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WRITTEN TESTIMONY OF PATRICIA THOMPSON, CPA

ON BEHALF OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

HEARING ON

SMALL BUSINESSES AND TAX REFORM

MARCH 3, 2011

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Good morning Chairman Tiberi, Ranking Member Neal and Members of the subcommittee. My name is Patricia Thompson. I am a CPA and I am the Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants ("AICPA"). My testimony today is based on my experiences working with small business clients. I am the Tax Partner at Piccerelli, Gilstein & Company, LLP, a CPA firm in Providence, Rhode Island, and have been with the firm for over 32 years. I would like to thank this Subcommittee for the opportunity to appear at today's hearing on Small Businesses and Tax Reform.

Today's hearing focuses on the special burdens that the Internal Revenue Code (Code) imposes on small businesses and those small businesses operating as pass-through entities. I understand the challenges Congress faces as it tackles the complex issues inherent in drafting tax legislation and appreciate your diligence in trying to do the right thing for taxpayers. The Code imposes many compliance and filing burdens on small businesses and tax reform should encompass simplification proposals designed to alleviate the burdens placed on small businesses. Many small businesses are organized as entities other than corporations. Accordingly, tax reform cannot merely involve changes to corporate tax rates or other tax provisions targeting corporations if the desired impact is to help all small businesses overcome the burdens and complexities of tax compliance.

There are a number of areas in the tax Code that impose burdens on small businesses including those operating as pass-through entities. Simplification is needed in areas such as depreciation, Alternative Minimum Tax ("AMT"), partnerships, and retirement plans. Minimizing overall uncertainty throughout the Code and expanding provisions intended to help small business to include non-corporate entities should also be considered. Finally, while momentum is building to repeal section 9006 of the *Patient Protection and Affordable Care Act* ("PPACA"), any reform should include repeal of section 2101 of the *Small Business Jobs Act of 2010* ("SBJA") which imposes significant compliance burdens on rental property owners by requiring them to file Forms 1099-MISC for the first time.

Depreciation

Depreciation is an example of an area of the tax law where simplification is sorely needed. The depreciation methods required by the Code are different than those used for financial accounting. There are differences in depreciation rates depending on the depreciation method, and different rules may apply depending on when an asset is purchased. There are special rules for "bonus" depreciation, options to compute depreciation under special "straight line" rules and different rules for depreciation allowed under code section 179. Different types of property qualify for different types and levels of depreciation, and states often require different depreciation methods or have different section 179 and bonus depreciation limits. Finally, there is an entirely different depreciation method used for AMT. As a result, businesses often have to maintain several different "books" of depreciation (i.e., tax, book, state, and AMT depreciation) which are maintained and updated annually for each asset. I'd like to share three client examples to illustrate the complexity of these depreciation rules.

Client #1 purchased equipment totaling approximately $145,000. She expected to write-off the entire purchase price as depreciation under section 179. However, when the tax return was completed and all the tax adjustments made, the amount of her section 179 depreciation deduction was limited because of her taxable income. Some portion of the section 179 was disallowed but is available for carryover to the future years.

She could have recalculated the depreciation but that would have meant more time to redo her books and records as well as the tax return. These assets were purchased before September 8, 2010. If they had been purchased after that date, she would have been entitled to a 100% bonus depreciation deduction that would not have been limited to her taxable income. The analysis for Federal purposes is further complicated by the required state analyses.

Client #2 provides an illustration of how the rules affect a taxpayer who, prior to bonus depreciation, was not eligible for the additional depreciation under section 179. The taxpayer would have to calculate depreciation using two different methods. One is based on MACRS using accelerated methods and another is based on MACRS recovery lives using a less accelerated method for AMT purposes. When any of the assets are sold, two different gain or loss calculations have to be done to take into consideration based on the different tax depreciation methods.

It is easy for a small business owner to be subject to AMT with the result that any tax benefit of the accelerated depreciation is non-existent.

