



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

July 30, 2013

The Honorable Dave Camp, Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Sander M. Levin, Ranking Member
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

RE: AICPA Comments on Option 2 of Chairman Camp's [Small Business Tax Reform Discussion Draft](#)

Dear Chairman Camp and Ranking Member Levin:

As Congress considers tax reform this year, the American Institute of Certified Public Accountants (AICPA) offers the following comments on Chairman Camp's [small business tax reform discussion](#) draft, Proposed Tax Reform Act of 2013, Title II – Tax Reform for Businesses (March 12, 2013), Subtitle C – [Option 2] Unified Rules for Passthroughs (“Proposal”). These comments are in addition to the [letter](#) and [written statement](#) on Option 1 of the discussion draft that the AICPA submitted on May 17, 2013 for the record of the May 15, 2013 hearing of the Committee on Ways and Means Subcommittee on Select Revenue Measures on the Small Business and Passthrough Entity Tax Reform Discussion Draft. Both sets of comments were drafted in response to the House Ways and Means Committee's [request](#) for such comments.

General Comments

The AICPA commends Chairman Camp and the House Ways and Means Committee on your continued efforts to simplify the Internal Revenue Code (IRC or “Code”) and your responsiveness to taxpayers’ concerns that the Code as written is currently too complex. The AICPA appreciates the opportunity to provide comments as part of the tax reform process.

Option 2 eliminates the current Subchapter S (S corporation taxation) and Subchapter K (partnership taxation) regimes and replaces them with a proposed single, unified regime. The AICPA believes that the Option 2 one-size-fits-all approach for taxing passthrough entities is not in the best interest of the business and investment communities or the taxpaying public. Therefore, the AICPA does not support Option 2.

Complexity Issues

We understand that one of the objectives of proposing a single passthrough regime was to simplify the tax rules. However, in our opinion, the single regime that was developed in the Proposal does not provide the needed simplification. Option 2 removes an entity choice for tax reporting purposes. However, fewer choices does not always result in overall and continued

simplification for taxpayers. We believe that Option 2 creates rigid rules with the complexities of the current partnership regime without the flexibilities of that regime. Option 2 also prevents tax-free distributions of appreciated property from passthrough entities. In addition, we believe transitioning from the current Subchapter K and Subchapter S regimes into a single regime would result in significant complexity and corresponding costs.

We strongly believe that the Subchapter S and Subchapter K rules should not be eliminated from the Code. Taxpayers need the simplicity of operating as S Corporations and the flexibilities allowed by partnerships with the ability to make allocations depending on their various and differing circumstances. Taxpayers benefit by having the choice of subjecting themselves to Subchapter K or Subchapter S. The Code should continue to include both forms as viable options for the business and investment communities. If taxpayers desire a simpler taxing regime, they can choose to form a simple partnership with pro rata allocations, or they can opt to be taxed as an S corporation and forego basis and ownership flexibility. If taxpayers prefer more complex allocations so that various participants' (e.g., investor, manager, entrepreneur) economic goals are achieved, they may select the current partnership regime. We believe that reducing the number of passthrough regimes does not obtain simplicity for the taxpayer. The owners of the business entity may choose the degree of complexity by weighing the benefits of flexibility (via the Subchapter K regime) against the complexity that it creates. In addition, the owners, should they choose the Subchapter K option, have the choice of minimizing the complexity by "straight-up allocations" or choosing complex allocation formulae that consider the varying goals and objectives of the individual owners.

We understand that Option 2 removes the one-time complexity of choosing the passthrough regime under which the entity is taxed under the Code. However, that choice is not overly complex for most taxpayers and once that decision is made, it is generally not reevaluated each year.

Existing Subchapter K uses a hybrid approach in allocating income and deductions to the owners. In some respects, Subchapter K views the owners as an aggregation of persons who join together to do business or hold assets for investment. In other respects, Subchapter K uses an entity approach (e.g., requiring elections and accounting methods to be selected by the entity). We do not believe that it is in the best interest of owners of partnerships and limited liability companies (LLCs) to move further away from the "aggregate" approach of Subchapter K. If the owners choose to structure their entity such that it is subject to Subchapter K, they may receive the benefit from an election under section 754 to adjust the basis of assets upon the purchase of an interest. Currently, there are a few situations requiring taxpayers to apply the provisions of section 754. If not otherwise mandated, the owners, through their agreement, may choose to have a section 754 election in effect, or may decide that the benefits of tracking sections 734(b) or 743(b) adjustments are not worth the complexity that such an election requires. These are important owner choices, and we recommend against the Option 2 removal of alternatives available to taxpayers to choose the level of complexity to which they may be subject.

Consequently, we do not believe that parity between taxpayers is an overriding principle as different taxpayers have different needs and aspirations.

Subchapter S

With respect to Subchapter S, the Code has provided (and expanded) the passthrough regime for corporations for 55 years. Since the 1982 Subchapter S Revision Act, the S corporation option has provided corporate entities a simplified passthrough regime while maintaining corporate status. “Small” corporate taxpayers (and entities choosing corporate taxation through the “check-the-box” regulations) with the consent of their shareholders are allowed to choose whether their income is taxed at the corporate or shareholder level. The freedom to choose under which subchapter of the IRC to compute tax liability provides needed flexibility as business and owner needs change through the maturity of the business or changes occur in the ownership group or owners’ lives.

A shareholder’s basis in an S corporation does not include the shareholder’s share of the corporation’s liabilities, and Subchapter S does not provide for special allocations or section 704(c) adjustments. In addition, gain is required to be recognized on the distribution of appreciated property by an S corporation.

