the flow of information between taxpayers (i.e., corporations, partnerships, and individuals).
- Promote earlier filing of more business and individual returns and reduce the need for extended and amended corporate and individual tax returns.
- Enable earlier filing of final flow-through returns as tax resources can be redirected from non-publicly traded C corporations to flow-through entities, whose returns would be due well in advance of such corporations.
- Significantly simplify tax administration for the government, taxpayers, and practitioners.

Taxpayers rely on timely information from others in order to file accurate returns. With an increase in the complexity and the quantity of partnerships, more taxpayers now routinely include the information from a Schedule K-1, the tax document with investment information provided by partnerships, in their tax returns. Currently, the statutory due date for partnerships to file a tax return is the same day as trusts, many estates, and individuals, and one month after the due date for corporations. Taxpayers and preparers have long struggled because Schedules K-1 often arrive months after the original due date of their or their clients' returns. Late Schedules K-1 make it difficult, if not impossible, to file a timely, accurate return. Many partners are often forced to seek extensions, a matter further complicated by the fact that partnerships sometimes also seek extensions.

In addition, the AICPA notes that currently extended due dates similarly do not align well in that corporate and partnership tax returns of calendar-year entities are due on the same extended due date – September 15. It is not uncommon for a corporate partner to be provided a final Schedule K-1 with inadequate time to properly vet the schedule or incorporate it into its own extended tax filings. The proposed change to the original due dates would similarly align the extended due dates for those taxpayers that have more complicated filings.

The interconnection of business entities and those who own them now demands a more logical flow of information between parties. Tax returns no longer serve only as a means for taxpayers to self-report and pay their tax liability to the government. Taxpayers, as part of their tax compliance process, equally rely upon the return information of others to properly report their own tax liability to the government. Individuals, S corporations, C corporations, trusts and other partnerships may all invest in or operate partnerships and, if they do, require Schedules K-1 (Form 1065) before completing their returns. The proposal highlights that the current two-step due-date system for most major returns does not reflect a logical flow of information between or among parties. The legislation acknowledges that change in the current due date structure is imperative.

Historically, calendar-year C and S corporations have been required to file their tax returns by March 15th (with an extension, to September 15th) while individuals, trusts and partnerships

have been required to file by April 15th (with an extension to October 15th – until the 2008 regulations changed the extension date for trusts and partnerships to September 15th). Since January 1997, when the "check-the-box[3]" regulations became effective and "eligible" entities found it easier to file as partnerships, the formation of new limited liability companies, limited liability partnerships and similar state law entities (collectively, LLEs) resulted in a dramatic increase in the number of partnership returns being filed. Understandably, this situation has increased the number of individuals and entities, including S and C corporations, trusts and estates relying on information from partnerships and other passthrough entities in determining taxable income.

The use of tiered partnership structures has also increased in recent years – and with it, the complexity of tax compliance – by vehicles such as hedge funds, master limited partnerships, business trusts, series limited liability companies (LLCs) and private equity. Further, the increased complexity of the Code and other tax laws has resulted in the need for significantly greater information gathering and analysis. In this new environment, practitioners and taxpayers often find that the current ordering of tax return due dates for partners (i.e., individuals, C corporations, S corporations, trusts, or other partnerships) and partnerships makes the timely filing of complete and accurate returns difficult. In far too many cases, the ultimate owner of a partnership interest does not obtain the information needed to prepare tax returns on a timely basis. Increasingly complex partnership transactions and reporting requirements have added to return preparation time as additional analysis time is needed to ensure accuracy.

We find it both logical and helpful to other entities that the proposal has the partnership Form 1065 as the first return due because all other entities and individuals can be partners in a partnership and may thus be anticipating one or more Schedules K-1 from their partnership investments. It is appropriate for S corporations to file next because once they receive required information from their partnership investments, they will likely be able to complete their returns and provide Schedules K-1 (Form 1120S) to their shareholders who may be individuals, trusts/beneficiaries and estates. Once partnership and S corporation returns have been filed and owners have received their Schedules K-1, individuals, trusts and C corporations will have the information they need from their passthrough entity investments to file accurate and timely returns. In addition, to facilitate timely and accurate filing of tax return and information returns, the Form 3520-A, Annual Information Return of a Foreign Trust with a United States Owner, and Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, would be due and extended at the same time as the individual tax return due date and extension. Finally, employee benefit plans required to file Form 5500 currently have just a two and one-half month extension to file their returns by October 15, which under current law is 30 days after the corporate filing deadline and the same day as individual returns. These returns should be permitted a deadline of three and one-half months to continue to provide 30 days beyond the filing of the benefit plan's related corporate and individual returns.

[3] See Treasury Reg. §§ 301.7701-1 through 301.7701-3.

The AICPA believes that C corporations will largely benefit from the due date changes to April 15 and October 15. Many C corporations extend their returns because they are waiting on audited financial statements which typically arrive by the end of March. These corporations may no longer need to extend the income tax return, filing by the new original due date of April 15 (or the 15th day of the fourth month following the close of the taxable year for fiscal year corporations). We note that the due dates for estimated tax payments would not change, therefore, not impacting the budgetary scoring of the legislation.

The Proposal would address the above problems and improve the prospects for the timely filing of the tax returns of partners, returns that are often not prepared by the same individual or firm that prepared the partnership's return. We encourage Congress to pass legislation with this provision to modernize the tax return due dates and to correct the mismatch of information flow that persists in the system today. By doing so, Congress will continue to improve the taxpayer experience.

Title II – Tax Reform for Businesses, Subtitle C – [Option 1] Passthrough Entities, Part 1 – [Option 1] S Corporations

1. Section 231 - Reduced Recognition Period for Built-In-Gains Made Permanent

The AICPA supports section 231 of the Proposal, which would permanently reduce the recognition period to five years from ten years for the built-in-gain (BIG) tax. In addition, we applaud the Proposal making permanent the rule that installment sales are governed by the provision applicable in the tax year that the sale was made.

The AICPA believes that the proposed change would provide more clarity and continuity for taxpayers who are affected by the BIG tax. Recently, Congress passed multiple pieces of legislation to temporarily reduce the recognition period in an effort to provide tax incentives to many S corporations. The American Recovery and Reinvestment Tax Act of 2009 reduced the recognition period from ten years to seven years for 2009 and 2010. The Small Business Jobs Act of 2010 temporarily further reduced the recognition period to five years from seven years for 2011. The American Taxpayer Relief Act of 2012 maintained the five-year recognition period for 2012 and 2013.

The AICPA supports section 231 of the Proposal, which would provide more clarity and simplification regulating the BIG tax for many small business taxpayers, including S corporations.

2. Section 232 - Modifications to S Corporation Passive Investment Income Rules

The AICPA supports section 232 of the Proposal to increase to 60 percent (from 25 percent) the portion of an S corporation's income that may be passive without incurring an entity-level tax, and eliminate the current rule that terminates an S corporation's passthrough status if it has excess passive income for three consecutive years.

The AICPA recently suggested modifications to S corporation passive investment income (PII) rules.[4] Our recommendation included an increase in the passive investment income limit to 60 percent from 25 percent and eliminating the current rule that terminates an S corporation status due to excess passive income.

As we previously stated in our comments, the personal holding company (PHC) regime has a provision that applies an additional 15 percent tax when at least 60 percent of adjusted ordinary gross income for the tax year is personal holding company income. PHC income includes dividends, interests, royalties, and annuities. Therefore, we believe the modification aligns the S corporation passive income provision with those relating to PHCs, and meets the historical tax policy behind the taxation of undistributed earnings and profits for PHCs.

The AICPA strongly supports eliminating S corporation status termination due to excessive PII. In today's economic environment, such a harsh restriction puts S corporations at a distinct disadvantage. Other passthrough entities, such as limited liability companies and limited partnerships, do not have such a restriction and achieve a single level tax at the individual level. As a result, the modification would elimininate uncertainties of an involuntary termination of the S election related to PII for many S corporation shareholders and would allow them to concentrate on growing their businesses.

The AICPA strongly supports this modification that brings parity to S corporations and PHCs.

3. Section 233 - Expansion of Qualifying Beneficiaries of An Electing Small Business Trust

The AICPA applauds the expansion of qualifying beneficiaries of an Electing Small Business Trust (ESBT) to include non-resident aliens in section 233 of the Proposal. The provision would permit non-resident aliens to be S corporation shareholders through a U.S. electing small business trust (a type of trust that is permitted to own stock of an S corporation), which would better align the S corporation rules with the partnership rules without adding complexity to the S corporation structure and operations. Upon termination of the ESBT, the non-resident alien beneficiary would be forced to dispose of his stock, similar to existing provisions if stock is bequeathed to an ineligible shareholder.

The AICPA supports expansion of Potential Current Beneficiaries to non-resident aliens.

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[4] See
http://www.aicpa.org/advocacy/tax/taxlegislationpolicy/downloadabledocuments/compendium%20of%20legislation%20proposals%20february%202013.pdf

4. Section 234 - Charitable Contribution Deduction for Electing Small Business Trusts

The AICPA supports section 234 of the Proposal, which would allow an ESBT to deduct charitable contributions made by the S corporation subject to the contribution limits and carryover rules applicable to individual donors.

Section 234 of the Proposal would provide that the charitable contribution deduction of an ESBT would not be determined by the rules generally applicable to trusts but rather to the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals would apply to contributions made by the portion of an ESBT holding S corporation stock.

We believe conforming the charitable contribution deduction rules to individual rules would provide simplification and avoid administrative burden on small business taxpayers.

5. Section 235 - Permanent Rule Regarding Basis Adjustment to Stock of S Corporations Making Charitable Contribution of Property

The AICPA supports modifying the shareholder basis adjustment rules for S corporations making charitable contributions.[5] This provision would make permanent a fair market value deduction for a charitable contribution, but would limit the decrease in the shareholder's stock basis to the adjusted basis of the contributed property. We believe such treatment more closely resembles the treatment of charitable donations in the partnership context.

The AICPA previously suggested allowing S corporation shareholders to 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 property's adjusted basis.[6]

The AICPA agrees with making the proposed basis adjustment rule permanent. However, we recommend that our suggested treatment be further considered by Chairman Camp and Committee members.

6. Section 236 - Extension of Time for Making S Corporation Elections.

The AICPA supports section 236 of the Proposal, which would extend the time for making an S corporation election, permitting a corporation to make the election on its first S corporation tax return. Section 236 of the Proposal would permit this election by the extended due date for new and existing corporations.

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[5] See http://www.aicpa.org/interestareas/tax/resources/partnerships/advocacy/downloadabledocuments/house-small-business-committee-hearing-april-10-2008.pdf

[6] See http://www.aicpa.org/interestareas/tax/resources/partnerships/advocacy/downloadabledocuments/house-small-business-committee-hearing-april-10-2008.pdf

We recently recommended that allowing a taxpayer to make an S corporation election by the extended due date would simplify the procedure.[7] Simplification is achieved because the deadline for all new corporate taxpayers wishing to make the S election is moved to a time when the business typically engages professionals to handle its tax affairs – clearly a step in the right direction for small business taxpayers worried about running their businesses and not necessarily focused on the web of rules and regulations confronting them.

Furthermore, the provision would eliminate administrative burdens, such as submitting reasonable cause statements for failing to file the election in a timely manner, for many small business taxpayers. In 2007, the IRS issued Revenue Procedure 2007-62, which permitted the filing of Form 2553, Election by a Small Business Corporation, with Form 1120S, U.S. Income Tax Return for an S Corporation, upon a showing of reasonable cause for failing to file the election in a timely manner. Nevertheless, the Proposal would eliminate the need to show reasonable cause and would, accordingly, reduce taxpayer and preparer frustration, as well as significant professional fees required when requests for relief (including private letter rulings) must be made under other procedures when the taxpayer does not qualify under the most recent revenue procedure mentioned above.

The AICPA believes that the Proposal's extension of time for making S elections provides much needed simplification to regulate such a straightforward election.

Title II Tax Reform for Businesses, Subtitle C [Option 1] Passthrough Entities, Part 2 [Option 1] Partnerships

1. Section 241 - Repeal of Rules Relating to Guaranteed Payments and Liquidating Distributions

The AICPA believes section 241 of the Proposal has merit and, in fact, incorporates comments that the AICPA has made previously.[8] However, we believe that additional clarification is needed on the proposed repeal of Code section 707(c) in the following areas:

- The Proposal should clarify whether payments made to a partner without regard to the net income or loss of a partnership for services rendered to the partnership would be considered to be payments made to one who is not a partner under Code section 707(a). The determination of whether such payments constitute distributive share as a partner, or salary and wages under section 707(a) affects the reporting and withholding obligations of the partnership and partner and, thus, should be clarified. Conforming changes to

[7] See http://www.aicpa.org/advocacy/tax/scorporations/downloadabledocuments/supportoffrankenselectionbill-final.pdf.

[8] See http://www.aicpa.org/InterestAreas/Tax/Resources/Partnerships/Advocacy/DownloadableDocuments/House-Small-Business-Committee-Hearing-April-10-2008.pdf and http://www.aicpa.org/interestareas/tax/resources/taxlegislationpolicy/taxreformstudies/downloadabledocuments/comments_on_jct_2-6-02_final.pdf.

other provisions should also be addressed. For example, to the extent that partners are treated as employees for purposes of payments that would otherwise constitute wages if paid to a non-partner, Congress also should act to allow partners to participate in qualified benefits plans, or alternatively, to remove the disqualification rules for partner participation in such plans.

- The Proposal should be expanded to clarify how much of a partner's allocable share of partnership income will be subject to self-employment tax. See AICPA comments following under *"Other Issues for Consideration."*

- The Proposal should address the appropriate treatment of payments for the use of capital. Such payments do not constitute interest, as the payment is with respect to an equity interest in the partnership. With the elimination of section 707(c), clarification should be provided as to whether such fixed payments for the use of capital constitute merely a distributive share of partnership income, and address the timing of income inclusions, particularly in situations where payments exceed the partnership's net income for the taxable year.

2. Section 242 - Mandatory Adjustments to Basis of Partnership Property in Case of Transfer of Partnership Interests and Section 243 - Mandatory Adjustments to Basis of Undistributed Partnership Property

The AICPA opposes section 242 of the Proposal as drafted and requests de minimis rules be included due to the added complexity for small taxpayers. The AICPA opposes section 243 of the Proposal as drafted in general because of the gain triggering rule and requests the addition of de minimis rules due to the complexity and gain implications for continuing, non-distributee partners. The AICPA recommends *de minimis* thresholds to exempt small partnerships and small transfers from mandatory adjustments to basis.

The AICPA believes that sections 242 and 243 of the Proposal, which would require mandatory adjustments to the basis of partnership property on the transfer of partnership interests and the distribution of partnership property, have merit, but the administrative burdens and costs placed on certain transactions outweigh the benefits, and in some cases will be contrary to the goal of simplification. Additionally, requiring mandatory adjustments is in conflict with the concern of the House Ways and Means Committee regarding the cost of tax compliance for small businesses. As such, the AICPA suggests including de minimis exceptions in such a provision so that small business taxpayers are not subject to the proposed rules. The AICPA suggests the following de minimis exceptions be added to the Proposal sections 242 and 243:

a. De Minimis Exception #1 – Small Partnerships

   i. Partnerships with average annual gross receipts of less than $10,000,000 (indexed) over the prior three years would not be required to make adjustments to basis related to the transfer of interests in a partnership or the distribution of property from a partnership.

b. De Minimis Exception #2 – Small Transfers

i. A transfer described in (A) or (B) below would not require a mandatory adjustment to the basis of partnership assets:

A) A transfer constituting five percent or less of an interest in partnership profits, loss or capital, if the interest is worth less than $2,000,000; or

B) A transfer that would result in an aggregate basis adjustment of less than $250,000.

In addition to providing de minimis exceptions, the AICPA requests that the "excess basis" provisions of Proposal section 243 associated with partnership distributions under Code section 734 be stricken in part. The AICPA request pertains to the gain recognition features of the provision. Under current law, when allocating basis related to section 734 adjustments, if there are no like character assets to which basis could be allocated, the additional basis is deferred until a like-character asset is acquired. Under the proposed rules, decreases in basis beyond the partnership's adjusted basis in property would be treated as gain from the sale of each partner's partnership interest. Likewise, increases in basis in the absence of property would result in loss to the partners from the sale of a partnership interest. Finally, if a transaction would have resulted in a basis decrease per the new rules, and if there is a corporate partner, any basis adjustment decrease to stock in that corporation that is held by the partnership will result in recognition of gain, except to the extent there is other partnership property to which the decrease in basis can be allocated.

Further, the AICPA notes that the proposed rule regarding the allocation of decreases in partnership basis is vague and should be clarified. Specifically, the rule should clarify whether all property would be decreased, all property except unrealized receivables and inventory would be decreased, or only like character property would be decreased.