Client #3 places various types of manufacturing equipment in service throughout the year. Some is new and some is used. Before the taxpayer can calculate depreciation, an analysis of the equipment is needed. When was it purchased? Was it new or used? What was the total amount of equipment purchased? Depending on the timing of the purchase, the taxpayer may be eligible for 50% bonus depreciation or 100% bonus depreciation. If the equipment is used, bonus is not available. If the taxpayer purchased more than $2 million, the section 179 deduction is not available. The dollar limit changes from time to time depending on the tax incentives provided by tax legislation. In 2007, the limit was $500,000 with a maximum section 179 deduction of $125,000. In 2008 and 2009, it was $800,000 with a maximum section 179 deduction of $250,000.

Another consideration is the taxpayer's taxable income, because section 179 is limited to the taxpayer's taxable income. The taxpayer may not have the sophistication to know that they need to calculate their taxable income as part of a process of evaluating the different depreciation methods available.

Overall, taking the section 179 deduction and bonus depreciation currently helps cash flow for a small business taxpayer. But there is uncertainty about whether or not taking advantage of these tax incentives is most beneficial in the long term. For example, if manufacturing equipment is written off completely in the first year when the highest individual income tax rate is 35%, the taxpayer may pay more in taxes in future years when the equipment is sold if the highest maximum tax rate in the year of sale is then 39.6%. There would be a need for a time value of money analysis to determine which depreciation method to use.

Alternative Minimum Tax

Small businesses, including those operating through pass-through entities, have become increasingly at risk of being subject to AMT. The AMT was created to ensure that all taxpayers pay a minimum amount of tax on their economic income. The AMT is one of the tax law's most complex components.

In fact, the AMT is a separate and distinct tax regime from the "regular" income tax. Code sections 56 and 57 create AMT adjustments and preferences that require taxpayers to make a second, separate computation of their income, expenses, allowable deductions and credits under the AMT system. This separate calculation must be done on all components of income including business income for sole proprietors, partners in partnerships and shareholders in S corporations.

Small businesses must maintain annual supplementary schedules used to compute these necessary adjustments and preferences for many years to calculate the treatment of future AMT items and, occasionally, receive a credit for them in future years. Calculations governing AMT credit carryovers are complex and contain traps for unwary taxpayers.

Sole proprietors who are also owners in pass-through entities must combine the AMT information from all their activities in order to calculate AMT. Including adjustments and preferences from pass-through entities contributes to AMT complexity. The computations are extremely difficult for business taxpayers preparing their own returns and the complexity affects the IRS's ability to meaningfully track compliance with the AMT.

Although most sophisticated taxpayers are aware of the AMT and that they may be subject to its provisions, the majority of middle-class taxpayers has never heard of the AMT and are unaware that it may apply to them. Unfortunately, the number of taxpayers facing potential AMT liability is expanding exponentially due to: (1) "bracket creep;" (2) classifying as "tax preferences" the commonly used personal and dependency exemptions, standard deductions, and itemized deductions for taxes paid, some medical costs, and miscellaneous expenses; and (3) the inability to use many tax credits to offset AMT.

Due to the increasing AMT complexity, the AMT's impact on unintended taxpayers, and AMT compliance problems, the AICPA supports repealing the individual AMT altogether. However, we recognize that simply eliminating the AMT would generate a new set of problems given the large loss of tax revenue that would accompany such a move. Consequently, the AICPA urges Congress to consider alternative solutions that would reduce or eliminate most of the complexity and unfair impact of the AMT as currently imposed.

Uncertainty of Tax Law

Despite IRS efforts to educate the public regarding new legislative provision and stimulus activity, small employers are too busy keeping their businesses afloat in difficult economic times to stay apprised of changes in the income tax laws. Many small businesses must rely on their tax professionals to inform them of the changes. Unfortunately, many small businesses cannot afford to retain tax professionals throughout the year.

Many of the legislative provisions enacted in 2010 were designed to help small business taxpayers put more money into their business, employ more workers and to improve the economy. Most small business taxpayers, however, find it challenging to plan their cash flow and business needs especially when the federal income tax laws change frequently, are sometimes temporary or are passed late in the year.

During 2010 there was a spate of tax legislation designed to stimulate the economy. Small businesses can be overwhelmed by the barrage of late-year tax law changes and do not have the time or the ability to evaluate properly the impact of the changes on their businesses. During 2010, for example, a taxpayer, depending on when equipment was purchased, needed to choose the correct and most beneficial depreciation method from a menu of choices, which necessitated cumbersome alternative computations.

