



July 25, 2017

The Honorable Peter Roskam
Chairman
House Ways & Means Tax Policy Subcommittee
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Lloyd Doggett
Ranking Member
House Ways & Means Tax Policy Subcommittee
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

RE: July 13, 2017 Hearing on “How Tax Reform Will Help America’s Small Businesses Grow and Create New Jobs”

Dear Chairman Roskam and Ranking Member Doggett:

The American Institute of CPAs (AICPA) respectfully submits the enclosed statement for the record of the hearing on July 13, 2017 on the “How Tax Reform Will Help America’s Small Businesses Grow and Create New Jobs.” We appreciate the efforts of the Members of the Subcommittee for considering ways to reduce the burden and complexity of tax compliance faced by small businesses to ensure that tax rules support rather than discourage growth of businesses.

The AICPA is the world’s largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state, local 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.

If you have any questions, please feel free to contact me at (408) 924-3508, or annette.nellen@sjsu.edu; or Melissa Labant, AICPA Director of Tax Policy & Advocacy, at (202) 434-9234, or melissal.labant@aicpa-cima.com.

Sincerely,

A handwritten signature in black ink, appearing to read "Annette Nellen".

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee



WRITTEN STATEMENT

OF

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

SUBMITTED FOR THE RECORD OF THE

JULY 13, 2017

HEARING OF

THE UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON TAX POLICY

ON

**HOW TAX REFORM WILL HELP AMERICA'S SMALL BUSINESSES GROW
AND CREATE NEW JOBS**

INTRODUCTION

The American Institute of CPAs (AICPA) applauds the leadership taken by the Subcommittee to consider ways to reduce the burden and complexity of tax compliance faced by small businesses to ensure that tax rules support rather than discourage growth of businesses, particularly small businesses. Small businesses are the backbone of the United States (U.S.) economy, accounting for 54% of all U.S. sales and providing 55% of all jobs.¹

Unfortunately, federal tax laws hinder growth for both small businesses and the U.S. economy. The increased time and effort needed to comply with the ever-changing tax laws forces small businesses to devote extra time and dollars to tax compliance instead of growing their businesses. Time spent learning and complying with current tax laws often does not save time in future years as rules may change. According to a National Taxpayers Union Foundation study, the U.S. economy loses \$233.8 billion annually from dedicating 6.1 billion hours complying with tax laws.²

Nonetheless, we recognize that tax compliance is necessary. In the interest of good tax policy and effective tax administration to help small businesses grow, we offer suggestions where Congress and the Internal Revenue Service (IRS or "Service") can help reduce the compliance burden, increase transparency and provide certainty.

GOOD TAX POLICY

First, we should consider the features of an ideal tax system for small businesses. The AICPA urges the Committee to consider comprehensive tax reform that focuses on simplification and other [Principles of Good Tax Policy](#)³ as explained in a report we recently updated and issued.⁴ Our tax system must be administrable, support economic growth, have minimal compliance costs, and allow taxpayers to understand their tax obligations.

We believe these features are achievable if the following twelve principles of good tax policy are considered in the design of the system:

- Equity and Fairness
- Convenience of Payment
- Information Security
- Neutrality
- Certainty
- Effective Tax Administration
- Simplicity
- Economic Growth and Efficiency

¹ U.S. Small Business Administration, Small Business Trends, "[Small Business, Big Impact!](#)"

² National Taxpayers Union Foundation, [Study: \\$233.8 Billion, 6.1 Billion Hours Lost to Rising Tax Complexity](#), April 8, 2015. Also see IRS National Taxpayer Advocate Annual Report to Congress, [IR-2013-3](#) (1/9/13).

³ AICPA concept statement, "[Tax Policy Concept Statement 1, Guiding Principles for Good Tax Policy: A Framework for Evaluating Tax Proposals](#)," January 2017.

⁴ For an explanation of why and how the AICPA Principles of Good Tax Policy were updated, see "[Tax Principles for the Digital Age](#)," May 1, 2017.