The AICPA notes that distributions from a partnership to a partner have not traditionally created immediate tax consequences for the continuing partners. Imposing tax on these transactions could restrict the free transfer of interests or cause unexpected gain or loss realization. Therefore, the AICPA suggests this feature of the provision not be included in tax reform legislation.

3. Section 244 - Corresponding Adjustments to Basis of Properties Held by Partnership Where Partnership Basis Adjusted

The AICPA opposes section 244 of the Proposal due to complexity for small taxpayers. While the AICPA agrees that requiring basis adjustments in tiered partnership settings has merit, section 244 of the Proposal will add undue complexity for small lower-tier partnerships and undue complexity associated with small adjustments. Accordingly, the AICPA recommends that

if section 244 of the Proposal is pursued in legislation, it be amended to provide exceptions for small taxpayers consistent with those recommended above for the Proposal sections 242 and 243, unless the upper-tier partnership holds either a controlling interest in the lower-tier partnership for which a basis adjustment is contemplated, or is the managing partner of such lower-tier partnership.

4. Section 247 - Repeal of Time Limitation on Taxing Precontribution Gain

The AICPA opposes section 247 of the proposal regarding repeal of the time limitation on taxing precontribution gain. The proposal would require that partners contributing property with built-in gains or losses be subject to tax on the pre-contribution gain or loss when the partnership distributes such property without the current limitation of seven years for recognition of such pre-contribution gains or losses. The AICPA is opposed to this repeal of the seven-year rule as it would add complexity. Partnerships would be required to trace property and the contributed gain for a long period of time and even indefinitely for some property such as zero basis intangibles. Further, if many assets are contributed, the tracing becomes an annual filing issue to determine if any of the properties were distributed. In addition, such repeal would impede the flow of capital investment in small businesses. There are business reasons for unwinding a partnership after seven years – the transactions are not tax motivated. If an extension beyond seven years is deemed necessary, we suggest that it should only apply for large contributions with built-in gain or loss in excess of $10 million.

Other Issues for Consideration

- **Repeal Technical Terminations of Partnerships and Repeal the Anti-Churning Rules of Section 197**

The AICPA supports the provisions in the Administration's Fiscal Year 2014 Revenue Proposals (released April 10, 2013) that would repeal the rules concerning technical terminations of partnerships and the anti-churning rules of IRC section 197. We agree with the Administration's reasons for suggesting repeal of these provisions – the current technical terminations rule serves as a trap for the unwary taxpayer, and the complexity and administrative burden associated with section 197(f)(9) outweigh the current need for the provision.

- **Self-Employment Taxation**

First and foremost, the AICPA applauds Chairman Camp and the Committee members for acknowledging the uncertainty regarding self-employment taxes for S corporation shareholders, LLC members and limited partners. The AICPA acknowledges this is one of the areas of passthrough entities taxation that has been controversial. We appreciate this opportunity to submit our concerns and recommendation.

AICPA Written Statement for May 15, 2013 Hearing
House Ways and Means Committee Select Revenue Subcommittee
Small Business and Pass-Through Entity Tax Reform Discussion Draft
May 15, 2013

1. Social Security/Self-Employment Tax Should Apply Only to Labor

The AICPA supports the goal of simplifying and possibly unifying the reporting system by expanding the Federal Insurance Contributions Act (FICA) reporting model for employment and self-employment taxes. However, moving away from the FICA withholding system standards and subjecting significantly increased amounts of capital in both S corporations and partnerships to self-employment taxes will not serve our tax system well.

The self-employment tax is intended to apply to income generated by an individual's labor. Partnerships have long been divided into categories for determining how the self-employment tax applies, for example: (1) general versus limited partnerships; (2) bifurcated or multiple partnership interests; and (3) managing LLC member versus non-managing member. Further, uniform state partnership laws have always interacted with the Code to help define the parameters of self-employment tax applicability.

The question for S corporations is whether a shareholder provides services to the corporation. To the extent a shareholder works and receives reasonable compensation for such services, he or she should pay employment taxes. The S corporation employment tax system is, in fact, more logical than that used for imposing labor-based taxes on partners and reflects the original intent of the FICA and Self-Employment Contributions Act (SECA) rules by more clearly drawing the division between labor and capital.

Operating S corporations and partnerships are engaged in business activities in order to generate a profit, and a majority of this profit is generated by the efforts of the non-owner employees. Therefore, in these common cases, corporations and partnerships are already contributing to the FICA system by paying their share of employer FICA, and the net profit represents a return of capital to the stockholders and partners. Simply subjecting substantially all of an S corporation and partnership's profit to self-employment tax is not appropriate because not all its profits can be attributed to the labor of its owners. In *Pediatric Surgical Associates*,[9] the IRS itself argued that profit attributable to services performed by non-shareholder employees could *not* be treated as compensation when distributed to shareholder employees. Therefore, we believe self-employment tax should not be imposed on net profits of S corporations and partnerships.

2. Professional Service S Corporations and Partnerships

In 2006, the Joint Committee on Taxation (JCT) proposed modifying the determination of amounts subject to employment tax or SECA for partners and S corporation shareholders. The 2006 JCT proposal would subject all income of professional service S corporations – including interest, dividends and rent – to self-employment tax. For professional service S corporations and partnerships, the AICPA believes that self-employment taxation of a professional service S corporation and partnership should not be treated differently from other S corporations and partnerships. As noted above, these types of income are clearly not derived from labor and,

[9] T.C. Memorandum 2001-81.

therefore, no acceptable policy reason supports removing the current-law exemptions applicable to both S corporations and partnerships.

Under current law, the "reasonable compensation" standard applies to professional service S corporation stockholders – whether or not they materially participate (as defined in Code section 469 and the related regulations) in the business. The 2006 JCT proposed modifications would apply the "reasonable compensation" standard only for stockholders and partners who do not materially participate in the business.

3. Regulatory Guidance

The AICPA supports a Congressional directive for Treasury to complete the development of self-employment tax regulations that apply to members of LLCs. Without such a directive, Treasury and the IRS may continue to delay finalizing any guidance in this area. We believe that much of the impetus for a more uniform self-employment tax system for passthrough entities would decline and a reduction of the tax gap would occur if Treasury were to create certainty for members of LLCs by issuing final guidance in this area. The lack of enforceable self-employment tax guidance for LLC owners has caused confusion and inconsistent reporting by tax practitioners and taxpayers.

Conclusion

The AICPA strongly supports the efforts of Congress to reform the tax system to provide for simplification in applying, and easing the administration of, the tax provisions. However, prior to undertaking such major changes in this area, we recommend Congress and the IRS solicit testimony from tax professionals and taxpayers in a broad cross-section of industries and entities to develop a factual basis for some of the underlying assumptions made in these proposals.

American Council of Engineering Companies

Statement of the
American Council of Engineering Companies
On the Ways and Means Committee Small Business and Passthrough Entity Tax Reform Discussion Draft

May 29, 2013

The American Council of Engineering Companies (ACEC) – the business association of the nation's engineering industry – is pleased to submit comments to the House Ways and Means Committee on the Committee's small business and passthrough entity tax reform discussion draft.

ACEC members – numbering more than 5,000 firms representing hundreds of thousands of engineers and other specialists throughout the country – are engaged in a wide range of engineering works that propel the nation's economy, and enhance and safeguard America's quality of life. The Council represents engineering businesses of all sizes, from the single professional engineer to firms that employ tens of thousands of professionals working in the United States and throughout the world.

A key concern for ACEC members in the discussion draft is the proposal to change the rules regarding the use of the cash method of accounting. Under current law, professional services firms, including engineering firms, can generally use cash accounting for tax purposes. The discussion draft proposes to limit the use of cash accounting to sole proprietorships and firms with less than $10 million in gross receipts.

ACEC supports the increase in the small business threshold to $10 million. However, a significant number of engineering firms with revenues over $10 million currently use the cash method of accounting, either under the QPSC exception, or because they are organized as S corporations or partnerships.

Engineering firms normally carry large balances of accounts receivable and work in progress, representing work performed for clients for which they have not yet been paid. The primary cost for engineering firms is labor, and approximately 85 percent of a typical firm's expenses can be attributed to payroll, benefits, and similar regular expenses. Engineering firms generally have to wait at least 120 days to be paid for services rendered to their clients, and at the same time must pay their employees every two weeks. While this situation can create cash flow challenges for firms, the use of cash accounting helps to mitigate those challenges by allowing firms to make tax payments after receiving payment for their services.

By contrast, forcing firms to switch to accrual accounting would create a number of problems, most notably requiring firms to use debt financing to cover the delta between expenses and receipts, which is much harder for small and mid-size firms to access today. The resulting cash flow challenges that would result from a switch to accrual accounting would create additional negative consequences, including workforce downsizing among some firms, delayed expansion plans, and decreased shareholder distributions. In fact, many S corporations utilize shareholder distributions to facilitate ownership transition, and any reduction could have a detrimental impact on a firm's long-term viability. All of these outcomes would take money out of the productive economy, jeopardize well-paying jobs, and burden firms that continue to struggle in the soft economy.

The simple premise of cash accounting allows engineering firms to pay income taxes on their revenue when they are actually paid, rather than when they submit an invoice. Conversely, they are not allowed to take deductions for expenses when they are incurred, but when the expense is actually paid. Once again, we believe this approach is fair for an industry whose product is intellectual capital, not hard physical inventory.

For these reasons, ACEC strongly recommends that the House Ways and Means Committee continue to allow engineering firms and other similar businesses to use cash accounting as they have done for decades.

ACEC appreciates the committee's focus on passthrough entity issues in its discussion draft. Nearly 80 percent of the Council's member firms are organized as some type of passthrough entity, including S corporations, partnerships, and sole proprietorships. The broad distribution of ACEC members across both the C corporation and passthrough structures drives the Council's support for comprehensive tax reform. Although reforming the corporate and individual sides of the tax code simultaneously will be challenging, it is the only approach that will not disadvantage a large segment of the business community and their employees.

ACEC has endorsed the S Corporation Modernization Act, on which Option 1 of the discussion draft is based. The Council believes that these are reasonable changes that would provide greater flexibility to S corporations. ACEC is continuing to assess the more comprehensive proposals to unify the federal tax rules for S corporations and partnerships that are presented in Option 2.

Finally, ACEC would like to express support for the discussion draft's proposal to make permanent the Section 179 expensing level to provide consistency for investment planning. We encourage you to make the permanent level as high as possible to promote investment and economic growth, but think that it should be at least $250,000, with the deduction phased out for investments exceeding $800,000. Expensing allows engineering firms to invest in the equipment they need in order to succeed.

Once again, on behalf of the nation's engineering industry, we thank the House Ways and Means Committee for the opportunity to submit comments.

American Farm Bureau Federation

Statement of the American Farm Bureau Federation

Filed Statement of the
American Farm Bureau Federation
for the
House Ways and Means Committee

Subcommittee on Select Revenue Measures
hearing on the
Small Business and Pass-Through Entity Tax Reform Discussion Draft

May 15, 2013

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600 Maryland Ave. SW | Suite 1000W | Washington, DC 20024 | p. 202.406.3600 | f. 202.406.3605 | www.fb.org

Farm Bureau supports replacing the current federal income tax with a fair and equitable tax system that encourages success, savings, investment and entrepreneurship. We believe that the new code should be simple, transparent, revenue-neutral, repeal the Alternative Minimum Tax (AMT), and be fair to farmers and ranchers. We commend the Ways and Means Committee on its methodical approach to tax reform through the release of discussion drafts, including the Small Business and Pass-Through Entity Tax Reform Discussion Draft that is the subject of today's hearing.

Cash Accounting

Under a progressive tax rate system, farmers and ranchers, whose incomes can fluctuate widely from year to year, will pay more total taxes over a period of time than taxpayers with more stable incomes, unless they are allowed to take advantage of tax tools to even out taxable income. Cash accounting, combined with the ability to accelerate expenses and defer income, gives farmers and ranchers the flexibility to manage their tax burden on an annual basis by allowing them to target an optimum level of taxable income.

Cash accounting tools that are important to farmers and ranchers include the deferral of commodity and product receipts and prepaying the cost of livestock feed, fertilizer and other farm supplies. The option to prepay input costs gives farmers and ranchers the flexibility they need to plan for major business investments. For example, many farmers and ranchers forward contract their fertilizer for the next year's crop to guarantee availability and/or to lock in the best price. This ability to pre-pay input costs is especially important because farm production expenses are rising, with 2013 costs forecast to be 5.7 percent higher than 2012 and 42 percent higher than the 2002 through 2011 average.

Generally, farming businesses are not currently covered by the requirement that taxpayers with over $5 million of average annual gross receipts must use accrual accounting. However, a family farm corporation is required to use accrual accounting if it has gross receipts of more than $25 million for any tax year since 1985. A family corporation is one where 50 percent or more of the corporation stock is held by one (or in some limited cases two or three) families. In addition, a partnership that has a corporation as a partner can't use cash accounting.

The Ways and Means Committee discussion draft for reforming the taxation of small businesses proposes eliminating the special exceptions for farming businesses and makes them subject to the general limitation on the use of cash accounting method. Those limitations would be that business entities (i.e. C-corps, S-corps, and partnerships) with average gross receipts of $10 million or more for the three prior taxable years must use accrual accounting. Sole proprietors would be able to continue to use cash accounting without limitation.

While the proposed changes to cash accounting rules may simplify the tax code, it will have the opposite effect on farm and ranch taxpayers who are required to switch from cash to accrual

accounting. The extra required bookkeeping, including but not limited to tracking inventory, accounts receivables and accounts payable, will be both time-consuming and costly to farm and ranch operations. Farmers and ranchers will either have to take time away from running their businesses or pay for help to comply. Both are harmful in an industry with tight profit margins, unpredictable income streams and an inability to pass on added expenses to customers.

Farm Bureau supports the continuation of unrestricted cash accounting currently available to most farmers and ranchers and cautions against reducing the number of partnerships, S-corps and C-corps farms and ranches eligible to use it.

Section 179 Small Business Expensing

Farming and ranching requires large investments in machinery, equipment and other depreciable capital. Due to these large capital investments, farmers and ranchers place great value on tax code provisions that allow them to write off capital expenditures in the year that purchases are made. Section 179 small business expensing that provides accelerated expensing and depreciation allows farmers and ranchers to better manage cash flow, minimize tax liabilities and reduce borrowing. The ability to immediately expense capital purchases also offers the benefits of lessening the record keeping burdens associated with the depreciation.

Under Section 179, farmers and other qualifying small businesses can immediately deduct the full cost of purchased business property, single-purpose agriculture structures, petroleum storage facilities and off-the-shelf computer software that are used in their farming business. For 2013 the maximum amount a taxpayer can expense under Section 179 is $500,000 reduced dollar for dollar by the amount that expenses exceed $2 million. These thresholds are temporary and will shrink to a $25,000 limitation with a $200,000 threshold for 2014. The Ways and Means Committee discussion draft for reforming the taxation of small businesses proposes a permanent $250,000 expensing limit that would be reduced dollar for dollar when expenses exceed $800,000. The amounts are indexed for inflation.

According to 2010 USDA Agricultural Resource Management Survey (ARMS) data, farm and ranch capital investments averaged $32,000 for those making investments. In addition, about 18 percent of all farms reported investing more than the prior 2012 expensing limit ($139,000) and more than 1 percent invested more than $500,000. But these facts don't tell a complete story because they don't account for the cyclical nature of farming and ranching. Whether caused by unpredictable weather that affects crop yields or uncontrollable markets that set the price of goods sold, it is not uncommon for farmers and ranchers to have a year of high income followed by several lean years. In a year when a farm business turns a profit and is able to make a major purchase, a combine for $350,000 or a tractor for $200,000, business expenditures will spike and can easily exceed the proposed $250,000 cap and the $800,000 threshold.

If the Section 179 small business exemption and threshold are allowed to drop at the end of the year, farmers and ranchers will lose some of the accounting flexibility they need to manage their businesses for success and growth in an industry that is cyclical in nature. For these reasons, Farm Bureau supports maintaining the $500,000 Section 179 small business expensing limitation and not reducing the $2 million acquisition limit.

Section 263A Unicap Rules

Uniform capitalization rules are complex and are a record keeping burden for those who grow plants for resale and for those who grow perennial crops. A grower must include certain direct and indirect costs in the basis of property and then recover these costs through depreciation or at the time of sale when there is a preproductive period of more than two years. Farm Bureau supports excluding businesses with less than $10 million of average annual gross receipts from the uniform capitalization rules as proposed by the small business discussion draft.

Since the discussion draft proposes to eliminate Section 263A requirements for businesses with gross receipts of less than $10 million, farmers and ranchers should be allowed to use the same depreciation methods as other taxpayers. In 1987, in a compromise that allowed producers of livestock an exception from Unicap requirements, all farm producers were restricted from using the 200-percent declining balance method of depreciation. With the elimination of Section 263A for the vast majority of farmers, the policy reason for limiting farm depreciation methods is moot.