There was also legislation that was intended to spur the economy and benefit businesses and employees. This legislation, however, was time sensitive and only provided tax benefits for a short period of time. For example, there were incentives for employers that hired certain unemployed workers after February 3, 2010, and before December 31, 2010. If the taxpayer is not aware of such time sensitive legislation immediately upon enactment, the tax saving opportunity is permanently lost. Not having taxpayers avail themselves of such tax saving opportunities is contrary to the intent of the legislation and nullifies the good intentions of our lawmakers.

Actions regarding the use of temporary provisions have also created uncertainty. While some measures, such as those designed for economic stimulus, are appropriate for temporary and sporadic use, temporary tax provisions, including many incentive provisions, have become far too common. Many are routinely allowed to expire for a period of time, with subsequent debate and legislative action to extend them for some additional temporary period, thus causing disruption and costs to thousands of businesses, individuals, and the Internal Revenue Service ("IRS"). From a pure tax policy perspective, it is both inefficient and ineffective to utilize temporary provisions.

In reality, the temporary nature of some provisions has not led to rigorous review of the related incentives before their renewal. Further, the temporary nature of the incentives may have served to blunt their effectiveness in motivating taxpayer behavior. This is particularly true for small business owners.

These ever-changing, oft expiring, short-term changes to the tax laws make it increasingly difficult for a small business owner to do any long-term planning, including strategic planning for growth, new business development and hiring. These planning challenges are further compounded when regulatory or administrative guidance is not timely or tax laws are changed after the year has already begun but are slated to take effect that same tax year. It can be difficult to change course, alter buying plans, secure new or different funding or change their hiring policies in response to a new, short-term, expiring tax provision. When tax laws, new regulations or Treasury guidance are issued late in the year or at the last minute, business owners do their best to comply with no ability to plan for such last-minute provisions, no matter how well-intentioned.

Partnership Taxation

Partnership tax rules are among the most complex in the Internal Revenue Code. Many small businesses are organized as partnerships. Individual partners cannot determine their personal tax liability until the partnership has computed and allocated the income, expenses, deductions and credits for the partnership. There are several issues that must be addressed at the partnership level and individual partner level, including determining basis (both inside basis and outside basis), application of the at-risk rules, and properly allocating liabilities and losses. Items, such as the maximum section 179 depreciation expense, are determined at the partnership level before passing through to the individual partner. Other items, such as charitable contributions, pass through to the individual partner before rules limiting the deduction apply.

The tax implications for various transactions for partners in a partnership are often very different from shareholders in C corporations or S corporations, or even sole proprietorships. The result is that there is an inequality in treatment between the different entity types. For example, a partner does not receive a W-2 for the services he or she may provide to a partnership but they would have received a W-2 if the entity was either an S or C corporation. Small business owners may have formed new business entities as a partnership rather than an S corporation and become confused when the tax practitioner informs them that they will not be receiving a W-2. Many small business owners would prefer to receive a W-2 so that the partnership can withhold the appropriate taxes and reduce or eliminate the need to make estimated tax payments.

Numerous Retirement Plans

When a small business grows and begins to explore options for establishing a retirement plan, the rules are immediately overwhelming. There are almost too many options for retirement plans that businesses need to consider before deciding which is appropriate for them. These options include a SEP, SIMPLE, 401(k), profit sharing plan, defined benefit plan, SIMPLE 401(k), among others. Some plans are only available to employers with a certain number of employees while other plans require mandatory contributions and higher administrative burdens. Some of the administrative burdens would include annual return filing, discrimination testing, etc. To determine which plan is right for the business, owners must consider their cash flows, projected profitability, anticipated growth of the work force, and expectations by their employees and co-owners.

The diversity of plans came about because of Congress' intent to create plans for small business owners that were easier to manage, allowed for more flexibility in funding, and creates choices for different size entities. Over the years, however, the plans have been modified, adjusted, expanded and limited. We are now at a point where the choices can be overwhelming and many are too complex or costly for the small business owner to be able to benefit.