- Transparency and Visibility
- Accountability to Taxpayers
- Minimum Tax Gap
- Appropriate Government Revenues

Our profession has long-advocated for a transparent tax system. For example, we urge Congress to use a consistent definition of taxable income without the use of phase-outs. Provisions, such as phase-out rules, that limit or eliminate the use of certain deductions and exclusions for those taxpayers in higher tax brackets, perpetuate the flaws of the current system, leading to nontransparent tax results and increased complexity. These rules also create marginal rates in excess of the statutory tax rate. In addition, multiple tax regimes (such as, the alternative minimum tax (AMT), which applies in addition to the regular income tax) make it almost impossible for taxpayers, including small business owners, to easily know their effective and marginal tax rates. Multiple tax regimes also make it difficult for owners to develop effective businesses plans. We urge Congress to use tax reform as an opportunity to remove phase-outs and multiple tax regimes, and develop the best definition of taxable income or adjusted gross income by creating simple, transparent, tax rules applied consistently across all rate brackets, eliminating additional complex and hidden taxes.

We also urge you to make tax provisions permanent. For all businesses, and small businesses in particular, uncertainty in the Internal Revenue Code (IRC or "Tax Code") creates unnecessary confusion and anxiety. Complexity can also result in taxpayers not taking full advantage of provisions intended to help them, resulting in higher taxes and greater compliance costs. While our Tax Code has always had a tendency to change, in recent years the rate of change has accelerated. Statutory changes result in new regulations, revenue procedures, notices and new or modified tax forms which take time and resources to understand and address. America's entrepreneurs need a Tax Code that is simple, transparent, and certain.

AICPA PROPOSALS

1. Cash Method of Accounting

The AICPA supports the expansion of the number of taxpayers who may use the cash method of accounting.⁵ The cash method of accounting is simpler in application than the accrual method, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the related income. Therefore, entrepreneurs often choose this method for small businesses.

We are concerned with, and oppose, any new limitations on the use of the cash method for service businesses, including those businesses whose income is taxed directly on their owners' individual returns, such as partnerships and S corporations. Requiring businesses to switch to

⁵ AICPA letter, "[Investment in New Ventures and Economic Success Today Act of 2017 \(S. 1144\)](#)," June 22, 2017.

the accrual method upon reaching a gross receipts threshold unnecessarily creates a barrier to growth.⁶

The AICPA believes that limiting the use of the cash method of accounting for service businesses would:

- Discourage natural small business growth;
- Impose an undue financial burden on their individual owners;
- Increase the likelihood of borrowing;
- Impose complexities and increase their compliance burden; and
- Treat similarly situated taxpayers differently (because income is taxed directly on their owners' individual returns).

Congress should not further restrict the use of the long-standing cash method of accounting for the millions of the U.S. businesses (e.g., sole proprietors, personal service corporations, and pass-through entities) currently utilizing this method.

2. Tax Rates for Pass-through Entities

If Congress, through tax reform, lowers the income tax rates for C corporations, all business entity types should receive a rate reduction. The majority of businesses are structured as pass-through entities (such as, partnerships, S corporations, or limited liability companies).⁷ Tax reform should not disadvantage these entities or require businesses to engage in complex entity changes to obtain favored tax status.

Congress should continue to encourage, or more accurately – not discourage, the formation of sole proprietorships and pass-through entities as these business structures provide the flexibility and control desired by many business owners that is not available within the more formal corporate structure. Entrepreneurs generally do not want to create entities that require extra legal obligations (such as holding annual meetings of a board of directors). They prefer business structures that are simple and provide legal and tax advantages.

3. Distinguishing Compensation Income

If Congress provides a reduced rate for active business income of sole proprietorships and pass-through entities, we recognize that it will place additional pressure on the distinction between the profits of the business and the compensation of owner-operators. We recommend determining compensation income by using traditional definitions of "reasonable

⁶ A required switch to the accrual method affects many small businesses in certain industries including accounting firms, law firms, medical and dental offices, engineering firms, and farming and ranching businesses.