Summary

Due to uncertain and fluctuating income that results from weather uncertainty and the unpredictable nature of markets, farmers and ranchers need a tax code that allows them to manage the risks associated with agriculture while complying with tax liabilities under the law. Cash accounting combined with the ability to accelerate expenses and defer income provides farmers and ranchers the flexibility they need to manage their tax burden. Section 179 small business expensing provides farmers and ranchers with a way to reduce borrowing and allows them to maximize business purchases in years when they have positive cash flow. For these reasons, we warn against reducing the number of farms and ranches eligible to use cash accounting and support maintaining the current $500,000 Section 179 small business expensing limitation and the $2 million acquisition limit.

Alliantgroup

HEARING ON WAYS AND MEANS SMALL BUSINESS AND PASS-THROUGH ENTITY TAX REFORM DISCUSSION DRAFT

SUBCOMMITTEE ON SELECT REVENUE MEASURES

COMMITTEE ON WAYS & MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

Written Comments for alliantgroup

May 15, 2013

Introduction

Chairman Tiberi, Ranking Member Neal, and distinguished Members of the Subcommittee, thank you for the opportunity to submit written comments regarding the Small Business and Pass-Through Entity Tax Reform Discussion Draft.

My name is Dean A. Zerbe and I am National Managing Director, Washington D.C. for alliantgroup. alliantgroup serves a broad spectrum of clients, from start-ups to the largest Fortune 1000 companies in nearly every industry. Our professionals consist of CPAs (including former Big 4 partners) and attorneys, in addition to individuals from a wide array of disciplines. alliantgroup works with businesses and their CPA firms to identify powerful, government-sponsored, cash-generating credits, incentives, and deductions. Previously I served as Senior Counsel and Tax Counsel for the Senate Finance Committee.

Testimony

It is critically important to the nation's economy and to your constituents that Congress helps small and medium businesses remain and become financially viable. Small changes to the tax code can be the way more employees get hired; more equipment is bought, built or exported. Small changes are HUGE game changers for small businesses.

A number of countries provide additional incentives for small and medium-size enterprises. By contrast, the U.S. R&D tax credit provides no additional incentives for small and medium businesses. In fact, U.S. tax policy actually erects barriers that limit these businesses from enjoying the incentives of the R&D tax credit.

The negative impact of these barriers is made clear by the findings of the GAO 2009 report to the Committee on the R&D tax credit which highlighted the small amount of overall dollars of the R&D tax credit that go to small and medium businesses.

We encourage you to support the following changes to IRC Sec. 41, the Research and Development tax credit:

- **INCREASE IN THE AMOUNT OF THE R&D CREDIT**

Increasing the amount of the credit from 14% to 20% will have an enormous REAL impact on small businesses. It could mean the difference between the status quo or hiring a new employee or purchasing new capital.

- **ALLOW THE R&D TAX CREDIT AGAINST THE AMT**

The biggest barrier for small and medium businesses taking the R&D credit is that the credit cannot be used to reduce the business owners' alternative minimum tax (AMT). This means, that a business owner of a pass-thru entity that is subject to the AMT cannot use the R&D credit to reduce her taxes. 8 out of 10 businesses that would otherwise benefit from taking the R&D credit will receive little to no benefit from the R&D credit because the credit cannot be used to reduce AMT. Given that the vast majority of small and medium businesses are organized as pass-thru entities, the potential benefit of the R&D tax credit to encourage innovation and create jobs is greatly diminished.

The Senate Finance Committee made the right policy call in allowing the R&D tax credit to be taken against AMT in enacting the Small Business Jobs Act of 2010. The only drawback is that this legislation was good for only one year – 2010.

- **ALLOW TAXPAYERS TO ELECT ASC ON AN AMENDED RETURN**

As the Committee proposes to change the R&D tax credit to allow solely for the alternative simplified credit (ASC), it is vital that the statute make clear that the ASC can be elected by businesses on amended returns. Currently, businesses can elect to take only the traditional R&D tax credit on an amended return not the ASC.

Congress created the ASC in Section 104 of the Tax Relief and HealthCare Act of 2006 (P.L. 109-432). The ASC was intended to broaden the number of companies that would be eligible to take advantage of the incentives provided by the R&D tax credit.

The policy intent of the ASC – expanding the number of companies eligible for the R&D tax credit – has been largely successful. The ASC has been especially beneficial for small and medium companies that could not take the regular R&D tax credit because of difficulties with the base years (and often substantiating expenditures in the base years).

However, a significant limitation for businesses – especially small and medium businesses – is the restriction in the *regulations*, published temporarily in 2008 and made permanent earlier this year, that do not allow a taxpayer to elect the ASC on an amended return. 1.41-9 (b)(2)("An election under section 41(c)(5) may not be made on an amended return."). There is nothing in the statute that requires such a limitation.

Thousands of companies that are performing activities that qualify for the R&D tax credit are being prevented by this regulation from benefitting fully from this important tax credit – and at times are discouraged from even taking the ASC on their current return.

Therefore, because of this regulation, thousands of our nation's most innovative small and

medium businesses are not receiving the assistance intended by Congress through the R&D tax credit.

- **ALLOW NEW AND SMALL BUSINESSES TO TAKE THE R&D CREDIT AGAINST THE EMPLOYER PAYROLL TAX**

While the AMT exclusion for the R&D tax credit would greatly benefit a large number of small and medium businesses, many *start-ups* would still be ineligible for the credit because they are not making a profit. The R&D credit is largely a wage-based credit - the only wage-based credit in the tax code. Allowing certain companies to take the credit against payroll taxes allows that company to both take advantage of the credit, but also increase its cash flow, as payroll is monthly, not annual.

Several states, and particularly Louisiana, Minnesota, New York and Arizona have had great success with an R&D tax credit that is provided even if a company doesn't owe income tax.

The Committee needs to bear in mind that while the engines for job growth are small and medium businesses, it is particularly new businesses that are key to an increase in jobs. A great deal of innovation is concentrated in new businesses. Therefore, an R&D credit that is also available to new businesses will bolster both innovation and jobs.

An R&D tax credit – refundable against payroll taxes paid by companies – and capped at $250,000 could provide much-needed cash for credit-starved innovative start-ups. Such a proposal would ensure that some of our most cutting edge new companies would actually receive the benefit of the R&D tax credit – as opposed to being on the outside looking in.

- **A MORE GENEROUS TAX CREDIT IF MANUFACTURED IN THE U.S.**

A policy goal of the R&D tax credit is to also support domestic manufacturing. The committee should encourage R&D that translates into U.S. manufacturing jobs by providing a greater credit to those companies that conduct a significant percentage of their manufacturing domestically.

An enhanced R&D credit for domestic manufacturers would particularly benefit small and medium businesses that rarely have manufacturing facilities outside the U.S. We encourage Congress to consider a 25% bonus in the R&D tax credit for U.S. companies that conduct a significant percentage of their manufacturing in the U.S. Such a credit would potentially create tens thousands of manufacturing jobs domestically and discourage companies from moving offshore.

- **A MORE GENEROUS R&D CREDIT FOR ENERGY EFFICIENT RESEARCH**

Special kinds of R&D, particularly the kind of grassroots R&D that provides the building blocks for other R&D (products or processes that create products that exceed industry standards for energy efficiency) should be rewarded.

Supplemental Information

Person(s) and/or Organization(s) to Whom Statement Will Be Attributed

Dean A. Zerbe
National Managing Director, Washington D.C.
alliantgroup
1200 New Hampshire Ave. NW, Suite 300
Washington, D.C., 20036
Phone: (202) 342-0099
Fax: (202) 342-1904
Email: dean.zerbe@alliantgroup.com

Contact Information

Dawn Levy O'Donnell
D SQUARED Tax Strategies
3238 P Street, NW
Washington, DC 20007
Phone: (703) 623-7317
Email: Dawn@DSQUAREDTAX.com

BIO

Written Testimony of the

Biotechnology Industry Organization

Submitted to the United States House of Representatives

Committee on Ways and Means

Subcommittee on Select Revenue Measures

on the *Small Business and Pass-Through Entity Tax Reform Discussion Draft*

May 15, 2013

The Biotechnology Industry Organization (BIO) represents more than 1,100 innovative biotechnology companies, along with academic institutions, state biotechnology centers, and related organizations in all 50 states. Entrepreneurs across the biotech industry are conducting groundbreaking research and are deeply invested in solving the problems that our nation and world face. Biotech companies are searching for new medicines to cure and treat devastating diseases, developing advanced biofuels and renewable chemicals to reduce our dependence on foreign oil, and improving agriculture to feed a growing world.

In the healthcare sector alone, there now are more than 200 biologic medicines and vaccines, including treatments for cancer, multiple sclerosis, diabetes, and numerous other diseases and rare conditions. In the last decade, innovative biotechnology companies and our partners in research universities have discovered over half of the scientifically novel treatments and therapies approved by the FDA. There are now more than 5,400 products in clinical development in biopharmaceutical labs across the U.S.

The biotechnology industry is also a powerful economic growth engine, directly employing 1.61 million Americans with an average salary of $82,697 and supporting an additional 3.4 million jobs. The vast majority of these employees work for small businesses – 90% of biotech companies employ fewer than 100 people. Biotech employees are scientific researchers, lab technicians, factory workers, and support staff in businesses across the country.

In order to protect these jobs and support biotech research and development, Congress should promote innovation in tax reform. A simpler tax code, lower corporate rate, and competitive territorial tax system will allow the United States to continue to lead the world in biotech research and development. The tax code should also support innovation through specific tax structures and incentives for pre-revenue, pre-tax R&D companies, given their continuing role in creating high-quality American jobs, stimulating long-term economic growth, and bolstering America's competitiveness on an increasingly global stage.

Importance of Tax Reform to Biotechnology

America currently leads the world in biotechnology, and BIO member companies are supporting high-quality jobs nationwide while also leading the search for groundbreaking medicines, renewable fuels, and other innovative technologies. As Congress considers reforms to the tax code, it is imperative that policymakers recognize the importance of the innovative R&D being conducted across the biotech spectrum, from start-ups and small businesses, to larger commercial-stage companies. Comprehensive tax reform that supports next generation

research and manufacturing will create jobs, spur investment, and encourage the growth of an R&D-intensive, modern American economy.

Multinational biotech innovators often face a competitive disadvantage due to the high U.S. corporate tax rate and America's burdensome worldwide tax system. BIO supports lowering the corporate rate and moving the United States to a territorial tax system in order to speed the delivery of innovative technologies to patients and consumers and stimulate job creation here in America.

Congress historically has recognized the importance of spurring innovation through the tax code. The R&D Tax Credit and Orphan Drug Tax Credit are two examples of the tax code providing incentives for innovative companies. However, constant uncertainty about whether the R&D credit will be extended makes tax planning extremely difficult. Though the credit was designed to support innovative research, companies cannot count on it and thus its purported benefits are undercut. Currently, 26 countries have more generous R&D incentives than the U.S. R&D credit. A permanent credit with an increased rate would do more to stimulate domestic innovation.

Congress enacted the Orphan Drug Tax Credit in 1983 to encourage biotechnology and pharmaceutical companies to develop therapies for rare diseases and conditions. By reducing the costs of developing drugs for smaller patient populations, the credit allows companies to develop products that would otherwise not be commercially feasible – helping millions of patients suffering from rare conditions get the new medicines they desperately need. In the 30 years since the initiation of this tax credit, the Food and Drug Administration (FDA) has approved more than 400 new drugs and biological products for rare diseases and has granted orphan designations to more than 2,000 compounds. In contrast, in the decade prior to 1983, fewer than 10 products were approved for rare diseases.

The Orphan Drug Tax Credit is a tremendously important incentive for manufacturers to engage in research and development of therapies for patients with rare diseases. Despite the success of the Orphan Drug Act, there is still huge unmet medical need. The National Organization for Rare Disorders (NORD) estimates that there are over 7,000 rare diseases, affecting up to 30 million Americans, for which there currently are no effective treatments.

BIO strongly supports both the R&D and Orphan Drug credits, as they are incredibly important elements of the current tax system and help to spur innovation in the life sciences. Comprehensive tax reform must be done in a way that preserves these incentives.

Promoting Investment in Small Business Innovation

The majority of companies in the biotech industry are pre-revenue small businesses without taxable income, and thus tax reform must go beyond the innovation-driving principles outlined above to address the unique issues faced by companies that are not yet taxpayers, but aspire to be. These research-intensive small biotechs are at the front end of a development timeline that, on average, will take more than a decade and cost more than $1 billion. Virtually all of this process will take place before a company has product revenue. These pre-revenue companies are unable to immediately utilize the incentives in the current tax code; instead, these credits are accumulated as deferred tax assets for later use to offset future profits and do not provide immediate or short-term tax benefits to companies or their investors. As Congress considers reforms to the tax code, it is vital that it address proposals to protect and promote small business innovation.

For growing biotech innovators, the tax code is extremely important due to their unique life cycle and development timeline. Their entire extended development period is undertaken in the context of tremendous risk and without the benefit of product revenue, so all operating capital must come from investors. These investor-backed companies depend on substantial private investment to provide the necessary funding for their capital-intensive research, development, and manufacturing. And yet, the current incentives for investors in the tax code are not sufficient by themselves to maximize biotech investment. The tax code should be reformed to support biotech research by providing incentives for private investors, such as other companies, individuals, and funds, to invest in innovative small businesses.

It is essential that investors in start-up businesses have a reason to invest early in a company's life cycle and continue that investment for a substantial period of time. A reformed tax code should include incentives for investors in high-risk industries, including pass-through structures to utilize certain tax assets and supportive capital gains treatment. Provisions that allow investors to utilize a small company's tax assets that cannot currently be used, or to expand their options for liquidity, would stimulate capital formation. By appropriately incentivizing innovation through the tax code, Congress has the opportunity to support and inspire breakthrough discoveries and bolster economic growth.

More should be done to support innovation by emerging companies, including allowing them to either immediately utilize their deferred tax assets to attract investment or maintain their value during transactions. The unique nature of innovative, pre-revenue companies with very long-term product cycles must be taken into account in tax reform, and the tax code should reflect the needs of these pre-revenue capital-intensive businesses.

Under the current tax system, companies are unable to use the tax code to attract investors, prevented from taking advantage of innovation and R&D incentives from a loss position, and hamstrung by a high corporate rate when they finally do become profitable. Congress should reform the tax code to make the corporate rate globally competitive, while also providing important incentives for the development and manufacturing of innovative products by companies of all sizes and revenue positions.

Proposals to Stimulate Next Generation R&D for Small, Pre-Revenue Biotechs

BIO supports a U.S. tax code that recognizes innovation as a crucial part of the 21st century American economy. Given the focus of this Subcommittee's hearing, the remainder of BIO's testimony will focus specifically on proposals aimed at small, pre-revenue companies.

Section 469 R&D Partnership Structures

In the 1980s, the growth of the biotech industry was fueled in part by the ability of growing companies to use R&D partnerships, in which individual investors would finance R&D projects and then utilize the operating losses and tax credits generated during the research process. These structures gave investors a tax incentive to support biotech research, which is heavily dependent on outside investors but often too risky or expensive to attract sufficient investment capital. However, the enactment of the passive activity loss (PAL) rules in 1986 prevented investors from using a company's losses to offset their other income, thus removing the incentive to support vital research in growing biotechs.

Prior to the 1986 changes, these structures had a proven track record in addressing the unique biotech funding challenge and in stimulating life-altering R&D. The research conducted through these partnerships contributed to the approval of several important new therapies – ranging from genetically-engineered proteins that were much safer and more reliable than the

conventionally harvested equivalents they replaced, to breakthrough drugs that have improved health outcomes and quality of life for large numbers of chronic disease patients.

BIO supports a limited exception from the PAL rules for R&D-focused pass-through entities in order to stimulate investment in groundbreaking research being conducted by emerging innovators. Under this proposal, small companies would be able to enter into a joint venture with an R&D project's investors. The losses and credits generated by the project would then flow through to the company and investors, who would be able to use the tax assets to offset other income. Instead of letting these deferred tax assets – which were designed to stimulate research in the first place – gather dust in an accountant's ledger book, this proposal allows them to be used immediately to move important research forward.

Reforming the PAL rules to allow investors to enjoy a more immediate return on their investment, despite the long and risky timeline usually associated with cutting-edge research, would incentivize them to invest at an earlier stage, when the capital is most needed. By limiting the exception to entities that devote a significant percentage of their expenses to R&D, have fewer than 250 employees, and have less than $150 million in gross assets, Congress can specifically support the growth of innovative small businesses.