Small Business Provisions that Exclude Non-Corporate Entities

A provision in the Code that was intended to help small business will likely not have the desired impact. The SBJA expanded an existing provision to allow gain on the sale of small business stock purchased after September 27, 2010, and before January 1, 2012, to be excluded from income if certain conditions are met. Prior to the expansion of this provision, the gain exclusion was based on when the stock was purchased. If the stock was purchased before February 18, 2009, the gain exclusion is 50%. Stock purchased after February 17, 2009 and before September 27, 2010 is eligible for a 75% exclusion. After December 31, 2011, the exclusion reduces to 50%. The stock must be held more than 5 years, be C corporation stock whose value at all times after August 10, 1993, and before issuance and immediately after issuance does not exceed $50 million. The corporation must conduct a qualified trade or business. Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset is the reputation or skill of one or more of its employees, farming, hotels, motels, restaurants, or certain other specified industries are excluded from eligibility.

The problem is that the majority of small businesses are not conducted as C corporations. They are operated as pass-through entities. In addition, many buyers prefer to purchase the assets of a company rather than the stock. If the assets of the company are sold, any portion of the gain relating to capital assets would be taxed at ordinary income tax rates which would be a maximum of 35%. The corporation would be liquidated and no additional tax would be due if the conditions relating to this provision were met. If those same assets were sold by a pass-through entity, the gain relating to capital assets would be taxed to the individual using capital gain tax rates, currently 15%. The result of the sale of the assets would increase the tax liability by 20% by taking advantage of the gain exclusion provision.

Different Definitions Used Throughout the Code

Many provisions in the Code and certain IRS guidance use similar terms but not similar definitions. These different definitions create more complexity to understand and apply tax law to small business. A recent example is a provision in the Health Care bill passed in 2010 allowing a health insurance tax credit for "small businesses". Many small businesses are offering health insurance and believed this credit would be available to them. However, "small business" is defined in various ways throughout the Code. A "small business" may be defined based on average annual gross receipts or it may be on the number of employees. Using average annual gross receipts still does not result in consistency. Sometimes gross receipts are defined for "small business" purposes as "$5 million or less," while other times it may be "$10 million or less." Using the number of employees to define a small business also varies. In some cases it is fewer than 20, other times fewer than 100, and yet other times it can range from 50 to 500. The definition used by the

Health Care bill was 25 full-time equivalents. Based on this definition, the benefit may not be available to as many small businesses as expected or intended. Small business owners would appreciate having one definition of a small business and have it apply to all provisions of the Code.

Concerns Regarding Form 1099 Reporting Requirements

A current example of the need for simplification of our tax law relates to recent changes that significantly increase the administrative burden on many small businesses and individual taxpayers – the revisions to the Form 1099 requirements made by section 9006 of the PPACA and the new Form 1099 reporting requirements placed on rental property owners by section 2101 of the SBJA.

Code section 6041 currently requires "persons engaged in a trade or business" to satisfy reporting requirements upon the purchase of $600 or more in services in a year from another entity. PPACA made two significant changes to the law that will take effect in 2012. First, the act overturns a longstanding tax regulation providing that corporations were generally exempt recipients for Code section 6041 reporting purposes. Second, the provision expands information reporting requirements to business payments for property (which is in addition to business payments for services, as required by current law). Thus, beginning in 2012, if a business generally purchases $600 or more in property or services from another entity (including a corporation), it must provide the vendor and the Internal Revenue Service with a Form 1099-MISC, Miscellaneous Income. The AICPA strongly supports repeal of section 9006 of the PPACA to avoid what will otherwise be an overwhelming compliance burden on the nation's small businesses beginning in 2012.

The SBJA further expands the information reporting requirements to include, with only limited exceptions, payments for rental property expenses paid by all persons receiving rental income, whether or not they were previously considered engaged in a trade or business. Similar to other "persons engaged in a trade or business," the reporting requirements are triggered upon the purchase of $600 or more in services from another entity. The information reporting requirements applicable to rental property expense payments are effective beginning January 1, 2011, but will be expanded in 2012 to include payments for property and payments to corporations as described above with regard to the PPACA changes.

The AICPA urges repeal of the expanded information reporting requirements on individuals receiving rental income. This requirement would be the first time that individual taxpayers owning rental property who are not "engaged in a trade or business," would be required to provide Forms 1099-MISC. For example, many individuals, who own a vacation property that is rented part of the year, or who rent a room in their home, to help defray costs, would be subject to the provisions of the SBJA. In order to comply with these onerous requirements, taxpayers will incur a significant increase in costs and/or time with respect to the accumulation of relevant information and the preparation and mailing of Forms 1099-MISC.