⁷ See Census Bureau, [County Business Patterns](#); Census Bureau, [Nonemployer Statistics](#).

compensation" supplemented, if necessary, by additional guidance from the United States Department of the Treasury ("Treasury").

We encourage Congress to consider codifying the existing judicial guidance on the definition of reasonable compensation that reflects the type of business (for example, labor versus capital intensive), the time spent by owners in operating the business, owner expertise and experience, and the existence of income-generating assets in the business (such as other employees and owners, capital and intangibles).

We acknowledge that reasonable compensation has been the subject of controversy and litigation (hence, the numerous court decisions helping to define it). Therefore, Congress should direct the IRS to take additional steps to improve compliance and administration in this area. For example, a worksheet maintained with the taxpayer's tax records would allow businesses to indicate the factors considered in determining compensation in a reasonable and consistent manner.

These potential factors include:

- Approximate average hours per week worked by all owners;
- Approximate average hours worked per week by non-owner employees;
- The owner's years of experience;
- Guidance used to help determine reasonable compensation for the geographic area and years of experience (e.g., wage data guides provided by the U.S. Bureau of Labor Statistics); and
- Book value and estimated fair market value of assets that generate income for the business.

Changes to payroll tax rules, such as a requirement for partnerships and proprietorships to charge reasonable compensation for owners' services and to withhold and pay the related income and other taxes, will also facilitate compliance for small businesses. We suggest that partners and proprietors are not treated as "employees," but rather owners subject to withholding – a new category of taxpayer – similar to a partner with a guaranteed payment for services but on which income tax withholding is required. Similar rules requiring reasonable compensation currently exist in connection with S corporations and such owners are considered employees of the S corporation. The broader inclusion of partners and proprietors in more well-defined compensation rules should facilitate and enhance the development of appropriate regulations and enforcement in this area.

There are advantages to using a reasonable compensation approach for owners of all business types, including:

- Fairness that respects the differences among business types and owner participation levels;
- A reduced reliance by taxpayers and the IRS on quarterly estimated tax payments for timely matching of the earning process and tax collection;
- Diminished reliance on the self-employment tax system (since businesses would include payroll taxes withheld from owners and paid for owners along with their employees); and
- Simplification due to uniformity of collection of employment tax from business entities, and an ability to rely on a deep foundation of case law (in the S corporation and personal service corporation areas) to provide regulatory and judicial guidance.

In former Ways & Means Committee Chairman Dave Camp's 2014 discussion draft,⁸ a proposal was included to treat 70% of pass-through income of an owner-operator as employment income. While this proposal presents a simple method, it would result in an inequitable result in many situations. If Congress moves forward with a 70/30 rule, or other percentage split, we recommend making the proposal a safe harbor option. For example, the proposal must make clear that the existence and the amount of the safe harbor is not a maximum amount permitted but that the reasonable compensation standard utilized for corporations will remain available to sole proprietorships and pass-through entities. These rules will provide a uniform treatment among closely-held business entity types. Appropriate recordkeeping, when the safe harbor option is not used, would also address the enforcement challenges currently faced by the IRS.

4. Limitation on Interest Expense Deduction

Another important issue for small businesses is the ability to deduct their interest expense. New business owners incur interest on small business loans to fund operations prior to revenue generation, working capital needs, equipment acquisition and expansion, and even to build credit for larger future loans. These businesses rely on financing to survive. Equity financing for many start-up businesses is simply not available. A limitation in the deduction for interest expense (such as to the extent of interest income) would effectively eliminate the benefit of a valid business expense for many small businesses, as well as many professional service firms. If a limit on the interest expense deduction is paired with a proposal to allow for an immediate write-off of acquired depreciable property, it is important to recognize that this combination adversely affects service providers and small businesses while offering larger manufacturers, retailers, and other asset-intensive businesses a greater tax benefit.