We believe the substantial differences discussed above between Subchapter K and Subchapter S warrant the continuation of Subchapter S in the Code.

Specific Comments

Since we do not support Option 2, we are not commenting on each of its proposals individually. However, we have provided a few comments on selected concepts within Option 2.

IRC Section 731

The ability of a partnership to distribute appreciated property without recognition of taxable gain (section 731) should continue in order to promote capital formation and allow flexibility to the aggregate of owners. Option 2, by prohibiting tax-free distributions, creates a “lock-in” effect, which causes an undue financial burden on the parties who desire to “back away” after joining together as partners. In addition, allowing tax-free distributions is consistent with the aggregate theory. We also believe that existing provisions of Subchapter K (e.g., sections 704(c)(1)(B), 707 and 737) prevent taxpayers from abusing the tax-free nature of section 731.

IRC Section 707

We encourage Congress to consider furthering the flexibility of Subchapter K by allowing partners to be treated as employees. Existing section 707 provides that a partner may act in a capacity other than as a partner (e.g., as a creditor, customer, or vendor). Current Internal Revenue Service (IRS) policy is to reject the notion that a partner may also act in an employee

capacity. Proposed section 762(a)(3) appears to allow owners to act as employees. Individuals who become partners may desire the opportunity to continue to be treated as employees (e.g., to remain subject to income and payroll tax withholding). Since the withholding of income tax aids in compliance with the IRC, partners should be encouraged, rather than prohibited, to treat themselves as employees if they desire.

Congress should also consider other provisions of the Code that will require modification upon a change in the treatment of partners as employees. For example, Congress may need to conform certain rules involving employee benefit plans in order to avoid a disqualification of the plan.

IRC Section 708

Existing section 708(b)(1)(B) (“technical termination” of a partnership upon sale or exchange of an interest) should be eliminated (as proposed by the Administration in its [Fiscal Year 2014 Revenue Proposals](#)). It is a trap for the unwary and causes complex adjustments to a partnership’s depreciable assets. A section 708(b)(1)(B) termination closes the partnership tax year, which often causes partnerships to unintentionally miss the filing deadline of the resulting short year partnership income tax return. Also, the closing of the partnership’s tax year can accelerate income to an earlier period if the partnership is on a calendar year basis but some partners are fiscal year taxpayers. We are unsure of the policy reasons for its continued existence, noting that a sale or exchange of an interest may trigger the application of the provision, but a redemption of a 50% or greater owner does not. Likewise, the death of the majority partner does not trigger the provision.

Section 33 of Option 2

We oppose income tax withholding on distributive shares (Option 2, section 33) as we believe that it is a burden on the entity to force a cash payment for owners’ income taxes that may not be due. The entity may not have cash available to remit the withholding liability. Individual owners have distinct tax attributes, with differing amounts of deductions and income from sources other than the partnership or S corporation, which substantially affect the applicable marginal tax rate. In addition, many passthrough entities enter into agreements with their owners that specifically address distributions to cover the owners’ tax liabilities on passthrough income. Commonly, these agreements will provide for offsets when the entity has income in one year and a loss in another year so that the entity is funding owner tax liabilities based on its cumulative taxable income over a period of years. If withholding is required, the entity has no ability to net income and losses recognized over multiple tax years; instead, in any year in which the entity has income, it must withhold. This requirement could result in an economic hardship to smaller entities, especially those entities whose businesses are cyclical.

The Proposal would require passthrough entities to withhold with respect to each owner’s distributive share of income. Then, the owners would claim their withholding as a credit against taxes on their respective returns. Foreign owners would not be subject to this withholding rule

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because withholding is already required for them. The Proposal includes no withholding exception for a domestic tax-exempt owner who is not subject to unrelated business income tax (UBIT) on the income in question.

The AICPA is concerned that such a provision will create additional administrative burdens for many tax-exempt organizations. For example, certain tax-exempt organizations would be forced to file [Form 990-T](#), Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e)), only to claim the taxes withheld at the passthrough entity level. At a minimum, we recommend an exception to this withholding proposal for all tax-exempt organizations. Such an exception would significantly reduce administrative burdens for passthrough entities, tax-exempt organization owners, and the IRS. Furthermore, we suggest an advance certification procedure. [Form W-9](#), Request for Taxpayer Identification Number and Certification, currently requires partners to certify their tax-exempt status to partnerships. An advance certification would reduce unnecessary burdens for the IRS to refund taxes withheld and passthrough entities to withhold taxes. We recommend a similar advance certification procedure for tax-exempt organization owners.

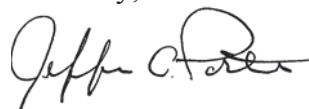
Mandatory withholding is not necessary to ensure tax collection, in that new IRS matching programs are able to determine mismatched income and deductions between the Schedule K-1 and the owners' tax returns. We encourage the IRS to work to improve the K-1 matching program to ensure that the proper tax liability is collected.

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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 draft discussion proposal or to answer any questions that you may have. I can be reached at (304) 522-2553 or jporter@portercpa.com; or you may contact Chris Hesse, Chair, AICPA Small Business Tax Reform Task Force, at (612) 397-3071, or Chris.Hesse@Cliftonlarsonallen.com; or Eileen Sherr, AICPA Senior Technical Manager, at (202) 434-9256, or esherr@aicpa.org.

Sincerely,



Jeffrey A. Porter, CPA
Chair, Tax Executive Committee

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cc: The Honorable Max Baucus, Chairman of the Senate Committee on Finance
The Honorable Orrin G. Hatch, Ranking Member of the Senate Committee on Finance
The Honorable Mark Mazur, Assistant Secretary for Tax Policy, Treasury Department
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation