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TREATMENT OF CLOSELY-HELD BUSINESSES IN THE CONTEXT OF TAX REFORM

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

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HEARING ON THE TREATMENT OF CLOSELY-HELD BUSINESSES IN THE CONTEXT OF TAX REFORM

WEDNESDAY, MARCH 7, 2012

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
WASHINGTON, DC.

The committee met, pursuant to notice, at 10:04 a.m., in Room 1100, Longworth House Office Building, the Honorable Dave Camp [chairman of the committee] presiding.

[The advisory of the hearing follows:]

HEARING ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

Chairman Camp Announces Hearing on the Treatment of Closely-Held Businesses in the Context of Tax Reform

Congressman Dave Camp (R–MI), Chairman of the Committee on Ways and Means, today announced that the Committee will hold the second of two hearings on how accounting rules cause different types of businesses—specifically, publicly-traded and closely-held businesses—to evaluate tax policy choices differently. Whereas the *previous hearing* focused on financial accounting rules and publicly-traded companies, this hearing will focus on the special challenges faced by small and closely-held businesses that are less concerned with financial accounting rules but must confront tremendous complexity in dealing with tax accounting and various choice of entity regimes. **The hearing will take place on Wednesday, March 7, 2012, in Room 1100 of the Longworth House Office Building, beginning at 10:00 A.M.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND:

Unlike publicly-traded companies, closely-held companies often rely less on Generally Accepted Accounting Principles ("GAAP") to report information to owners and creditors, although there are exceptions. (For example, a non-public entity with outside investors or a closely-held entity that issues debt instruments might be required to provide GAAP-compliant statements.) Instead, closely-held entities tend to focus almost exclusively on how tax policy changes affect cash flows. Closely-held companies, however, face their own set of challenges with regard to tax complexity and uncertainty. These challenges range from compliance with complicated rules on inventory accounting and cost recovery to numerous sets of tax rules governing different business forms.

The three major business forms from which closely-held companies must choose for federal tax purposes are C corporations, S corporations, and partnerships, although a number of other types of business entities exist to serve specific purposes. While C corporations are subject to entity-level tax and shareholders are again subject to tax on dividends and capital gains, S corporations and partnerships are "pass-through" entities that do not pay entity-level tax—rather, partners and shareholders pay tax on their share of the entity's income on their individual tax returns (and therefore under the individual rate schedule). Companies must choose to operate under one of these regimes, and this choice can have significant tax consequences. Many commentators recommend modifications to the choice of entity rules to reduce the potential distortions introduced by such rules—with ideas ranging from consolidating existing pass-through rules into a "unified pass-through regime," making it easier for closely-held C corporations to convert to pass-through status, or even subjecting some existing pass-through entities to double taxation as C corporations. On the other hand, tax reform proposals that create too large a spread between the top corporate rate and the top individual rate risk exacerbating these distortions rather than reducing them.

In announcing this hearing, Chairman Camp said, **"Closely-held businesses—including millions of small and family-owned businesses—form the backbone of our economy, but our current Tax Code imposes a variety of burdens on them that public companies do not face. Tax compliance costs are**

especially high for small and closely-held businesses, and complex rules often prevent them from maximizing their ability to invest and create jobs. Higher marginal rates on individuals, as have been proposed by others, would stunt their growth even more. As part of comprehensive tax reform, the Committee must determine how best to reduce tax compliance costs and tax rates on closely-held businesses so that they can devote their resources to innovation and job creation, rather than to tax compliance and tax planning."

FOCUS OF THE HEARING:

The hearing will examine how the Tax Code affects closely-held businesses in particular, and how tax reform might improve their ability to grow and create jobs. To this end, the hearing will consider how and under which sets of rules closely-held entities should be taxed, as well as general burdens imposed on closely-held businesses such as high compliance costs and tax rates.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Wednesday, March 21, 2012**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–3625 or (202) 225–2610.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://www.waysandmeans.house.gov/*.

Chairman CAMP. Good morning. Before we begin, I just wanted to say that I was saddened to learn that a former staff member of the Joint Committee on Taxation, Cyndi LaFuente, passed away earlier this week. I know she was a valued colleague and friend to many people in this room, and I want to express my deepest condolences to her family and her friends for their loss, and just to say Cyndi will be missed.

Today we are continuing our series of hearings on comprehensive tax reform and how a flatter, simpler, and fairer Tax Code can lead to economic growth and job creation. Our last hearing focused on publicly traded companies' use of generally accepted accounting principles, GAAP, when compiling their SEC-required filings. For these companies, both earnings results and cash flow are important to investment decisions and performance measurement.

During today's hearing, we will shift gears to examine the other side of the coin, closely-held businesses. The complexion of these businesses varies greatly. They range from mid-size manufacturers to local law firms to the Main Street restaurants that sponsor local Little League teams. In this hearing, we will examine the rules that dictate how these entities should be organized for purposes of taxation, as well as general burdens imposed on closely-held businesses such as high compliance costs and tax rates.