In the 112th Congress, Representatives Jim Gerlach and Richard Neal introduced the High Technology Small Business Research Incentives Act (H.R. 6559), which would have granted this targeted PAL exemption to small, R&D-intensive pass-throughs. BIO strongly supported this legislation and urges the 113th Congress to consider it. Reforming Section 469 has the potential to stimulate capital formation for groundbreaking R&D and speed the development of cures and breakthrough medicines for patients suffering from serious and life-threatening diseases.

Section 382 Net Operating Loss (NOL) Reform

As discussed, biotechnology companies have a long, capital-intensive development period, meaning that they often undergo a decade of research and development without any product revenue prior to commercialization. During this time period, companies generate significant losses, which can be used to offset future gains if the company becomes profitable. However, Section 382 restricts the usage of NOLs by companies which have undergone an "ownership change." The law was enacted to prevent NOL trafficking, but small biotech companies are caught in its scope – their reliance on outside financing and deals triggers the ownership change restrictions, and thus their NOLs are rendered useless.

Under current law, most forms of biotech financing, including venture capital deals, partnerships, mergers, and IPOs, often qualify as an ownership change that triggers the Section 382 restriction. When NOLs are limited, the tax code negates the years of pre-revenue research that went into generating the losses, and subjects innovative companies to onerous taxation earlier than it should. Further, internal analysis of a company's ownership to determine whether NOLs will be limited by Section 382 can be costly and cause a further diversion of funds from important R&D.

BIO supports reform of Section 382 to exempt NOLs generated by qualifying research and development conducted by a small business from Section 382's restrictions. This change would allow growing companies the freedom to raise capital for innovative research without fear of losing their valuable NOLs. Additionally, the ability of a small business to maintain its NOLs makes it more attractive to investors and purchasers looking to take its research to the next level.

This targeted reform, restricted solely to losses generated by R&D, will support growing innovators as they engage in the search for the next generation of American technologies.

Section 1202 Capital Gains Reform

Private investment is key to small, research-intensive biotechs. Section 1202 allows investors to exclude from taxation a portion of their gain from the sale of a qualified small business (QSB) stock if they hold the stock for five years. Currently, the exclusion is set at 100%, but it will revert to 50% on January 1, 2014. BIO believes that the 100% exclusion should be made permanent in order to provide the maximum incentive for small company investors.

Section 1202 was designed to promote investment in growing businesses, but its overly restrictive size requirements prohibit innovative biotech companies from accessing valuable investment capital. Currently, QSBs must have gross assets below $50 million. The high costs of biotech research, coupled with valuable intellectual property (IP) and successive rounds of venture financing, often push growing biotechs over the $50 million gross assets limit and out of the QSB definition.

BIO supports a change to the QSB definition to include companies with gross assets up to $150 million, with that cap indexed to inflation. Increasing the gross assets limit will more accurately capture the true nature of innovative pre-revenue companies, while continuing to target Section 1202's investment incentives at small businesses. The current $50 million limit has hampered investment, and increasing it will stimulate important capital formation in emerging companies.

BIO also supports excluding IP from a small business's gross assets valuation. Innovative biotechs have valuable IP that is the basis of a company's research, but in and of itself the IP provides no cash to further said research. A growing company should not be punished for owning IP that might hold the key to a scientific breakthrough; rather, IP-centric companies are the very ones to whom Section 1202 should direct investment. Excluding the value of an innovator's IP from the gross assets test will incentivize investment in groundbreaking start-ups and small businesses.

Congress's original intent in enacting Section 1202 was to encourage and reward individuals for taking risks by investing in new ventures and small businesses. These proposed reforms will expand the outdated parameters of its current rules and lead to increased investment for innovative job creators. Providing incentives to invest in biotech research will increase the innovation capital available to research-intensive businesses and speed the development of groundbreaking medicines and other critical biotechnologies.

Conclusion

The current tax code is complicated and expensive to administer and comply with. Further, temporary tax rules are always in danger of expiring and result in extreme uncertainty for businesses trying to plan for their growth. Companies planning their development pipelines and investors considering biotech investments need to know what they can expect as these companies move through the development process. Ineffective innovation incentives combined with the world's highest tax rate among developed countries render the U.S. tax code unsuccessful in sufficiently stimulating next-generation research and development.

Congress has the opportunity to foster innovation, spur small business investment, and support the growth of an R&D-intensive, modern American economy. In order to create domestic jobs and ensure that the United States maintains its global leadership, tax reform

must lower the corporate rate and move towards a territorial system, while preserving innovation-driving incentives such as the R&D and Orphan Drug Tax Credits. But it must go further. Innovation by pre-revenue companies also must be promoted in tax reform if America is going to lead the way in the global economy.

The U.S. biotechnology industry remains committed to developing a healthier American economy, creating high-quality jobs in every state, and improving the lives of all Americans. Federal tax policy that recognizes the special demands placed on biotech companies and other highly innovative industries will speed the development of products to vastly improve the lives of Americans and people around the world. By recognizing the importance of innovation and the economic potential of the biotech industry, Congress can incentivize further development, create jobs, and improve America's economic health.

Biotechnology Industry Organization
1201 Maryland Avenue SW, Suite 900
Washington, DC 20024

Contact:
Charles H. Fritts
cfritts@bio.org
(202) 962-6690

CBSI

Written testimony of the

Coalition of Small Business Innovators

Submitted to the United States House of Representatives

Committee on Ways and Means

Subcommittee on Select Revenue Measures

on the *Small Business and Pass-Through Entity Tax Reform Discussion Draft*

May 15, 2013

The Coalition of Small Business Innovators (CSBI) is a national, non-partisan coalition of organizations dedicated to stimulating sustained, private investment in small companies focusing on the development of transformative, life-changing new technologies. With small businesses working to advance research, development, and manufacturing of technologies that have the potential to solve critical economic, environmental, and societal challenges around the world, the Coalition seeks to educate lawmakers and the public about the value of stimulating investment in these cutting-edge companies.

Small business innovators are mostly pre-revenue companies that require private investment and years of research and development in order to bring the next generation of groundbreaking ideas to market and become profitable. The current tax code does not adequately support this growing segment of small businesses, which means fewer high-quality research jobs and fewer revolutionary new products, medicines, and technologies available to the public. The Coalition is focused on small innovative companies with fewer than 250 employees that devote a significant percentage of their expenses to R&D-related activities. These companies rely on investors who are willing to carry investment risk over several years, which the current tax code does not support as well as it could.

Growing research companies are a leading force for innovation in the U.S. – and the discovery of next generation products is key to America's economic health and prosperity. These small businesses support high-paying, high-quality jobs across the country while also leading the search for the next scientific breakthroughs and revolutionary technologies. Industries relying on innovative IP support 40 million jobs in the United States and contribute over $5 trillion to U.S. GDP. Small and new businesses are responsible for creating two out of every three net new jobs in America. These growing innovators devote their time and assets to important R&D, pushing the boundaries of science and technology during a long and costly development process. If Congress wants to spur investment in growing companies and stimulate breakthrough R&D to drive the U.S. economy, it must protect and promote small business innovation through the tax code.

Pre-Revenue Innovators and Tax Reform

Comprehensive tax reform that fosters innovation by growing companies could spur investment and support the growth of an R&D-intensive, modern American economy. Many emerging research-centric businesses do not generate revenue, and therefore do not have tax liabilities at the early stages of their development. Lowering corporate tax rates and broadening the tax base will not help these companies in the near term. Considering the long term significance of innovative small businesses to the economy, the Coalition believes that tax reform should address their unique capital needs.

Targeted reforms to specific sections of the tax code can play a part in the broader effort to make America's tax system simpler and more efficient. CSBI supports a stable tax code, anchored by lower corporate tax rates, that makes the U.S. competitive with our global challengers. However, the tax code

can also support next generation research by providing incentives for other companies, individuals, and funds to invest in small businesses.

It is essential that investors in start-up businesses have reasons to invest early in a company's life cycle and hold that investment. A reformed tax code should include incentives for investors in high-risk industries, including provisions that allow investors to expand their options for liquidity or utilize a small company's tax assets that it cannot currently use.

Further, tax reform should recognize that most innovative companies are in a loss position, so existing credits and deductions in the tax code are not sufficient to stimulate their innovation. Small companies that are pre-revenue are unable to immediately utilize these incentives; instead, they are accumulated as deferred tax assets for later use to offset future profits. These deferred assets do not incentivize much-needed investments in pre-revenue companies because they do not provide immediate or short-term tax benefits to investors or to the companies themselves.

As Congress considers reforming the corporate tax code, it is important to remember that these pre-revenue innovators are not yet taxpayers, although they aspire to be. As such, tax reform that is defined only by lowering the corporate tax rate and broadening the tax base will not stimulate innovative R&D in the near term. CSBI strongly supports changes to the tax code that will protect and promote small business innovation.

Tax Reform Proposals to Stimulate Pre-Revenue Innovation

The Coalition of Small Business Innovators believes that R&D and advanced manufacturing must be a cornerstone of any effort to reform the corporate tax system. The continued development of cutting-edge products helps maintain America's global competitiveness, sustains and creates American jobs, and encourages investments in the U.S. Because small business innovators are at the forefront of this effort, it is vital that tax reform specifically address the needs of growing R&D companies. Targeted reforms to the passive activity loss rules under Section 469, treatment of net operating losses under Section 382, and small business capital gains tax rates under Section 1202 will spur capital formation for small businesses and support vital pre-revenue innovation.

Section 469 R&D Partnership Structures

Prior to 1986 tax reform, many growing companies attracted investors by using R&D partnerships, in which individual investors would finance R&D projects and then utilize the operating losses and tax credits generated during the research process. These structures gave investors a tax incentive to support cutting-edge research, which is entirely dependent on outside investors but often too risky or expensive to attract sufficient investment capital. The enactment of the passive activity loss (PAL) rules in 1986 prevented investors from using a company's losses to offset their other income, thus removing the incentive to support vital research.

CSBI supports a limited exception from the PAL rules for R&D-focused pass-through entities. Under this proposal, introduced in the 112th Congress as the High Technology Small Business Research Incentives Act (H.R. 6559), small companies would be able to enter into a joint venture with an R&D project's investors. The losses and credits generated by the project would then flow through to the company and investors, who would be able to use the tax assets to offset other income. Relaxing the PAL rules to allow investors to enjoy a more immediate return on their investment, despite the long and risky timeline usually associated with groundbreaking research, would incentivize them to invest at an earlier stage, when the capital is most needed.

Section 382 Net Operating Loss (NOL) Reform

Innovative companies often have a long, capital-intensive development period, meaning that they can undergo a decade of research and development without any product revenue prior to commercialization. During this time period, companies generate significant losses, which can be used to offset future gains if

the company becomes profitable. However, Section 382 restricts the usage of NOLs by companies which have undergone an "ownership change." The law was enacted to prevent NOL trafficking, but small innovative companies are caught in its scope – their reliance on outside financing and deals triggers the ownership change restrictions and their NOLs are rendered useless.

CSBI supports reform of Section 382 to exempt NOLs generated by qualifying research and development conducted by a small business from Section 382. This change would allow small companies the freedom to raise capital for innovative research without fear of losing their valuable NOLs. Additionally, the ability of a small business to maintain its NOLs makes it more attractive to investors and purchasers looking to take its research to the next level.

Section 1202 Capital Gains Reform

Section 1202 allows investors to exclude from taxation a portion of their gain, temporarily set at 100%, from the sale of a qualified small business (QSB) stock if they hold the stock for five years. This provision was designed to promote investment in growing businesses, but its overly restrictive size requirements prohibit many innovative companies from accessing valuable investment capital. Currently, QSBs must have gross assets below $50 million. The high costs of research, coupled with valuable intellectual property and successive rounds of venture financing, often push growing innovators over the $50 million gross assets limit and out of the QSB definition.

In addition to making the 100% capital gains exclusion permanent, CSBI supports changing the QSB definition to include companies with gross assets up to $150 million, with that cap indexed to inflation. CSBI also supports excluding the value of a company's IP when calculating its gross assets. These changes would allow more growing innovators to attract investors to fund their vital research. Providing incentives to invest in high tech research will increase the innovation capital available to research-intensive businesses and speed the development of groundbreaking technologies.

Conclusion

The Coalition of Small Business Innovators believes that Congress can and should incentivize research and development by groundbreaking small companies. Tax reform can improve America's economic health by recognizing the importance of innovation and its potential to save lives, create new technologies, spur scientific advancement, and create vital jobs in growing businesses. Federal tax policy that recognizes the special demands placed on highly innovative pre-revenue companies will speed the development of products to vastly improve the lives of Americans and people around the world.

Coalition of Small Business Innovators
smallbusinessinnovators.org

805 15th Street NW, Suite 650
Washington, DC 20005

Contact:
Stephanie Silverman
ssilverman@vennstrategies.com
(202) 466-8700

FAIR Coalition

May 15, 2013

The Honorable Pat Tiberi
Chairman, Subcommittee on Select Revenue Measures
Committee on Ways and Means
United States House of Representatives
Washington, D.C. 20515

Re: Hearing on Ways and Means Small Business and Pass-Through Entity Tax Reform Discussion Draft

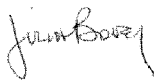
Chairman Tiberi:

Below is a letter signed by over 200 organizations—including energy manufacturers and project developers, financial institutions, non-profit organizations, trade associations, and organized labor representatives—that strongly support extending the master limited partnership structure to renewable energy projects.

This letter was originally submitted to the Energy Tax Reform Working Group on April 15, 2013. We believe that the views of these organizations on the benefits of the master limited partnership structure would be of interest to your Subcommittee in considering small business and pass-through tax reform issues.

Thank you for your time and attention to this matter.

Sincerely,



Julia Bovey
FAIR Coalition

April 15, 2013

The Honorable Kevin Brady
Chair
Energy Tax Reform Working Group
United States House of Representatives
Washington, DC 20515

The Honorable Mike Thompson
Vice Chair
Energy Tax Reform Working Group
United States House of Representatives
Washington, DC 20515

Dear Representatives Brady and Thompson,

We encourage you to expand Master Limited Partnership (MLP) eligibility from primarily the oil and gas sectors to renewable energy and other clean energy technologies that are a growing part of America's energy infrastructure. This letter represents the endorsement of a diverse group of energy manufacturers and project developers; financial institutions; environmental, health, science and other non-profit organizations; energy trade associations; and organized labor representatives who favor smart tax policy for all energy sectors.

An MLP is a "publicly traded partnership" that holds energy or other specified assets. MLPs are traded on public stock exchanges so that small and institutional investors can buy and sell them at any time. Similar to how mutual funds allow investors to make small investments in diversified stock portfolios, MLPs allow investors to take direct stakes in energy projects. MLPs have helped build much of our modern oil and gas infrastructure, fueling the shale revolution in oil and gas. In 2012 alone, MLPs raised over $23 billion of new capital for eligible projects. Supplementing dozens of tax incentives along various stages of the oil, gas, and coal energy supply chains, MLPs have provided a stable and efficient source of capital, but only to the energy sectors that are currently eligible.

Supplementing the existing federal investment tax credit (ITC) and production tax credit (PTC) with MLPs could work for renewable energy and other clean energy technologies as it has for oil and gas. The ITC and PTC have been foundational to spurring private sector investment, creating jobs, and driving down costs significantly, to the point where some renewable technologies are approaching cost competitiveness. Still, clean energy markets, like other economic sectors, have been hampered by capital constraints in the aftermath of the U.S. financial crisis. All energy industries require private capital to fund projects, and the recent financial market volatility illustrated the value of capital supply afforded by the MLP structure. Furthermore, clean energy projects are attractive assets for MLP investors, featuring stable revenue sources and a good long-term risk profile for investors. Supplementing successful energy tax credits with access to MLPs for renewables and other clean energy technologies would enhance the sources of capital for the industry and increase investors' opportunities to take ownership in America's clean energy future. It has worked for traditional energy technologies and would work for clean energy.

We look forward to working with you and other Members of Congress to make clean energy eligible for MLP investment structures.