Currently, small businesses can expense up to \$510,000 of acquisitions per year under section 179 and deduct all associated interest expense. One tax reform proposal⁹ under consideration

⁸ H.R. 1 (113th Congress), [The Tax Reform Act of 2014](#), Sec. 1502; also see [Section-by-Section Summary](#), pages 32-33.

⁹ House Republican's Tax Reform Task Force Blueprint, "[A Better Way: Our Vision for a Confident America](#)," June 24, 2016.

would eliminate the benefit of interest expense while allowing immediate expensing of the full cost of new equipment in the first year. However, since small businesses do not usually purchase large amounts of new assets, this proposal would generally not provide any new benefit for smaller businesses (relative to what is currently available via the section 179 expensing rule). Instead, it only takes away an important deduction for many small businesses who are forced to rely on debt financing to cover their operating and expansion costs.

5. Definition of "Compensation"

Tax reform discussions have considered whether the tax system should use the same definition for taxable compensation of employees as it does for the compensation that employers may deduct. Businesses may lose some of their current payroll-type deductions if employees are not required to report those same compensation amounts as income.

We are concerned, particularly from a small business perspective, about any decrease of an employer's ability to deduct compensation paid to employees, whether in the form of wages or fringe benefits (health and life insurance, disability benefits, deferred compensation, etc.). We are similarly concerned about expansion of the definition of taxable income for the employees, or removal of the exclusion for fringe benefits. Such changes in the Tax Code would substantially impact the small and labor-intensive businesses' ability to build and retain a competitive workforce.

6. Net Operating Losses

We recommend that Congress provide tax relief to small businesses in the calculation of benefits related to net operating losses (NOLs). An NOL is generally the amount by which a taxpayer's business deductions exceed its gross income. Corporations currently operating at a loss can benefit from carrying these NOLs back or forward to offset taxable income. According to the current rules, these losses are not deducted in the year generated, but are carried back two years and carried forward 20 years to offset taxable income in such years.

One of the purposes of the NOL carryback and carryover rules is to allow a taxpayer to better reflect its economic position over a longer period of time than generally is allowed under the restraint of the annual reporting period. Since 1987, our experience with the 90% AMT limitation on the use of NOLs shows that this limitation often imposes a tax on corporations, especially small businesses in their early growth years, when such businesses are still struggling economically. Therefore, a proposal¹⁰ for a 90% limitation on NOLs imposes an artificial restriction on a company's use of business losses and discriminate against companies with volatile income. The limitation could result in loss companies paying more tax than companies with an equal amount of steady income over the same period.

¹⁰ *Id.*

We also recommend that Congress simplify the calculation while retaining the carryback option for small businesses. For sole proprietors, the calculation of the NOL is overly complicated. Most startup businesses are formed as pass-through entities¹¹ and the initial startup losses incurred are "passed down" and reported on the owners' tax returns. Since individual taxpayers' report both business and nonbusiness income and deductions on their returns, the required calculations to separate allowed business losses from disallowed personal activities is complex.¹² Individual business owners would benefit from more specific guidance on NOL computations that is simple to understand and calculate.

7. Increase of Startup Expenditures

In the interest of economic growth, we encourage Congress to consider increasing the expensing amount for startup expenditures. Section 195 allows immediate expensing of up to \$5,000 of startup expenditures in the tax year in which the active trade or business begins. This amount is reduced dollar for dollar once total startup expenditures exceed \$50,000, with the excess amortized ratably over 15 years. Thus, once startup expenditures exceed \$55,000, all of the startup expenditures are amortized over 15 years. The rationale for the \$5,000 expensing was to "help encourage the formation of new businesses that do not require significant startup or organizational costs."¹³ These dollar amounts, which were added in 2004, are not adjusted for inflation. Only for tax years beginning in 2010, the expense limit of \$5,000 was increased to \$10,000 and the \$50,000 phase-out level was increased to \$60,000.¹⁴