The administrative burden reaches far beyond the completion of an additional tax return. Many CPAs and advisors are recommending that individuals begin taking action as soon as possible if they think the new reporting requirements might apply to them.

First, these individuals should obtain their own Employer Identification Number (EIN) to report on a Form 1099-MISC. Although an EIN is not required by the IRS, we strongly recommend obtaining one to reduce identity theft risk associated with using a Social Security Number. Individuals must complete Form SS-4, Application for Employer Identification Number, to obtain an EIN or apply online at IRS.gov. An individual who already has an EIN will need to contact the IRS or research whether to apply for a separate EIN for the rental activity.

Next, these individuals should begin collecting information from their regular vendors if they anticipate making payments of at least $600 to them during the year. Each vendor should complete a Form W-9, Request for Taxpayer Identification Number and Certification, to provide its name, address, EIN or Social Security Number and type of business (sole proprietor, partnership, corporation, etc.). The vendors must also certify that information provided is accurate, they are not subject to backup withholding and they are United States citizens (or other eligible persons). Since the "vendor" is the business to whom individuals issue payment, not necessarily the individual rendering the service, we anticipate that additional time and effort may be required to gather the vendor's information. For individuals who own rental property out of state, it may be even more difficult to obtain this information.
It is important to note that the administrative burden does not merely occur during "tax time." We are recommending that individuals who receive rental income keep detailed accounting records throughout the year. In order to track which vendors are paid $600 or more in a year, individuals will need to keep more detailed records than in prior years. For example, individuals should record how much of a payment to a vendor is related to services as opposed to the purchase of goods. In addition, individuals should only note the amount paid to a service provider in connection with the rental activity.

By January of next year, not a time when most individuals have received their own tax information or began thinking about their personal income tax returns, individuals receiving rental income will need to complete Forms 1099-MISC. A separate Form 1099-MISC will be required for each vendor to whom the individual engaged in rental activity paid at least $600 during the year. Generally, an individual will need to provide "Copy B" of the Form 1099-MISC to the service provider by January 31, 2012 and file "Copy A" with the IRS by February 29, 2012. Unlike most tax forms which taxpayers can download from the IRS website and use, Form 1099-MISC must be obtained in hard copy from the IRS (or office supply store) to file as it is a special type of scannable form.

Finally, if an individual uses a vendor who is subject to backup withholding or obtains a wrong or incomplete EIN from the vendor, the individual's administrative burden significantly increases. There is an additional tax return that must be completed, a requirement to withhold a certain percentage from each payment to the vendor, various notices which individuals are required to send to the vendor, and a requirement to submit backup withholding amounts to the IRS. Beginning January 1, 2011, individuals are generally required to deposit these funds electronically using the Electronic Federal Tax Payment System ("EFTPS"). Individuals will need to spend additional time, at least the initial year, to enroll in EFTPS and learn how to use the system.

Although the AICPA generally supports information reporting, we think the extraordinary burden this approach imposes far outweighs any potential benefit. Accordingly, the AICPA urges Congress to take action to repeal section 2101 of the SBJA in addition to the more widely known expansion of the Form 1099 reporting requirements under section 9006 of the PPACA.

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The AICPA is the national professional organization of certified public accountants comprised of approximately 370,000 members. 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, tax-exempt organizations, small and medium-sized businesses, as well as America's largest businesses.

Thank you, again, for the opportunity to testify. In addition to this testimony, I encourage you review our recent publications on alternatives for tax reform and our report on penalty reform, both of which are available online, as follows:

> *Tax Reform Alternatives for the 21st Century*, is available at:
> http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/TaxReformStudies/DownloadableDocuments/Tax%20Reform%20Alternatives%202009.pdf
>
> *Report on Civil Tax Penalties: The Need for Reform*, is available at:
> http://www.aicpa.org/InterestAreas/Tax/Resources/IRSPracticeProcedure/Advocacy/DownloadableDocuments/AICPA_report_civiltax_penalty_reform1.pdf

I hope you will find this testimony and additional publications useful in your continued work on tax reform for small businesses. We welcome the opportunity to discuss this information with you informally or in any future public hearing.