Sincerely,

360 Sun Solutions, LLC
4thoughts Energy LLC
Algae Aqua-Culture Technology, Inc.
Alliance for Industrial Efficiency
Alternative Energy Inc.
American Biogas Council
American Council for an Energy-Efficient Economy
American Council on Renewable Energy (ACORE)
American Power Net
Aquion Energy, Inc.
Aries Energy
Ashlawn Energy LLC
Atlantic Renewable Energy Services, Inc.
Axiom Engineers
Beachstone Sustainable Surfaces
Biomass Power Association
Birch Tree Capital, LLC
Black Coral Capital
Blue Honey Biofuels
BlueWave Capital, LLC
Butler Sun Solutions
California Clean Energy Fund (CalCEF)
CapitalFusion Partners
CCI Energy
Center for American Progress Action Fund
Center for Energy Efficiency and Renewable Technologies
Ceres
Clean Economy Development, LLC
Clean Energy Renewable Fuels
Clean Energy Venture Group
Clean Tech LA
Climate Action Now - Eau Claire Chapter
Climate Resolve
Community Energy Partners, LLC
Conservation Law Foundation
Conservation Services Group
ConVerdant Vehicles
Convergence Energy
CR&R Incorporated
Current Electric Co.
Daikin McQuay
Dovetail Solar and Wind
Earth Day Coalition
EarthNet Energy

Echo Valley Hope, Inc
Echogen Power Systems, LLC
EcoLogical Solutions, Inc.
EcoManity
Edison Solar & Wind Ltd
ElectraTherm
Element Markets, LLC
Energy Opportunities, Inc.
Energy Recovery Council
Energy Source Partners
Envinity Incorporated
Environmental Entrepreneurs
Environmental Health Watch
Environmental Law and Policy Center
Eolian Renewable Energy
Equity Enhancers
ESC Corporation
EV Communities Alliance
Everpower
Exergy Integrated Systems
FAIR Coalition
FireFlower Alternative Energy, LLC
First Wind
FloDesign Wind Turbine Corp.
FLS Energy
Fresh Energy
FuelCell Energy, Inc.
Fusionview LLC
Gamesa
Global Renewable Solutions
Global Wind Network
Granite State Biofuels
Green Alliance
Green Alternatives
Green Energy Capital Partners, LLC
Green OnRamp
Green Search Partner
Green Works Energy
Greene Tech Renewable Energy
GreenerU, Inc.
GreenField Solar Inc.
GT Advanced Technologies
Handy Law, LLC
Heat is Power Association (HiP)
HeatSpring
Helios Solar Works

H-Energy Systems
High Plains Architects
Holland & Knight
Holocene
Hudson Energy
Imani Energy, Inc.
Indiana Distributed Energy Alliance
Inside Straight Strategies
JW Crouse, Inc.
Kilowatt Ours
Kingport Corporation
Lakeside Advanced Builders
LighTec, Inc.
Longwood Energy Group
Los Angeles Cleantech Incubator
Maine Energy Performance Solutions
Maine Ocean and Wind Industry Initiative
Maine Solar
MAPA Group
Mascoma Corporation
Medora Corporation
MESA Landscape Architects
Midwest Cleantech Open
Minnesota Conservation Federation
Minnesota Renewable Energies, Inc.
Minnesota Solar Energy Industries Association
MMK Solar Thermal
Montpelier Construction
Morton Solar, LLC
Motiv Power Systems
Mann Plumbing and MPI Solar
MTPV Power Corp.
Myriant Corporation
National Electrical Contractors Association (NECA)
Natural Resources Defense Council
Nautica Windpower LLC
NBF Architects
New Energy Capital Partners
New England Clean Energy
New England Clean Energy Council
No Fossil Fuel, LLC
North Carolina League of Conservation Voters
North River Capital Advisors, LLC
North Wind Renewable Energy, LLC
Northeast Sustainable Energy Association (NESEA)
Oasis Montana Inc.

Orange Energy Solutions
OwnEnergy
Papesch Associates
Paradigm Consulting Group
Patriot Renewables, LLC
Pattern Energy Group
Powers Energy of America, Inc.
Powertree Services, Inc.
Practical Energy Solutions
Prairie Solar Power & Light
QBotix
Quality Connections
Quasar Energy Group
RainWise, Inc.
Recurrent Energy
Recycled Energy Development (RED)
Redwood Renewables
RENEW Wisconsin
RER Energy Group
ReVision Energy
RH Irving Homebuilders
Riverbend Advisors
Rural Renewable Energy Alliance (RREAL)
Saunders Hotel Group
Save Energy Systems, Inc.
Sea Solar Store
Sheet Metal and Air Conditioning Contractors' National Association (SMACNA)
Sheet Metal, Air, Rail, and Transportation Workers (SMART)
Sierra Club
Silicon Valley Leadership Group
Smart Grid Library
Sol Systems, LLC
Solar Plexus
Solar Source
Solar Systems of Indiana
Solbridge Energy
Solutions for Utilities, Inc.
Solventerra, LLC
Southern Alliance for Clean Energy
Southern New Hampshire University Sustainability Dept.
Sparkplug Power, Inc.
Specialized Real Estate Group
Stellar Sun
Strategic Energy Systems, Inc.
Stumpner's Building Services, Inc.
Sundance Solar Products,Inc.

Sundog Solar
SunReports
SunSpec, LLC
Sustainable Living Group
Sustainable New Energy
SustainX, Inc.
TAS Energy
Teamsters Local 391
Ten Penny Opera Inc.
Tennessee Alliance for Progress
Tennessee Solar Energy Association
Terra-Gen Power
The Coalition for Green Capital
The Gemstone Group
The Lathrop-Trotter Company
The League of Conservation Voters
The Ohio Environmental Council
The Pew Charitable Trusts
The Power Company
The Stella Group, Ltd
The Wilderness Society
Third Sun Solar
Third Way
Transition Nashville
Treadwell Institute
Union of Concerned Scientists
Vela Gear, LLC
Veolia Energy North America
Vermont Energy Investment Corporation
Vestas
W.W.Williams
WES Engineering Inc.
Whole Sun Designs
Wisconsin Sustainable Business Council
Williams, Allwein and Moser, LLC
Winpower West
WIRE-Net
World Wildlife Fund
Zapotec Energy Inc.

Florists Coalition

WRITTEN TESTIMONY

COMMITTEE ON WAYS & MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

U.S. HOUSE OF REPRESENTATIVES

HEARING ON

"Ways and Means Small Business and Pass-Through Entity Tax Reform Discussion Draft"

On behalf of the

American Nursery & Landscape Association
Connecticut Florists Association
Connecticut Nursery & Landscape Association
Craft & Hobby Association
Drycleaning & Laundry Institute
Florida Nursery, Growers & Landscape Association (FNGLA)
Kentucky Florists Association
Jewelers of America
NACS – The Association for Convenience & Fuel Retailing
National Association of College Stores
National Christmas Tree Association
North American Retail Dealers Association
OFA – The Association of Horticulture Professionals
Outdoor Power Equipment Aftermarket Association
Small Business Majority
Society of American Florists
Wisconsin and Upper Michigan Florists Association

May 15, 2013

Contact:

Corey Connors
Society of American Florists
(703) 836-8700

We write in support of your committee's efforts to simplify compliance with the federal tax code for America's Main Street businesses. As you noted in the committee's March 12, 2013 overview of the committee's small business discussion draft, tax compliance costs are 65% higher on small businesses than for large businesses, costing owners more than $18 billion annually. Similarly, a 2004 study released by the SBA Office of Advocacy estimates that small businesses incur an averaged monetized compliance cost per employee of approximately $4,500, a number that has undoubtedly grown in the last eight years. We believe that a simpler, fairer compliance system for Main Street that allows for investment and innovation without significantly increasing the effective tax rate of our member businesses should be at the heart of any comprehensive tax reform proposal.

The *"Strengthening the Economy and Increasing Wages by Making the Tax Code Simpler and Fairer for America's Small Businesses"* document represents a solid first step towards achieving simplicity and equality in the federal tax code for small businesses. Generally, we support the following "Core Component" concepts outlined in the draft:

Simplifying and Expanding the Use of Cash Accounting for Small Businesses

This proposal is similar to the recommendations of bipartisan tax panels convened during both the George W. Bush[1] and Obama[2] administrations. Reporting receipts and expenses through cash accounting would have the practical effect of lowering accounting costs, allowing Main Street businesses to reinvest those resources into growing their businesses. Additionally, this simplification could reduce reporting errors to the IRS, improving compliance and presumably closing the tax gap.

Spurring Investment by Providing Permanent Expensing of Investments in Equipment and Property

The ability for Main Street businesses to immediately deduct investments in new equipment and property is imperative. Though the draft proposal suggests making permanent section 179 expensing at pre-stimulus levels, we urge the committee to carefully consider and include the recommendations of both the Bush and Obama tax panels on this subject.

Specifically, both the Bush and Obama tax reform panels recommended allowing unlimited expensing for most asset purchases made by small businesses. Notably, the 2010 panel did not limit this potential expansion by income size, indicating that such a provision would be of benefit to all small businesses. This practice would include immediate expensing for all assets other than land and buildings, which would retain the treatment they receive under current law. In essence, "checkbook accounting" would make the taxable income of small businesses equal to cash receipts minus cash business expenses – including cash outlays for inventories, materials and depreciable property other than buildings.

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[1] Simple Fair and Pro Growth: Proposals to Fix Americas Tax System, Report of the President's Advisory Panel on Federal Tax Reform (11-2005)

[2] The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation, Report of the President's Economic Recovery Advisory Board (8-2010)

The implementation of a checkbook accounting system for small businesses would have numerous benefits. As noted by the 2010 tax reform panel:

> "Rather than having to keep an additional set of books solely for tax purposes, small businesses could simply use their cash flow records – mainly their bank accounts. Expanding full cash accounting to all but the largest firms could allow millions of small businesses to simplify their tax accounting and lower their compliance costs. Relieving small businesses of the burden of maintaining these records could free up resources for more productive uses and, by simplifying rules, could reduce errors and improve compliance. Taxpayers currently using cash accounting are the vast majority of businesses, but they account for only a small share of overall business activity. Hence, the dollar amounts involved for provisions related to supplies, inventories, and depreciable property are very low, making the current recordkeeping requirements related to such property onerous relative to the revenue gained." (Chapter 7, pp. 47-48)

Though the 2010 panel indicated that checkbook accounting could reduce the present value of revenues collected, we believe that the improved compliance mechanisms would dramatically reduce error rates and actually close the tax gap as it relates to small business compliance. Further, we believe the cash expensing provisions would score favorably in a dynamic model that accounts for the purchases of supplies, inventory and equipment in generating sales tax revenue within local communities. Indeed, immediate and simplified expensing would encourage robust investment by America's small entrepreneurs, allowing them to hire new workers, lower the cost of goods by reducing overhead and grow their businesses.

True Parity in Deductibility of Charitable Donations of Inventory Property

Though not contained in the committee's small business draft, we also recommend the inclusion of reforms that would provide true parity across all business sizes and types regarding the deductibility of charitable donations of inventory property. Specifically, we write in support of H.R. 2592, the "Charitable Contributions Parity and Enhancement Act" as introduced by Rep. Aaron Schock during the 112th Congress, with minor modifications that would enable small businesses across all industries to more robustly support local charitable organizations.

Requests for charitable contributions of inventory from local charities are quite common for local Main Street businesses. Under current law, deductions for charitable contributions of inventory property are generally limited to a donor's basis in the property. Under Section 170(e)(3) of the Internal Revenue Code, C-corporations are entitled to an enhanced deduction of contributions of inventory for the care of the ill, needy and/or minors. Unfortunately, many small businesses that are organized as S-corporations, sole proprietorships or partnerships do not currently qualify for this enhanced deduction.

To control costs and gain the business efficiencies needed to survive, the purchase of excess inventory by small retailers and service industry businesses has been significantly reduced. To make charitable donations, Main Street businesses need to plan ahead and make careful considerations when purchasing inventory to effectively meet the charitable requests of

local groups. They must also weigh the potential consequences of not fulfilling those requests among influential consumers within a local community. Access to the 170(e)(3) deduction for charitable donations of inventory could provide some incentive for small businesses in all industries to contribute and support charities more effectively. Such an expansion would also provide local charities with greater flexibility to use donated property and services to more effectively raise funds to support their mission.

To begin achieving parity in the tax treatment of charitable donations of inventory, Congress should allow S-corporations and other small businesses to qualify for the Section 170(e)(3) deduction as proposed in H.R. 2592 during the 112th Congress. However, to truly provide parity in charitable giving and incentivize the contributions of all businesses, Congress should also expand the potential uses of donated property and services made to charities to include fundraising events and campaigns that benefit the ill, needy and/or minors within a local community.

Thank you for your continued leadership on behalf of our country's small business entrepreneurs. Through an expansion of cash accounting, the application of checkbook accounting principles and providing parity for charitable donations of inventory to all businesses, Congress would most certainly strengthen the national economy by strengthening America's Main Street businesses. As you consider reforms of our federal tax code, we hope that you will continue to acknowledge the benefits that that a simpler, fairer tax code would provide for our national economy, for small businesses in all industries and for local communities.

Independent Community Bankers of America

INDEPENDENT COMMUNITY BANKERS *of* AMERICA®

May 15, 2013

The Honorable Dave Camp
Chairman
Committee on Ways and Means
U.S. House of Representatives

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
U.S. House of Representatives

Dear Chairman Camp and Ranking Member Levin:

Thank you for the opportunity to comment on the Ways and Means Committee Small Business Tax Reform Discussion Draft. We appreciate your leadership on this critical issue. The Independent Community Bankers of America (ICBA) represents the nation's 7,000 taxpaying community banks which are organized in a variety of forms including mutual's, and C and S corporations. As small businesses themselves, community banks understand the needs of small businesses and are prolific lenders to the small business community. In fact, community banks under $10 billion in assets are responsible for approximately 60% of all small business loans between $100,000 and $1 million. Providing common sense reforms to the small business community will be a critical component of comprehensive tax reform and an important step to improving the economy.

A number of the provisions provided in Option One of the discussion draft would help give the approximately 2300 S corporation community banks greater flexibility in their tax planning as well as help them raise additional capital. For example, permitting non-resident aliens to be S corporation shareholders through a U.S. electing small business trust (ESBT) would give many community banks an additional source of capital. Another helpful provision permanently reduces to five years the amount of time a converted S corporation must pay the highest corporate tax rate on certain built-in-capital gains.

In addition to those listed in the discussion draft, ICBA supports a number of other important S corporation reforms, including:

- Increasing the S corporation shareholder limit to 200
- Allowing S corporations to issue preferred shares
- Allowing individual retirement accounts (IRAs) to invest in S corporations

With bank regulators consistently calling for higher capital levels, it is critical that community banks have additional avenues to raising more capital. The shareholder limit for S corporations has been increased over time, but has remained at 100 since 2004 despite higher capital needs. Allowing S corporation community banks to raise capital from additional shareholders would not only satisfy regulatory demands for more capital, but also give community banks more capital to lend to small businesses in their communities.

Further, S corporations are barred from issuing more than one class of stock and thus cannot issue preferred stock. Allowing S corporations to issue a second class of preferred stock would provide greater flexibility to raise capital without diluting current shareholder ownership interests. It would also give many community banks an additional group of investors to attract.

Likewise, granting holders of IRAs the ability to invest in S corporations would help many community banks raise additional capital in order to satisfy regulatory demands. As you know, this idea is included in H.R. 892, the S Corp Modernization Act of 2013, introduced by Representatives Dave Reichert (R-WA) and Ron Kind (D-WI). In fact, the American Jobs Creation Act of 2004 allowed C corporation banks with shares held in an IRA to convert to S corporations. However, pursuant to this legislation, once a bank has made the conversion to an S corporation, any new investments by IRA holders are strictly prohibited. Due to this restriction, bank owners who have funds tied up in IRAs are prevented from using those funds to recapitalize their banks.

Option Two of the discussion draft seeks to repeal current law Subchapter K and Subchapter S to create a new single, unified pass-through structure. As the discussion draft correctly notes, often times, two similar transactions may receive vastly different tax treatments due to the form of business elected by the business owner. This option recognizes access to the capital markets as the distinguishing characteristic between pass-through and C corporation tax treatment. Option Two represents a significant change to current tax law for the small business community and we look forward to additional study and analysis.

Principles for Tax Reform

As an association representing a mix of S and C corporations, we believe it is critical to reform both the corporate and individual tax codes together and to keep the tax rates at similar, low levels. Reform of the corporate code alone would create an even larger gap between the corporate and individual rates. In addition, by reducing or eliminating business deductions, corporate-only reform could dramatically increase the effective tax rate paid by pass-through corporation owners on their individual tax returns, including shareholders in the 2300 Subchapter S banks and their small business customers. ICBA and other small business trade groups commissioned an Ernst & Young study on the macroeconomic impact of increasing tax rates on high-income taxpayers.[1] The study

[1] "Long-run macroeconomic impact of increasing tax rates on high-income taxpayers in 2013." Drs. Robert Carroll and Gerald Prante. An Ernst & Young LLP report prepared on behalf of the Independent Community Bankers of America, the National Federation of Independent Business, the S Corporation

found that higher tax rates on high income individuals, including shareholders in pass through corporations, will result in the long run in a smaller economy, fewer jobs, less investment and lower wages.

In addition, ICBA would strongly oppose any curtailment of the ability of businesses to deduct interest. Many small businesses prefer debt financing and do not have access to equity markets. ICBA also believes tax reform should work to increase private savings and investment. The current tax code discourages or even punishes savings and investment with double or even triple taxation. A superior tax system would promote savings not punish it.

Finally, any serious tax reform effort should consider the credit union industry's controversial tax exemption. Credit unions are becoming harder and harder to distinguish from the taxpaying banks with which they directly compete. Their efforts to raise the statutory cap on credit union commercial lending would further blur that distinction though, according to a recent analysis by Ike Brannon of the Capital Policy Analytics Group, the credit union industry's claims of economic growth and job creation that would result from this policy change are highly questionable.[2]

Most importantly, the credit union tax exemption comes at a significant cost to taxpayers. The most comprehensive estimate to date, done by the independent Tax Foundation, valued the tax subsidy at $31.3 billion over 10 years[3]. The Debt Reduction Task Force of the Bipartisan Policy Center, chaired by former Senator Pete Domenici and former OMB Director Alice Rivlin, recommended eliminating the tax exemption for credit unions. The Joint Committee on Taxation, the Office of Management and Budget, and the Congressional Budget Office (CBO) have all identified the credit union subsidy as a growing tax expenditure.

Again, thank you for the opportunity to comment on the discussion draft. We appreciate your leadership and thoughtful approach to tax reform.

Sincerely,

/s/

Camden R. Fine
President & CEO

CC: Members of the U.S. House Ways & Means Committee

Association, and the United States Chamber of Commerce. July 2012. Available at http://www.icba.org/files/ICBASites/PDFs/taxstudy.pdf

[2] "An Analysis of the Impact of Expanding the Ability of Credit Unions to Increase Commercial Loans." Ike Brannon, Capital Policy Analytics. November 2012.
URL: http://www.icba.org/files/ICBASites/PDFs/MBLAnalysis.pdf

[3] "Competitive Advantage: A Study of the Federal Tax Exemption for Credit Unions." Tax Foundation. February 28, 2005. URL: http://taxfoundation.org/article/competitive-advantage-study-federal-tax-exemption-credit-unions

National Association for the Self Employed

National Association
for the Self-Employed

Legislative Office
325 7th Street, NW, Suite 250
Washington, DC 20004
P: 202-466-2100
F: 202-466-2123
www.NASE.org

Statement for the Record
Submitted to the Ways and Means Committee
Subcommittee on Select Revenue
United States House of Representatives
Washington, D.C.

Hearing on:
Small Business and Pass-Through Entity Tax Reform Discussion Draft

Submitted by Kristie Arslan
CEO & President, National Association for the Self-Employed
May 15, 2013

The National Association for the Self-Employed (NASE) respectfully submits this official statement for the record regarding the small business discussion draft related to reducing the burden the tax code imposes on small businesses.

BACKGROUND

The NASE represents the 22 million self-employed and micro-business owners (10 employees or fewer), providing business skills education and cost-saving benefits for those looking to start and grow their businesses. Founded in 1981, the association has been the sole voice advocating for America's smallest businesses in all areas of public policy, especially in the area of the tax inequities faced by the self-employed, for the past 30 years.

At present, there are roughly 27 million small businesses nationwide, ranging from 1 to 499 employees and of those, **22 million are identified as self-employed, accounting for more than 79 percent of the entire small-business community, generating roughly $950 million dollars annually in sales** (*2010 Non-Employer Statistics, U.S. Census Bureau*). The majority of our members, roughly 56 percent, have their business organized as a sole-proprietorship, and thus any significant tax reform in the corporate area will have little if any impact on the self-employed.

On behalf of our members, of which 78 percent indicated overwhelming support in a 2012 survey on tax reform, the NASE is in favor of comprehensive tax reform, in order to create a simplified tax code that treats all businesses fairly while also removing unnecessary hurdles and streamlining a cumbersome and overwhelming tax filing process. So strong is the call for reform that in 2012, 96 percent of our members deemed individual and corporate tax reform as a "very important or moderately important" issue for Congress to address in 2013.

SMALL BUSINESS AND PATH-THROUGH ENTITY DISCUSSION DRAFT

The NASE fully understands that the Ways and Means small-business draft is not inclusive of all potential recommendations for reform, but we are concerned that the draft seems to be **completely void of any proposals that would address the continued disparity faced by the self-employed under the current tax code**. In blunt terms, only one of the four components has any bearing on the self-employed community, *Unified Deduction for Start-Up and Organizations Expenses*. And it is ironic that the framework for the unified deduction is included in H.R. 886, *Small Business Tax Relief Act of 2013*, which includes an additional six other tax measures that the small-business draft overlooks (**Note:** the small business draft does include the permanent expensing provision which is included in H.R. 866).

NASE PROPOSED RECOMMENDATIONS

The following are additional tax proposals put forth by the NASE:

1. Deduction of health insurance costs for the self-employed as a qualified business expense by adding a line item on the Schedule C form and not on page one of Form 1040;

   - The biggest tax inequity faced by the self-employed continues to be their inability to deduct the cost of the health insurance as a qualified business expense. This amounts to roughly $1,800 in additional taxes per year for self-employed individuals.

2. Amend the definition of "employee" to include the owner and spouse of a sole proprietorship, or a 2 percent or greater shareholder in an S Corporation – a simple legislative or administrative fix to current language;

   - This would address many issues related to "fringe benefits," for example: the applicability of an HRA 105 plan, retirement plan contributions, and health insurance premiums.

3. Simplified and streamlined definition of independent contractor versus employee by expanding the Form 1099 that requires the owner and contractor to agree to their business relationship in a transparent manner;

   - Reduction of abuse by business owners and their use of independent contractors.

4. Simplified depreciation calculators, reporting requirements, and accelerated options for most standard business items and amounts, all of which would be included as a line on the Schedule C form;

   - In developing simplified deduction calculators, the business owner would be able to easily apply for the correct deduction amount and simplify a process that is currently unnecessarily complicated.

5. Building off the simplified home office deduction, identify other areas to establish standard deduction options based on industry and location, resulting in the development of a Standard Schedule C-EZ form.

   - Recognizing the difficulty in creating standard deductions, we believe that if the necessary time and energy were directed towards creating such a system, the taxpayer would benefit enormously. This has the opportunity to becoming the greatest tool towards simplifying the tax code for small business owners.

All of the above proposals meet the criteria of creating a lean, simplified, equitable tax code – inspiring entrepreneurship and growth within the small-business community.

While we don't want to over-simplify the impact of these changes, we do believe it is important to note that we would encourage the Ways and Means Committee to be bold in their actions.

JOINT COMMITTEE ON TAXATION REPORT

With the release of the Joint Committee on Taxation report last week, the NASE was pleased to see that many of our proposed recommendations were highlighted. We appreciated the reports deliberate nature to identify proposed changes for sole-proprietorships, in essence the NASE believes that the three items highlighted in the report provide a great starting point for creating an equitable tax code for America's self-employed:

- Raise the self-employment exemption amount to the standard deduction amount;
- Simplify depreciation calculators, reporting requirements, and accelerated options for most standard business items and amounts, all of which could be included as a line on Schedule C; and
- Provide additional safe harbors (similar to the home office deduction) providing standard deduction options based on industry and location.

These are the types of bold proposals that if included in the final legislation will be truly transformational in moving from a complex, unfair tax code, to one that encourages entrepreneurship and small business growth.

The NASE will however continue to push for the inclusion of the self-employed health insurance deduction, for our members this is the single most significant tax inequity they face when compared to other business entities.

CONCLUSION

It goes without saying that any significant reform to the tax code will be challenging, but we believe that putting forth a dynamic, common-sense proposal for bringing the tax code into the 21st Century can be accomplished if the proposal provides for a transformational change to all aspects of the tax code, individual and corporate.

As it stands now, our concern remains that the draft proposal looks only to modify or tweak the current tax code, but falls short of taking a path to overhauling the dysfunctional and byzantine tax code with a vision for complete reform of the individual and corporate tax structure.

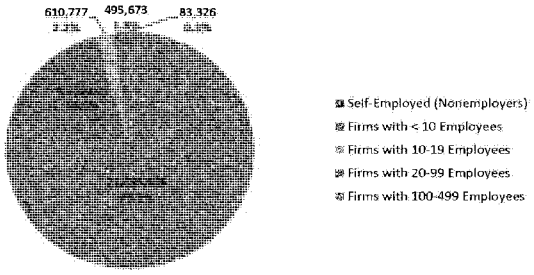
We look forward to continuing to work with the Ways and Means Committees on achieving comprehensive tax reform in the 113th Congress.

Respectfully,

Kristie Arslan, President & CEO
National Association for the Self-Employed

The Majority of U.S. Small Businesses are Self-Employed

FACT: 79.66 percent of small businesses in the United States are self-employed.



Source: U.S. Census Statistics of U.S. Businesses and Nonemployer Statistics, 2009

Prepared by the National Association for the Self-Employed (NASE)
www.NASE.org

National Pork Producers Council

The Honorable Pat Tiberi
Chair, Subcommittee on Select Revenue Measures
House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Richard E. Neal
Ranking Member, Subcommittee on Select Revenue Measures
House Ways and Means Committee

RE: Hearing on Ways and Means Small Business and Pass-Through Entity Tax Reform Discussion Draft

Dear Chairman Tiberi and Ranking Member Neal:

The National Pork Producers Council submits, for the hearing record dated May 15, 2013, the attached letter detailing U.S. pork producers concerns regarding impacts on the production of U.S. pork and pork products pursuant to the Ways and Means Small Business Discussion Draft released March 12, 2013.

Should you have any questions, please contact:

Ms. Audrey Adamson
Vice President, Public Policy
National Pork Producers Council
122 C Street, NW Suite 875
Washington, DC 20001
(P) 202 347-3600
(F) 202 347-5265

Sincerely,

Randy Spronk

Randy Spronk
President
National Pork Producers Council

May 13, 2013

The Honorable Dave Camp
Chairman, House Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Sander Levin
Ranking Member, House Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Camp and Ranking Member Levin:

The National Pork Producers Council is an association representing a federation of 43 state producer organizations and the federal and global interests of 67,000 U.S. pork operations that annually generate approximately $15 billion in farm gate sales. The U.S. pork industry supports an estimated 550,000 domestic jobs and generates more than $97 billion annually in total U.S. economic activity.

We have several pork industry specific concerns with the Committee's Discussion Draft Provisions to Reform the Taxation of Small Businesses and Pass-through Entities, released March 12, 2013, particularly its unintended consequences.

The proposal contemplates restricting the use of cash basis accounting by even the smallest scale commercial pork producers. Under this method of accounting, cash revenues received in any year are attributed to total gross income for that tax year. Generally, expenses such as animal feed, animal health products, etc. are deducted in the tax year in which they are paid. U.S. pork producers/farmers are not covered by the requirement that taxpayers with over $5 million of annual gross receipts use accrual basis accounting. However, a family farm corporation is required to use accrual accounting if it has gross receipts of more than $25 million for any tax year since 1985. A family corporation is one where 50 percent or more of the corporate stock is held by one family (or in some cases, two or more families). In addition, a partnership that has a corporation as a partner is unable to utilize cash basis accounting.

The Committee Discussion Draft proposes eliminating the "special exceptions" for farming businesses, an action that would expose small- to medium-sized pork farmers to the general limitation on the use of cash method accounting for federal income tax purposes. Those limitations would force taxpayers with average gross receipts of $10 million or more for the three prior taxable years to use accrual basis accounting.

And reaching that $10 million threshold is quite common in the U.S. pork industry. An operation with 3,000 sows, for example, would surpass the threshold, or one with 1,500 sows and

about 4,200 acres of corn would as well. Those farms would be considered "medium-sized" operations.

Today, many U.S. pork producers/farmers use the cash method of accounting because they find it easier to keep farm records and because it more accurately reflects the nature and volatility in income during a period of years. While this issue is not unfamiliar to small businesses, it is perhaps more significant in the agriculture industry and particularly in the livestock business because of the longer lead time in growing a live animal from birth to market and because of the many largely uncontrollable factors such as weather and volatility of commodity markets in general and livestock and feed stocks in particular. On-farm livestock income fluctuates greatly from year to year. Under the Discussion Draft proposal, producers/farmers would need to recognize income that might not ultimately materialize, the accrual basis of accounting accelerates the recognition of income on pigs that have yet to go to market.

Even with a 10-year phase-in, U.S. pork farms/entities that previously used the cash basis would confront a situation whereby the cost of inventory – pigs in progress and pigs that are not ready to go to market, meaning younger pigs – would in effect become immediately taxable. Most market hogs are harvested around six months of age and require approximately one year from conception to market. Farmers raising pigs would be required to recognize income on pigs that might not go to market until the following tax year and, since they are not paid until after the pigs are delivered to the packing house, those farmers would be recognizing income for tax purposes without actually receiving cash with which to pay the resulting tax. In addition, receivables from packing houses and other customers, prepaid expenses, as well as other inventory items (such as animal feed ingredients, farm supplies, et cetera), would be effectively taxed well before cash is received.

Requiring U.S. pork producers to use the accrual method of accounting would subject them to Section 263 inventory capitalization rules. Compliance with the hundreds of pages of regulations under Section 263 would create a massive burden for smaller U.S. pork producers from a professional accounting and administrative cost perspective. The computations required under Section 263 can be complex and open a "whole new world" to many smaller U.S. pork producers. This is not tax simplification but rather a proposal that would impose massive compliance costs that would threaten to put smaller U.S. pork producers out of business.

Additionally, the proposal violates the principal that a tax should not be imposed until cash is received with which the taxpayer is able to pay the tax. The cumulative net difference of taxable income, now taxable under this proposal, would require that most U.S. pork producers borrow money to pay related taxes. This will have an inordinate impact on smaller pork producers/farmers, many of whom may not be able to obtain financing to pay these new federal taxes.

Paying taxes on inventory "in progress" might actually result in a "double whammy" situation. If livestock markets deteriorated and costs on inputs such as animal feed rose precipitously – as has been the case over the past six years because of numerous factors, including commodity speculation and federal renewable fuels mandates – this situation could create a net loss in the subsequent tax year. In other words, federal taxes are paid on inventory "in progress" in one

year, then losses (real cash losses) are incurred in the next, some of which might not be recoverable immediately via the federal tax rules and regulations at the applicable time.

Further, the effects of the proposed change will be compounded because many U.S. pork producers live in "high income tax" states such as Minnesota, the second-largest pork-producing state, and they would bear an additional state income tax burden.

Finally, we would offer several additional comments on specific sections of the proposal.

NPPC is concerned that there appears to be "discrimination" built into this proposal in terms of treatment of sole proprietorships versus any number of pass-through entities (partnerships and Sub Chapter S corporations). The proposal appears to violate the principal that tax liability should not differ between similarly situated sole proprietorships and any number of pass-through entities. If Subchapter S Corporation "farmers" are now going to be required to report taxable income using the accrual method, so must all farmers—regardless of the organizational structure of their business.

NPPC opposes the proposed reduction in the level of immediate expensing of capital additions. If implemented, it would reduce the long-term competitiveness of the U.S. pork industry. The proposed Section 179 provisions are yet another deterrent to successful U.S. pork farming and to investing in the future of U.S. pork production. The U.S. tax code should encourage the expensing of all on-farm capital additions. We would support and encourage 100% expensing of all capital additions for federal tax purposes. This is the only way that the U.S. pork industry will remain ahead of its global competitors in the production of pork and pork products. The tax code should encourage U.S. pork producers to invest in barns, automatic feeders, ventilation equipment and other technology to ensure the long-term future and global competitiveness of the U.S. pork industry.

In conclusion, we thank Chairman Camp and Ranking Member Levin for soliciting comments from stakeholders. We look forward to the opportunity for further dialogue on the impacts this proposal would have on the U.S. pork industry. Should you need additional information or wish to discuss further, please do not hesitate to call Audrey Adamson, Vice President, Public Policy, at (202) 347-3600, or alternatively she can be reached at adamsona@nppc.org.

Sincerely,

Randy Spronk
President
National Pork Producers Council

National Retail Federation

May 29, 2013

The Honorable Pat Tiberi
Chairman
Select Revenue Measures Subcommittee
Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

The Honorable Richard Neal
Ranking Member
Select Revenue Measures Subcommittee
Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

Re: Hearing on Small Business and Pass-Through Entity Tax Reform Discussion Draft

Dear Chairman Tiberi and Ranking Member Neal:

The National Retail Federation (NRF) submits the following comments for the record of the May 15 subcommittee hearing on the Ways and Means Small Business and Pass-Through Entity Tax Reform Discussion Draft.

NRF believe that the most important aspect of any tax reform measure is its impact on the economy, jobs, and the consumer. The U.S. economy is coming out of the worst recession since the Great Depression, but economists predict that economic growth may continue to be slow, which will also continue to depress consumer spending. Tax reform can provide much needed stimulus to the economy and should be enacted as expeditiously as possible.

We believe that a reform of the income tax, by providing a broad base and low rates, will bring the greatest economic efficiency to the federal tax system. These changes will lead to greater investment, more jobs and greater economic growth. In making these reforms, it is important that the tax code not place different tax burdens on taxpayers in similar economic circumstances. For this reason, tax reform must be applicable to all businesses, not just "C corporations." A reformed income tax code should not include tax preferences based on form of legal entity (e.g. C corporations vs. pass-through entities), how property is owned (e.g. leased stores vs. owned stores), and distribution channel (e.g. brick and mortar sales vs. remote sales).

Exchanging so-called "tax expenditures" for lower tax rates will not only result in greater economic efficiency, it will also eliminate some of the major complications in the current Internal Revenue Code. The vast majority of retailers are small businesses. In fact, 96% of all retailers have only one location. The policy of eliminating tax expenditures in exchange for lower tax rates is important for both large and small businesses because it will lead to a more productive employment of capital and more economic growth. Retailers, both small and large, are high effective taxpayers and prefer the simplicity of a tax system that exchanges complex tax expenditures for lower rates, allowing businesses to make economic decisions for their enterprises that are based on the best business result, rather than tax motivations. Because most small business owners report taxes as individuals, generally as S corporations or partnerships, there are some additional considerations to this reform that may not be present in the debate of corporate tax reform.

Liberty Place
325 7th Street NW, Suite 1100
Washington, DC 20004
800.NRF.HOW2 (800.673.4692)
202.783.7971 fax 202.737.2849
www.nrf.com

The NRF commends Chairman Camp for issuing a discussion draft for reforming small business tax rules. The options included in the draft recognize that tax reform must be comprehensive with respect to all businesses, whether C corporations or "pass-throughs." The Chairman's proposed expansion of the cash method of accounting will be particularly helpful to small retailers. Section 179 expensing is also very helpful for small retailers, but the current definition of qualifying expenses puts retailers that own their buildings at a competitive disadvantage vis-à-vis retailers that lease their buildings.[1] Many small retailers own their buildings in order to achieve the best location for their store in the community, or because they want to invest in an asset that will maintain its value for retirement, or because they have inherited a family business that includes the real estate. The NRF believes that tax reform should eliminate provisions that discriminate between taxpayers in the same industry. To accomplish this, the current rules regarding leasehold improvements probably need to be expanded to include all commercial improvements, in order to eliminate the bias in favor of improvements to leased property over owned property in the same industry.

The NRF supports income tax reform that will lower tax rates and broaden the tax base. We believe this type of income tax reform will be good for the retail industry and good for the economy as a whole. The NRF urges Congress to pass tax reform legislation this year, and we offer whatever assistance we may provide in meeting this goal. Income tax reform will encourage investment, create jobs and simplify administration of the tax system.

Sincerely,

Rochelle Bernstein

Vice President, Tax Counsel
Government Relations

[1] The definition of "qualified retail improvement" is narrower than the definition of "qualified leasehold improvement." For retailers that own their buildings, only improvements to space that is "open to the public" is eligible for Section 179. Retailers that lease their buildings can also get Section 179 benefits for improvements to backroom, warehousing, and other non-public space.

Real Estate Roundtable

The Real Estate Roundtable

May 29, 2013

The Honorable Patrick Tiberi
Chairman
Subcommittee on Select Revenue Measures
House Committee on Ways and Means
1136 Longworth House Office Building
Washington, DC 20515

The Honorable Richard Neal
Ranking Member
Subcommittee on Select Revenue Measures
House Committee on Ways and Means
2208 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Tiberi and Ranking Member Neal:

Thank you for the opportunity to submit written comments in relation to your May 15, 2013 hearing on the Ways and Means Committee's small business and pass-through entity tax reform discussion draft.

The Real Estate Roundtable brings together leaders of the nation's top publicly-held and privately-owned real estate ownership, development, lending and management firms and leaders of major national real estate trade associations. Collectively, Roundtable members' portfolios contain over 5 billion square feet of office, retail and industrial properties valued at more than $1 trillion; over 1.5 million apartment units; and in excess of 1.3 million hotel rooms. Participating trade associations represent more than 1.5 million people involved in virtually every aspect of the real estate business. The real estate industry accounts for nearly 1/4 of taxes collected at all levels of government.

Federal tax laws need to be revamped to unleash entrepreneurship, investment, and job creation. Well-designed tax reform will remove unnecessary complexity, create a level playing field, and ensure transactions are motivated by legitimate business purposes. Poorly conceived tax reform, or tax reform that unduly increases the overall tax burden, however, could depress capital investment and undermine the economic recovery.

Congress must carefully study and consider how changes to entity classification rules or the tax treatment of pass-through businesses will affect real estate and other sectors that rely on the use of pass-through entities to mobilize capital for new, job-creating ventures. Shifting large pass-through firms into an entity-level tax regime would alter the underlying economics of real estate investment and transactions to the detriment of new projects and economic growth.

Market Square West • 801 Pennsylvania Ave., NW • Suite 720 • Washington, DC 20004 • Phone: 202-639-8400 • Fax: 202-639-8442 • www.rer.org

The U.S. commercial real estate sector uses the full range of organizational forms available under the tax code to develop, finance, and manage income-producing projects, including: partnerships, limited liability companies (LLCs), S corporations, C corporations, and real estate investment trusts (REITs). The availability of these different forms of organization serves the capital, ownership, and operational needs of diverse real estate projects and endeavors. Nearly half of the 3.2 million partnerships in the country are real estate partnerships. Current pass-through entity classification rules contribute to the dynamic nature of the U.S. commercial real estate market, and The Roundtable supports preserving the elective pass-through structure regardless of the size of the business.

The small business and pass-through discussion draft proposes a menu of potential tax policy changes. Option 1 seeks to modernize current tax rules affecting S corporations and partnerships. Option 2 seeks to overhaul the taxation of pass-through entities by repealing existing tax rules governing partnerships and S corporations and replacing those rules with a new unified pass-through regime.

Option 1: Revisions to current pass-through tax rules

Option 1 includes several well-designed reforms to simplify and improve current Subchapter K and Subchapter S of the Internal Revenue Code. For example, the discussion draft's proposal to repeal existing rules related to guaranteed payments to partners would simplify tax reporting for partners and partnerships and reduce the tax gap by improving compliance through employer withholding. The provision in Option 1 to repeal the special rule governing payments to retiring and deceased partners would update an area of partnership taxation to better reflect underlying changes in the tax law.

A proposal in Option 1 to repeal the 7-year limitation and perpetually apply the so-called "anti-mixing bowl rules" in sections 704(c)(1)(B) and 737, however, would unnecessarily increase administrative burdens on real estate partnerships, artificially distort business decisions, and effectively discourage job-creating economic activity. Anti-mixing bowl rules are an appropriate means of preventing tax avoidance through disguised sales. But requiring partnerships to indefinitely trace property and the contributed gain would further complicate an area of partnership tax already prone to error. Taxpayers frequently unwind partnerships for legitimate, non-tax business reasons, and this proposal would impede the efficient allocation of resources to new and more productive investments.

Option 2: Unified rules for pass-through business entities

Option 2 proposes replacing the current rules with a new, unified pass-through regime. Despite its conceptual appeal, The Roundtable is concerned that the unified pass-through regime in Option 2, as currently drafted, would adversely affect commercial real estate development and growth. A unified pass-through regime that promotes entrepreneurship, investment, and job creation would require significant changes that take into account the flexibility and other benefits inherent in Subchapter K of the tax code. A few of The Roundtable's specific concerns with Option 2 include the following:

- **Curtailing the ability of partnerships to specially allocate items between partners would disrupt common real estate arrangements.** Disproportionate distributions are normal in capital-intensive partnerships and arise from the disparate ways in which partners contribute to the success of a real estate enterprise—*e.g.*, management or operational skill, capital contributions, guaranty of construction loans, or some combination of these factors. The timing of capital contributions can also influence distribution priorities among partners, especially in distressed businesses. Special allocations help real estate partnerships bring varied parties together to participate in risk-based investments. By limiting special allocations in three broad categories--ordinary items, capital gains, and tax credits--Option 2 would impede future, job-creating commercial real estate development.[1]

- **Requiring partners to recognize gain on distributions of appreciated property would result in the taxation of noneconomic gains and make it difficult to exit from real estate partnerships.** The proposal would complicate, and in some cases prevent, normal partnership restructuring transactions, including mergers, acquisitions, and reorganizations. As a consequence, the proposal would likely discourage capital formation and investment in commercial real estate ventures by altering potential investors' analysis of the risks and commitment involved in new ventures.[2]

- **Imposing a new, mandatory withholding regime on the distributive share of pass-through income would require complex rules and create unnecessary administrative burdens.** Unlike salary arrangements between employers and employees, partnership income is highly volatile and unpredictable. A tax withholding regime for pass-through income would require a complicated set of rules to address income fluctuations within a given taxable year. Special rules would be necessary for tax-exempt partners and other partners with deductions that offset partnership income. Even with exemptions, a mandatory withholding regime would inevitably result in over-withholding for many taxpayers, thus withdrawing scarce capital from private investment uses. Taxpayer compliance costs associated with a withholding regime would likely exceed the benefits to the U.S. Treasury.[3]

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[1] The three category approach does not simplify the administration of pass-through entities or "level the playing field." Instead, the opposite effect may occur and lead to a new set of controversies over arrangements designed to circumvent the rules.

[2] Most small business corporations taxed as C corporations rarely distribute appreciated property unless the distribution is part of a tax-free reorganization. It is unlikely making all distributions from partnerships taxable would raise revenue. Such a provision would drive real estate "partners" to more co-ownership arrangements. Such arrangements may eliminate special allocations and Subchapter K complexity, but would increase the cost and complexity of tax administration. Co-ownerships would also complicate real estate financing and could hamper economic activity.

[3] A number of States impose mandatory withholding on nonresident partners' distributive shares of income. These rules are inconsistent and complex. Difficulties arise when income is earned unevenly throughout the tax year and where partners have different economic sharing arrangements. For example, withholding may vary quarter to quarter where net income allocations are based on a "waterfall" that represents varying capital priorities among the partners.

Additional reforms to simplify, streamline, and improve the tax system for partnerships and pass-through business entities

The Roundtable supports alternative steps that could be taken to address the complexity, uncertainty, and inadvertent mistakes that arise under current partnership and related rules. For example, Congress should consolidate rules that limit or defer the use of partnership losses. Second, Congress should repeal and replace the overly-mechanical provisions governing the allocation of income between taxable and tax-exempt partners in leveraged real estate partnerships.

Reduce uncertainty and complexity by consolidating partnership loss limitation regimes. Congress should simplify and consolidate the four separate statutory regimes aimed at limiting or deferring a partner's ability to deduct partnership losses: (1) at-risk rules under section 465; (2) allocation rules under section 704(b) and (c); (3) limitation on deductible losses to outside basis under section 704(d) and 752; and (4) passive activity loss rules under section 469, all of which are very important to real estate investment. The first three regimes seek to limit deductible losses to the taxpayer's investment exposure to the business, including some measure of the taxpayer's share of borrowed capital. Each regime, however, has rules that are materially different from the others and often conflict with one another.

The interaction of these loss-limitation regimes leads to unnecessary complexity, business uncertainty, and misapplication of the rules by taxpayers and the IRS. For example, the same nonrecourse debt that allows a partnership to allocate a loss to a partner and increases the partner's outside basis does not necessarily increase the partner's at-risk amount because the at-risk rules impose a unique set of requirements on *qualified nonrecourse financing*. Such non-intuitive distinctions frequently confuse tax practitioners and revenue agents.

Uncertainty and unnecessary taxpayer mistakes could be avoided by repealing at-risk rules and modestly harmonizing the allocation and basis rules. The purpose of the at-risk provisions is adequately served by the allocation and basis loss limitation rules. Additionally, Congress should clarify that distributions in excess of a partner's basis (section 731) and deemed distributions (section 752(b)) are measured only at year-end after all allocations, including any special allocations. Such a clarification supports the annual accounting concept.

Remove barriers to investment in U.S. commercial real estate by replacing the "Fractions Rule" and expanding the debt-financed real property exception. Tax-exempt investors can generate passive income without tax from sources such as dividends, interest, rent, and gains from the sale of property. Such income is generally taxable, however, if it is debt-financed. An exception to tbe debt-financing rule applies to pension funds and educational institutions that own real property. In addition, if certain requirements are met, pension funds and educational institutions can earn nontaxable income from debt-financed, real property held by a partnership that includes a taxable partner, such as a real estate company. In real estate partnerships, the so-called Fractions Rule, section 514(c)(9)(E), is intended to prevent the abusive allocation of taxable income to tax-exempt partners. The Fractions Rule strictly requires that the exempt organization's share of partnership income in any year is not greater than the smallest share of loss allocated to it.

The Fractions Rule, as currently written, prevents pension funds, educational endowments, and other tax-exempt investors from efficiently diversifying their investment base and deploying much-needed capital into job-creating real estate ventures. The Fractions Rule should be repealed and replaced with a more flexible rule that requires the partnership allocations to have substantial economic effect. This will prevent tax avoidance yet allow the partnership to allocate income and loss that reflects the economic relationship of the partners.

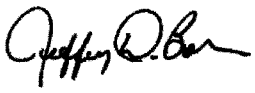
Also, currently, even the slightest violation of the Fraction Rule's statutory requirements generally taints the entire investment and converts to unrelated business taxable income all debt-financed income earned by all tax-exempt partners from the investment. This cliff effect for even a minor, non-abusive infraction of the allocation requirements is unduly harsh and should be replaced with a penalty more proportional with the violation.

More broadly, Congress should expand the debt-financed real property exception to cover other types of tax-exempt investors, such as private foundations and public charities. Extending the exception to other tax-exempt organizations would remove an artificial barrier to new investment in U.S. commercial real estate.

Lastly, while The Roundtable welcomes a simpler, more rational tax code, we strongly urge that Congress undertake comprehensive tax restructuring with caution, given the potential for tremendous economic dislocation. The Tax Reform Act of 1986, for example, ushered in a series of overreaching and over-reactive policies—in some cases, such as the passive loss limitations, on a retroactive basis and applicable to preexisting investments. The changes had a destabilizing effect on commercial real estate values, financial institutions, and Federal, state and local tax bases. Any changes, therefore, must provide for a reasonable multi-year transition regime that minimizes dislocation in, and disintermediation from, real estate markets.

Thank you again for the opportunity to present The Roundtable's perspective on the small business and pass-through tax reform discussion draft, we appreciate your consideration of these comments. We look forward to continuing our productive dialogue in the weeks and months ahead.

Sincerely,



Jeffrey D. DeBoer
President and Chief Executive Officer

SBLC

On behalf of the Small Business Legislative Council, we use to submit the following comments for the record for the hearing about tax reform and the impact on small businesses.

INTERNAL REVENUE CODE SECTION 179 DIRECT EXPENSING ALLOWANCE

Section 179 allows a business to deduct the expenses for the purchase of equipment and machinery in the year of purchase. The amount of the deduction is limited and the ability to use the allowance is further reduced and eliminated if the total amount of investment in equipment and machinery exceeds a certain amount. The allowance is currently $500,000 and the purchase "cap" is $2 million. At the end of the year, the allowance and cap will revert to the 2003 amounts of $25,000 and $200,000 respectively.

We support making the current temporary amount and cap permanent and indexing them for inflation.

There are three phrases associated with the direct expensing allowance: "cash flow," "simplicity," and "encouraging investment."

If you understand small business, you understand the importance of reliable cash flow. Talk to a small business owner, and you will hear talk of the "monthly nut." The direct expensing allowance allows small business owns to manage their investments and tax consequences in a real time cash flow environment.

The simplicity is obvious when you like at the alternative: depreciation. With a robust direct expensing allowance, you buy it, you pay for it, you report on the tax return and you are done with it. No issue the next year, or the year after or the year after or…

We talk a lot about small businesses' job creation abilities and those come hand and hand with the investment in the resources to grow and meet the demand for your innovations. The direct expensing allowance encourages that investment. We might add the direct expensing allowance is not just about the small businesses that benefit from the ability to use it. Often overlooked are the small businesses that make, distribute, and sell the innovative equipment and machinery that other businesses purchase. The ability to encourage their customers to invest in their equipment and machinery is important to those small businesses.

Small Business Legislative Council
email@sblc.org, 202-639-8500

The modern day version of the direct expensing allowance has its roots in the 1980 White House Conference and passage of legislation in 1981. The amount was $5,000 with a glide path to $10,000 in 1986 that was subsequently disrupted. Later, we got on a new glide path to get us to the $25,000 in 2003. If you dust off documents in the congressional archives, you will find that the Small Business Legislative Council played an active role in securing passage of the 1981 legislation and subsequent efforts to improve it. We would like to finish the job.

CASH ACCOUNTING

The ability for small businesses to use cash accounting has been a long time goal of the Small Business Legislative Council. With our good friends, former Senator Kit Bond and former Representative Wally Herger and former Internal Revenue Service Commissioner Charles Rossotti we worked on this problem in the late 1990's and early 2000's. We were able to make some headway with administrative activity but tax accounting remains one of the banes of small business' existence.

Again, the phrase "cash flow" and "simplicity" come to the forefront. Our tax accounting rules are all about getting the tax revenues to the government as soon as possible. Putting aside the time value of money issue, at the end of the day the government does gets its tax revenues, whether cash accounting, accrual accounting, or capitalization is used. Ironically, it is the methods that get the government the tax revenue the soonest that provide the most complexity for small business.

If you want to match up small business tax accounting with cash flow, cash accounting is the option that fills the bill. Cash in, cash out. Buy or make goods, sell the goods.

If you want to match up small business tax accounting with simplicity, cash accounting fills the bill. Cash in, cash out. Buy or make the goods, sell the goods.

You just have to get over the tax revenue deferral transition and the government gets it money either way.

However, if you want to truly claim a simplicity victory, we have to deal with inventory accounting. For most small businesses, inventory accounting is what creates the complexity. Some industries may have other issues that defer expenses but it is the inventory accounting that provides the layers of complexity for most. We sat through countless meetings with our Congressional and IRS friends when we looked at this more than a decade ago, and what you realize is that the clear lines between service providers and sellers of goods has long become blurred. But even for those most clearly sellers of goods, the complexity of the tax accounting necessary to get the tax revenues to the government sooner than later have just continued to burden small businesses.

Unfortunately, it is an illusion to call cash accounting simplicity without reducing the inventory accounting burden. Again, it is important to bear in mind; the government ultimately gets its revenue. This is not about reducing the tax liability of these small businesses.

As to the proposed $10 million ceiling on cash accounting, the $10 million number has been a remarkably consistent benchmark over decades that has withstood the test of time. It continues to ensure the vast number of small businesses will never have to worry about a transition from cash to accrual. There are very few small businesses that ever cross the threshold. We are sure we can find a way to ease the transition when it does happen. It is not like it happens in an instant. A business can plan for coming up on the ceiling.

BUSINESS TAX SYSTEMS UNIFICATION

While we keenly value the fact most small business owners are taxed only once on their business income, small business is constantly whipsawed between the focus on large multi-national C Corporations and high income individuals. We would be tempted to say small business is painted with the same brush in these debates. Whether the topic is the estate tax, top marginal rates and myriad of business deductions and credits, small businesses are frequently painted, ironically, with two brushes at the same time, with the large corporations and with the high-income individuals. We would prefer if we had our own brush.

In addition to being able to focus on what is good for small business, if we could move to a unified business tax system that is bifurcated along the size of business, we could do amazing things to simplify the tax responsibilities of small business. We could address the need for the myriad deductions and credits and many of the administrative rules that attempt to distinguish various types of tax-related activities.

To that end, we support the modest steps proposed in the draft without indicating a preference for one or the other of the two proposals to move the S Corporation and partnership worlds into a more unified structure. Our only concern is that in the small business community, it is not uncommon for small business partners to allocate income based on factors such as experience and business acumen notwithstanding a "50-50" ownership structure. We hope the new system accommodates that concern.

We know there are going to be some challenges such as the issue of withholding on the net income of owners. We have never been enamored with withholding and recent experiences have only reinforced our reservations but we approach this process with an open mind.

At the end of the day, however, we need to move towards the unification of business tax structures. There will be thousands of reasons why we should not. A fair and simple tax system is the reason why we should.

Thank you.

The Small Business Legislative Council is a permanent, independent coalition of more than 50 trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. Our policies are developed through a consensus among our membership. Individual associations may express their own views

Small Business Investor Alliance

Statement for the Record on behalf of
Small Business Investor Alliance
1100 H Street, Suite 610
Washington, D.C. 20005
(202) 628-5055
cwalters@sbia.org

Hearing on Ways and Means Small Business and Pass-Through Entity Tax Reform Discussion Draft
1100 Longworth House Office Building at 10:00AM, May 15, 2013

May 15, 2013

The Honorable Pat Tiberi
Chair, Subcommittee on Select Revenue Measures
House Ways and Means Committee
1100 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Tiberi and Members of the Select Revenue Measures Subcommittee,

On behalf of the Small Business Investor Alliance (SBIA), we appreciate the opportunity to provide a written statement to the Subcommittee on Select Revenues Measures on the *small business tax discussion draft* released by the Ways and Means Committee on March 12, 2013. SBIA is the premier association representing lower middle market private equity funds. Our members provide vital capital to small and medium sized businesses nationwide, resulting in economic growth and job creation.

The small business tax reform discussion draft makes significant changes to S corporation and partnership taxation. The comments by the SBIA focus on the partnership taxation changes because the most common tax structure for small private equity funds is a limited partnership. The ability to pool capital for investment via partnerships allows inactive capital to be actively invested in growing companies.

The partnership structure provides flexibility to private equity funds for allocating and distributing income and property to the partners. This flexibility is not intended to allow partners to avoid taxes. Rather, this flexibility is intended to promote healthy economic behavior within the partnership structure and it is essential to making capital available to small businesses in an efficient and cost effective way. Placing limits on how a partnership can function may distort markets and reduce the capital that is available for small businesses.

SBIA makes comments regarding four areas of the discussion draft: 1) mandatory entity-level withholding; 2) mandatory adjustment of partnership's basis in partnership property whenever there is an in-kind distribution or a partner transfers its interest; 3) partnership allocation rules; and 4) changes to the partnership tax filing date.

Mandatory entity-level withholding. The small business tax discussion draft proposes tax withholding on partnerships on their distributive share of pass-through income. This proposal would add a significant new administrative burden for private equity partnerships, which would be particularly onerous to small funds, the funds most likely to be investing in small businesses.

The proposal may be inoperable for certain private equity funds that have strict rules governing distributions in the partnership.

Under current law, partnerships are not required to withhold taxes because taxable income flows through to the partners of the partnership. Partnerships report their income to the IRS at the partnership level on Schedule K-1 (Form 1065). Schedule K-1 is used to report the allocations of income, loss, and gain that are passed through to each partner that has an interest in the partnership. This system allows for the partners, not the partnership, to be subject to taxable income.

The current information reporting system allows the IRS to make a determination of the payment standing of a taxpayer. The IRS can match the data provided on Schedule K-1s with the individual tax returns to make sure a taxpayer is not underreporting their taxes. This is a very effective way for the IRS to make sure taxpayers are not underreporting. As long as the IRS matches the Schedule K-1 data with the individual tax return data, the IRS has all it needs to ensure that partners are paying taxes on income from partnerships.

According to the Ways and Means Committee, the purpose of the entity level withholding is to close the federal tax gap, which is the difference between taxes owed but not paid to the IRS. Withholding procedures have proven in some cases to be an effective mechanism to bring in tax revenue because as long as an income transaction between two parties is periodic and estimable, it sets up a reliable collection process for the IRS. For example, employers are required to withhold taxes for their employees each pay period. This system works because the flow of income from the employer to the employee is generally straight forward and the tax liability of the employee is easier to estimate.

We do not believe the partnership withholding proposal is workable for private equity partnerships. The fluctuations of investment income, gain, and loss, as well as the complexities of the makeup of a limited partnership make this proposal highly complex. Unlike an income transaction between an employer and employee where estimated income is highly predictable, the income into a private equity fund changes based on the life of the fund and success of the investments. From an investor perspective, the investor may well have offsetting losses which would result in the taxpayer not owing any taxes. This would put the taxpayer in a position of having to file for a refund for taxes unnecessarily withheld.

The entity-level withholding proposal is most likely inoperable for a private equity fund organized as a Small Business Investment Company (SBIC). SBICs are highly regulated, specialized private equity companies that are licensed and regulated by the U.S. Small Business Administration (SBA). Requiring an SBIC to withhold at the partnership entity level would put SBICs in a position of potentially violating the rules promulgated by the SBA under which the SBIC must operate.

SBICs are subject to special rules with respect to distributions. Distributions of profits can only be made by SBICs drawing leverage (government funds) if the SBIC has Retained Earnings Available for Distribution ("READ"). READ is defined as net realized cumulative retained earnings, that is cumulative earnings after all expenses and realized and unrealized depreciation of investments have been deducted. An SBIC may have gains that are taxable but may not have READ, in which case the SBIC would be prohibited from making a distribution under the regulations under which the SBA operates. The SBA could not make a payment of the withheld amounts to the IRS without violating SBA regulations, as the payment by the SBIC would be treated as a distribution by the SBA.

This violation of SBA regulations could result in draconian penalties, including the acceleration of all outstanding Leverage, the loss of the SBIC's license to operate, the removal of its general partner or the SBIC being put into receivership. In addition, an SBIC is restricted in the amount of capital it may return to investors. This amount is 2% of Regulatory Capital (essentially private capital from investors) in any year. As a consequence, the SBIC may have insufficient funds to pay required tax withholding to the IRS without again violating the SBA regulations.

An additional serious concern for both SBICs and other lower middle market private equity funds is the treatment of tax exempt investors with respect to any withholding requirements. If no withholding is required for such investors, the issue of UBTI remains. It is untenable to require a private equity fund to deal with the tax obligations of its investors. By way of example, assume the investor is a state pension fund and the investment fund has UBTI generated by the private equity fund's investment in a limited liability company. State pension funds generally take the position that they are exempt from UBTI. We do not believe that the IRS has ever taken a position on this issue.

Entity level withholding is also a serious problem to a private equity fund if a portfolio company is formed as a pass-through such as an LLC. Accounting complications could arise when a portfolio company is required to withhold from a distribution it might otherwise make to the private equity fund. The problem is the investment funds are in turn pass-through entities. Consequently, how much should be withheld by the portfolio company? What if the investment funds have offsetting losses for the taxable gains of the portfolio company? These are real issues that would need to be addressed, and as a result would be costly to the entity withholding the taxes.

Recommendation to the Ways and Means Committee: We recommend removing the entity level withholding proposal from the small business tax return draft. We stand ready to work with the Ways and Means Committee and the IRS to review the current Schedule K-1 (Form 1065) to identify any adjustments to the form that will help to improve tax reporting by the partnership and the tax preparer.

In relation to the question on page 7 of the discussion draft fact sheet, "in light of the entity level withholding proposed in Option 2, should the IRS be permitted to audit and assess tax liability at the entity level", we do not believe the IRS should be permitted to audit at the partnership level. The IRS already has the ability to audit individual partners of a partnership. During the potential audit of a partner, the IRS can view partnership information such as that detailed on Schedule K-1 (Form 1065).

Mandatory adjustment of basis in partnership property whenever there is an in-kind distribution or a partner transfers its interest. The proposal to require adjustment of basis for transfers of partnership interests and in-kind distributions would be burdensome and add material operational costs to private equity funds, again with proportionately greater burden on small funds.

As a consequence of the number of investors, the type of investors and the terms, it is common in private equity funds for investors to transfer their interests within the partnership. Under the discussion draft proposal, a private equity fund would be required to make a basis adjustment at the time of each transfer. This requires the partnership to maintain additional books and records, resulting in added costs and time demands on management. Private equity funds generally do not make these adjustments (referred to as the 754 election) because of the burdens involved.

The proposal would make it mandatory for the private equity fund to value their whole portfolio at the time of each transfer. Normally, valuations only occur during the buying and selling of portfolio companies. While the value changes during the fund's ownership of a portfolio company, the private equity fund should not be required to value their portfolio company's or assets unless it is buying or selling certain assets. The buying and selling of an asset is a taxable moment for the private equity company because the gain or loss on the asset is needed to figure out the taxable income of the partnership.

Tracking the basis of the assets of a private equity fund is expensive and often requires the professional services of a third party valuation company or tax attorney. Because owners can transfer their interests at different points of a life cycle of a partnership, it would become very expensive if a private equity fund had to value their entire portfolio every time an owner transfers interest in the fund. The process of valuing a company requires the portfolio company to produce financial documents and revenue predictions, and these are usually private companies – not publically traded companies with active stock prices on the open stock exchanges.

It is also worth noting that transfers of interests are private transactions, with the transferee receiving the capital account of the transferor. As a private transfer, the fund should not be asked to make a basis adjustment and be required to maintain these separate tax and bookkeeping accounts. While the number of in-kind distributions made by private equity funds varies

depending on the fund and its partners, an adjustment in basis would be an added cost to the fund and could consequently discourage such distributions.

Some funds have more transfers than others. As 12-year plus partnerships, transfers arise by reason of death, change in investment policies, financial conditions of the holder (often adverse), changes in investment philosophy, changes in allocation of funds among competing types of investments, family transfers, transfers to affiliates, etc. During the life cycle of a fund, the transfers can add up and if the fund is required to adjust basis every time a transfer occurs, the costs will be prohibitive.

Recommendation: SBIA recommends keeping the 754 election for adjustment of basis optional. In order to track the transfers, in-kind contributions, and other transactions, partnerships should keep these records during the life of the fund. Should any transfers or new contributions occur, it is the responsibility of the partnership to keep these records and notify any other partners of these occurrences.

Partnership Allocation Rules. The small business discussion draft places a restriction on the ability to provide different distributive shares of pass-through items within a particular category to the same owner.

In some circumstances, investors in a private equity partnership may have different investment shares across the portfolio of investments or business divisions. This flexibility is one of the traditional benefits of a partnership. It is an economic arrangement that allows the partners of the partnership to make different levels of contributions to different portfolio companies and to take on different levels of risk within the portfolio companies.

Partnerships rely on the substantial economic effect test for guidance on allocation rules and the IRS relies on this test to prevent tax sheltering. The fundamental principal underlying the concept of economic effect in the regulations is as follows:

> "In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or economic burden."[1]

A partnership must pass one of three tests to meet the economic effect for allocation of income, loss or deduction for tax purposes. For example, the basic test for economic effect outlines three requirements: 1) capital account requirement; 2) liquidation requirement; and 3) deficit makeup

[1] Section 1.704-1(b)(2)(ii)(a).

requirement. If all three requirements are met, the IRS can be assured the partnership's allocations are consistent with the economic benefits and burdens corresponding to these items. Private equity partnerships also rely on the *shifting tax consequences*[2] guidance that determines, more subjectively, if an allocation has substantiality. As a result of the substantiality test and the economic effect test, the IRS has the ability to determine if there is a tax scheme that should be reeled in.

In some circumstances, it may be necessary for the partnership to allocate income, loss, or deductions for certain purposes. The proposal to limit partnership allocations could be a problem if a limited partner invests in a private equity fund, but is prevented by law from making investments in certain industries. In this case, the private equity may still want to make an investment in those prohibited areas, but would need to allocate the income to other partners that are tied to that investment. Private equity partners come and go at different times, and some partners may want a reduced or expanded interest in any of the portfolio companies during the life of the fund.

Recommendation: We recommend keeping the substantial economic test in place to allow private equity funds to make allocations in most circumstances. These rules have been historically recognized by both the industry and the IRS and in most cases they have economic merit. With that said, there may be areas that the law should be tightened, such as deferrals, in order to crack down on the areas where most tax schemes take place. The IRS should focus on areas where tax dodging is most rampant and continue to enforce the law to make sure tax schemes do not take place in other uncommon areas.

Require the partnership tax return to be filed on or before the 15th day of the third month following the close of the taxpayers fiscal year. The small business tax return discussion draft proposes a new tax return due date for partnerships. The provision moves back the original filing date of federal income tax returns of partnerships. The filing date would be on or before the 15th day of the third month following the close of the taxpayer's taxable year, or March 15 in the case of a calendar year taxpayer.

Generally private equity partnerships invest in corporations which would under the proposal be required to file their returns a month later. This lag in time between a partnership filing date and the portfolio company (filing as a C Corp) filing date could lead to errors because a private equity fund would not have in hand the portfolio company information necessary for it to file a complete and accurate return. Thus, it may be necessary to have to file for an extension or provide its investors corrected K-1s. Consequently, having a month separation in the filing dates of partnerships and corporations creates a hardship and additional costs.

[2] Section 1.704-1(b)(2)(iii)(b).

Recommendation: We recommend keeping the filing date the same for partnerships and their portfolio companies to prevent errors in tax administration and unnecessary costs in paying for tax filing extensions.

We appreciate your commitment to tax reform during the 113th Congress, and look forward to working with you to draft smart tax policy that prioritizes job creation and small business investment. Please contact us at any time to discuss this comment letter in more detail. Thank you again for allowing an open process to hear from the public on tax reform.

Please contact Chris Walters at cwalters@sbia.org or (202) 628-5055 if you have any questions about this document.

Sincerely,

Brett Palmer
President
Small Business Investor Alliance

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