The AICPA recommends increasing the \$5,000 expense limit and \$50,000 phase out amounts of section 195 and adjusting them annually for inflation. These changes will further simplify tax compliance for small businesses by reducing (or eliminating) the number of businesses that must track and report amortization of startup expenses over a 15-year period. In addition, as was suggested for the 2004 and 2010 legislative changes, the larger dollar amounts will better encourage entrepreneurship. Higher dollar amounts also reflect the costs for legal, accounting, investigatory, and travel that are frequently incurred when starting a new business. Also, in light of the increased, inflation-adjusted dollar amounts under section 179¹⁵ to help small businesses, it is appropriate to similarly increase the section 195 dollar amounts and adjust them annually for inflation.

¹¹ Center for American Progress, "[Ending the Pass-Through Tax Loophole for Big Business](#)," August 2016.

¹² IRS Publication [536](#).

¹³ P.L. 108-357 (10/22/04), American Jobs Creation Act, Sec. 902; Joint Committee on Taxation, General Explanation of Tax Legislation Enacted In the 108th Congress, [JCS-5-05](#), p. 504, May 31, 2005.

¹⁴ P.L. 111-240 (9/27/10), the Small Business Jobs Act of 2010, Sec. 2031(a); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress, [JCS-2-11](#), p. 474, March 2011.

¹⁵ P.L. 114-113 (12/18/15), Sec. 124(a).

8. Mobile Workforce

The AICPA [supports](#) the Mobile Workforce State Income Tax Simplification Act of 2017, [H.R. 1393](#), which provides a uniform national standard for non-resident state income tax withholding and a *de minimis* exemption from the multi-state assessment of state non-resident income tax.¹⁶

The current situation of having to withhold and file many state nonresident tax returns for just a few days of work in various states is too complicated for both small businesses and their employees. Businesses, including small businesses and family businesses that operate interstate, are subject to a multitude of burdensome, unnecessary and often bewildering non-resident state income tax withholding rules. These businesses struggle to understand and keep up with the variations from state to state. The issue of employer tracking and complying with all the different state and local tax laws is quite complicated, consumes a lot of time and is costly.

H.R. 1393 would provide long-overdue relief from the current web of inconsistent state income tax and withholding rules on nonresident employees. Therefore, we appreciate the House of Representatives passing H.R. 1393 that provides national uniform rules and a reasonable 30 day *de minimis* threshold before income tax withholding is required.

9. Retirement Plans

Small businesses are burdened by the overwhelming number of rules inherent in adopting and operating a qualified retirement plan. Currently, there are four employee contributory deferral plans: 401(k), 403(b), 457(b), and SIMPLE plans. Having four variations of the same plan type causes confusion for many plan participants and small businesses. A suggested approach is to eliminate SIMPLE IRAs and amend the rules of SEPs to allow for salary reduction contributions, as previously permitted. In addition, Congress could eliminate the SIMPLE 401(k) plan because while the fees are similar to that of a 401(k) plan, the 401(k) is favored since it is more flexible.

We also propose eliminating the top-heavy rules because they constrain the adoption of 401(k) plans and other qualified retirement plans by small employers. Since the top-heavy rules were enacted in 1982, there have been a number of statutory changes which have made the need for separate top-heavy rules unnecessary. The existing discrimination rules for retirement plans ensure that non-highly compensated employees receive nondiscriminatory benefits such that the top-heavy rules often do not increase benefits in a meaningful way. In addition, the annual contribution limitations ensure that no employee's benefits are excessive.

¹⁶ For additional details, see AICPA [written statement](#), "AICPA Statement for the Record of the April 13, 2016 Hearing on "Keep it Simple: Small Business Tax Simplification and Reform, Main Street Speaks," April 7, 2016.

10. Tax Administration

As we approach the 20th anniversary of the [Report of the National Commission on Restructuring the IRS](#) ("Restructuring Commission"), we recommend that any effort to modernize the IRS and its technology infrastructure should build on the foundation established by the Restructuring Commission. The current degradation of the IRS taxpayer services is unacceptable. The percentage of calls from taxpayers the IRS answered between 2004 and 2016 has dropped from 87% to 53%, however, the need for taxpayer assistance increased (the number of calls the IRS received increased from 71 million to 104 million).¹⁷

As tax professionals, we represent one of the IRS's most significant stakeholder groups.¹⁸ As such, we are both poised and committed to being part of the solution for improving IRS taxpayer services. We recently submitted a letter¹⁹ to House Ways and Means Committee and Senate Finance Committee members in collaboration with other professional organizations. Our recommendations include modernizing IRS business practices and technology, re-establishing the annual joint hearing review, and enabling the IRS to utilize the full range of available authorities to hire and compensate qualified and experienced professionals from the private sector to meet its mission. The legislative and executive branches should work together to determine the appropriate level of service and compliance they want the IRS accountable for and then dedicate appropriate resources for the Service to meet those goals.

Additionally, we recommend the IRS create a new dedicated practitioner services unit to rationalize, enhance, and centrally manage the many current, disparate practitioner-impacting programs, processes, and tools. Enhancing the relationship between the IRS and practitioners would benefit both the IRS and the millions of taxpayers, including small businesses, served by the practitioner community. As part of this new unit, the IRS should provide practitioners with an online tax professional account with access to all of their clients' information. The IRS should offer robust practitioner priority hotlines with higher-skilled employees that have the experience and training to address complex issues. Furthermore, the IRS should assign customer service representatives (a single point of contact) to geographic areas in order to address challenging issues that practitioners could not resolve through a priority hotline.

11. Emerging Issues

Online crowdfunding and the sharing economy are quickly expanding mediums through which individuals obtain funds, seek new sources of income, and start and grow businesses. Individuals may understand the steps through which they can use these new crowdfunding and

¹⁷ National Taxpayer Advocate, [Annual Report to Congress 2016, Executive Summary: Preface, Special Focus and Highlights](#), page 16, 2016.

¹⁸ 60% of all e-filed returns in 2016 were prepared by a tax professional, according to the [Filing Season Statistic for Week Ending Dec. 2, 2016](#).

¹⁹ AICPA letter, "[Ensuring a Modern-Functioning IRS for the 21st Century](#)," April 3, 2017.

sharing economy opportunities to their advantage. However, many small businesses do not have the guidance necessary to accurately comply with the complex, out-of-date, or incomplete tax rules in these emerging areas.

Lawmakers and tax administrators must regularly review existing laws, against new changes in the ways of living and doing business, to determine whether tax rules and administration procedures need modification and modernization. We urge Congress and the IRS to develop simplified tax rules and related guidance in the emerging sharing economy and crowdfunding areas.²⁰ Some of the areas in need of modernization include information reporting (such as to avoid reporting excluded income, such as a gift as income), simplicity in reporting and tracking rental losses from year to year, and simplified approaches for recordkeeping for small businesses. Offering clarity on these issues will allow taxpayers to follow a fair and transparent set of guidelines while the IRS benefits from a more efficient voluntary tax system.

CONCLUDING REMARKS

Tax compliance requirements have become an everyday burden for small businesses. The current complexity and uncertainty of the Tax Code forces small businesses to utilize critical resources and can hinder their ability to grow and create jobs. As Congress tackles the complex issues inherent in drafting tax legislation, we encourage you to consider tax reform that will provide simplicity, certainty and clarity for small business owners.

The AICPA has consistently supported tax reform simplification efforts because we are convinced such actions will reduce small businesses' compliance costs and fuel economic growth. The AICPA appreciates the opportunity to submit this written testimony and we look forward to working with the Subcommittee as you continue to address the needs of small businesses.

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²⁰ AICPA [written statement](#), "The 2017 Filing Season: IRS Operations and the Taxpayer Experience," April 6, 2017.