AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

ORAL TESTIMONY (FOR THE RECORD) BEFORE

THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS

HEARING ENTITLED

MODERNIZING THE TAX CODE: HOW UPDATING THE INTERNAL REVENUE CODE CAN BETTER SERVE SMALL BUSINESS

LONGWORTH HOUSE OFFICE BUILDING ROOM 1539

APRIL 10, 2008

Chairwoman Velazquez, Ranking Member Chabot and other distinguished members of this Committee, my name is Jeff Hoops and I am the Chair of the AICPA Tax Executive Committee. We appreciate this opportunity to present testimony on modernizing the tax code in ways that will assist small businesses to better compete in an increasingly global marketplace. We request that our previously submitted testimony be included in the official record of this hearing.

It is clear that what were the mom and pop shops of yesterday are no longer competing with just the competitors around the corner, but face an internet age with universal and instant access to products and information by consumers. This is true of today's start-ups in just about any industry. Accordingly, to compete, business owners must be able to focus on the quality of their products, on marketing and on financing, more than ever before. Compliance with multiple administrative burdens has always been difficult for small businesses. The Internal Revenue Code should not "tax" this incredibly important part of our economy any more than absolutely necessary.

In its written testimony, the AICPA has made suggestions affecting S corporations, partnerships, estates, the AMT, and other areas of the tax code. In today's testimony, we are highlighting only a few of those issues.

With regard to S corporations, I'd like to highlight some important areas that need to be changed.

Often the most significant hurdle faced by a corporation desiring to make an S election, the LIFO recapture tax can make the S election cost-prohibitive; it violates the principle of entity equality; and it is more-than-sufficiently addressed through the built-in-gains tax. We believe a repeal of section 1363(d) of the Internal Revenue Code would allow more small businesses, such as car dealerships, jewelry stores and others to participate in the most popular business structure in this country – the S corporation.

Addressing now a second corporate-level tax currently paid by S corporations, the excess passive investment income tax (known informally as the sting tax) is paid by many S corporations whose gross receipts consist of more than 25 percent in royalty, rent, interest, dividend and/or annuity income. The corporation pays the tax at a rate of 35 percent, the highest corporate rate currently imposed on the largest of corporations, regardless of its overall level of total income and regardless of whether the character of such income would otherwise be taxed at a lower rate. These double-tax payments continue for as long as the S corporation has accumulated earnings and profits carrying over from a year in which it operated as a C corporation but if it happens in three consecutive years, the corporation can no longer operate as an S corporation – the S election is automatically terminated.

We ask that this Committee assist small business S corporations in their transition years from C corporation status by relieving some of the unnecessary burden associated with the excessive passive investment income rules. Our written testimony highlights ways that relief could be accomplished.

A third area causing concern in the S corporation world warrants brief mention here. Nonresident alien individuals may participate indirectly in the operations of S corporations, but only if the taxpayer has access to sophisticated and affordable tax planning advice. This is because current law allows S corporations to own partnerships and partnerships to be owned by nonresident aliens. This is a restructuring long sanctioned by the IRS. The smaller, less sophisticated S corporations do not effect this restructuring and thus lose out on an important source of capital available to its more established S corporation counterparts. We suggest that the playing field be leveled for S corporations across the spectrum, thereby helping those with the least amount of resources.

I'd like to now address a couple of items with respect to small partnerships. As you know, small business owners have the option to operate in many different forms, including C or S corporations, partnerships, sole proprietors, and others. Generally, Subchapter K of the Internal Revenue Code (which governs the taxation of partnerships and partners) can be extremely complex, yet there are a limited number of de minimis rules or other ways for small businesses that are required to report under the partnership rules to simplify their lives by electing out of Subchapter K.

One recent enactment created what is called the Qualified Joint Venture and was based on a noble Congressional desire to simplify the tax life of husbands and wives operating businesses together and to make certain that both spouses received credit for the purposes

of Social Security and Medicare. This election allows the two participating spouses to forget about the complexities of Subchapter K, with all its contribution, allocation, and distribution rules, and file as two separate sole proprietors on Schedules C of Form 1040.

If a recent IRS interpretation of this new statute is allowed to stand, it is unclear which husband/wife partnerships, if any, will qualify for this simplified treatment. Accordingly, the AICPA supports a technical correction to the new husband/wife partnership rules under section 761(f) clarifying that Qualified Joint Ventures include, or at least do not bar, entities defined under state law.

Another impediment for small, often construction, partnerships is a statute that hasn't changed since the 1950s while the business world around us has drastically changed. Section 118 of the Internal Revenue Code currently permits an exclusion from gross income (with appropriate and corresponding adjustments to basis) for contributions to the capital of a corporation. This exclusion allows corporations to work effectively with local governments which want certain development projects to take place within their jurisdictions. The municipalities often provide a monetary incentive for a business to relocate, to build, or to provide their services to local residents. If the business has to pay tax on this monetary incentive simply because they are a partnership, then that partnership will either not bid on the project or will be unable to sustain the project's costs. Since partnerships are utilized in today's business world much like corporations were in 1954 when this rule was codified, there is no theoretical reason why section 118 should not be expanded to apply to partnerships. We therefore support an amendment to

section 118, allowing for the tax-free contribution of capital to all businesses regardless of entity type.

Transitioning now away from specific pass-through entity issues, the last two items I would like to mention today affect almost all of us.

The first represents an acknowledgement of changes in the mobile phone and personal digital assistant (PDA) markets and how those changes should impact record keeping requirements for tax purposes. Current law treats these everyday devices used by almost 80 percent of small business owners and which are usually priced, in modern times, similar to land-line phones, as so-called "listed property" requiring businesses to keep a detailed log of business and personal usage and to then apportion the business use percentage for deductibility purposes. H.R. 5450, *the MOBILE Cell Phone Act of 2008* and its companion bill in the Senate would reclassify cell phones and PDAs from listed property to that of business property. Such a reclassification would update the tax treatment of cell phones and PDAs by eliminating the onerous substantiation requirements on small business owners. The AICPA supports H.R. 5450.

The last but not least of my issues for you today relates to the disparity between standards that taxpayers have to meet and standards that tax practitioners have to meet when taking positions on tax returns. A recently enacted law requires tax practitioners to have a much higher level of certainty with respect to tax return positions they take on client returns than the level of certainty that applies to those who prepare their own returns. The new reporting standard applicable to practitioners does not take into account the many, many

gray areas of the tax law for which educated judgments must often be made. Because of the different reporting standards, it would not be uncommon for a practitioner to be subject to a penalty with respect to a position on a client's return, unless it is formally disclosed, even though the client could take the same position without disclosure without being subject to a penalty. H.R. 4318 remedies this situation by equalizing the tax return reporting standards for both taxpayers and tax practitioners, thus eliminating potential conflicts of interest between these two parties. The AICPA supports this important bill.

I am happy to take any questions regarding the matters discussed today or those discussed in our written testimony.

THANK YOU VERY MUCH.