



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



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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.

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.

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:

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-box³” 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 eliminate 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.

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.

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.

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.