The difference between individual and corporate tax rates has an important effect on a business and how it is organized. For example, if individual income tax rates are substantially higher than corporate income tax rates, there is a clear incentive for taxpayers to organize business activity in corporate form. In addition, businesses that are subject to the higher individual rates may face a competitive disadvantage.

There is little doubt that economic distortions can be created by a Tax Code that tilts too much in any one direction, and naturally one of the most effective ways to prevent that distortion is to create a neutral Tax Code in which the individual tax rates are similar to corporate tax rates.

This is an approach that the Republicans have taken by calling for a top rate of 25 percent for both individuals and corporations. It also mirrors one of the most important achievements of the 1986 Tax Reform Act, cementing the principal of closely aligning individual and corporate rates to eliminate abuse and economic distortions related to business structures.

According to the Joint Committee on Taxation, in 2007 pass-through entities earned 56 percent of total net business income, which is taxed under the individual tax rate structure. Census data reveals that in 2008, pass-through entities employed more than 54 percent of the private sector workforce. Both statistics point to the strong role pass-through entities play in our economy, and recent proposals have raised concerns from many in the pass-through community.

For instance, under the President's budget and other corporate reform proposals, the top statutory rate on individuals would rise to roughly 40 percent. At the same time, however, President Obama proposes to lower the corporate rate to 28 percent. Corporate taxpayers would enjoy a tax rate that is 12 percent points

lower than the top rate faced by pass-through businesses, and this will create more harm than good.

As we continue to consider ways to transform the code from one that inhibits to one that spurs job growth, we must take steps to ensure that corporate reform is not financed on the backs of those who we have historically depended on the most to move us out of recessions, and that is small business.

Adding to the challenges posed by a disparate rate is the ever-increasing tax complexity facing closely-held businesses. Unlike large, publicly-held companies that have armies of accountants and lawyers, the complexity of the Tax Code disproportionately hits small businesses, which tend to be closely-held businesses.

The Small Business Administration found that small businesses face a tax compliance burden at $74.24 per hour. That is 67 percent higher than that faced by large businesses. This burden results from reporting requirements, such as 1099s, as well as complex accounting rules for inventories, depreciation, and other business activity.

In addition to the many tax rules a business must contend with, it is the first tax-related decision that businesses make, the manner in which they should organize themselves. That will affect all other tax decisions from that day forward.

Whether a business organizes as a C corporation, an S corporation, a partnership, or some other form of business entity, that decision should not be driven by tax considerations. Instead, it ought to be driven by what form of organization best suits that business and its needs.

As we move forward on reform, this committee should ask when it is appropriate to tax business income on a pass-through basis and when, if ever, it is appropriate to subject business income to entity-level taxation. And given the importance of pass-through entities to the U.S. economies and the prevalence of closely-held businesses, the treatment of job creators is critical to tax reform.

Our goal with comprehensive tax reform remains clear, to create an environment that is ripe for economic growth and job creation. And I look forward to hearing from our witnesses about how we can best achieve that goal.

And I now yield to Ranking Member Levin for his opening statement.

Mr. LEVIN. Thank you very much, and welcome to all of you. And I know the chairman always wants you to have your testimony in in advance, and you all did that, and that was really helpful, though in one case your testimony was 12 pages and I am curious how you are going to do that in five minutes.

[Laughter.]

Mr. LEVIN. But it let us read rather late into the evening. Again, welcome, all of you knowledgeable people.

Today's hearing on closely-held businesses covers a vitally important topic. One of the measures of tax reform should be how well it promotes economic growth and job creation. So-called pass-through businesses represented over a third of business receipts in 2008 and just under half of business income. They are a major part of our economy and a major source of growth and jobs.

Because pass-through entities do not pay corporate income tax at the entity level, and because they range in size from very small businesses to very large ones, they face a different set of issues with respect to tax reform than do C corporations. To understand how pass-through businesses will be affected by reform, we have to understand—and that is one of the purposes of the hearing today—who exactly they are.

It used to be that pass-throughs were a reasonable proxy for small businesses. But with the growth both in number and size of S corporations and especially LLCs, this identity is breaking down. This is vitally important, among other issues, as we debate the question of whether to continue the upper income Bush tax cuts.

Some have sought to continue to draw a straight line between pass-throughs and small business to justify continuing the tax cut for the highest earners. But pass-throughs are often quite large. For instance, in 2008, 64 percent of partnership income was earned by partnerships with more than $100 million in assets.

Small business income is also a small fraction of the income that would be affected by an expiration of upper income tax cuts. Only a small fraction, 8 percent, is associated with small business employers.

This has implications for how this committee approaches the universal, or nearly universal, desire to encourage small businesses. We need to keep in mind that if this committee contemplates the repeal of provisions that affect the cash flow of small businesses, such as accelerated depreciation or the domestic manufacturing deduction, in order to finance a corporate tax reduction, pass-through entities will not benefit from a reduction in the corporate rate. Pass-throughs also would not benefit from some of the international changes that the committee has discussed.

One area where I think most of us agree where we can help small business is complexity. In reading through your testimony and the excellent Joint Committee pamphlet, I think there is plenty of complexity for us to explore. I look forward, therefore, and all of my colleagues on the Democratic side do, to your testimony. Thank you.

Chairman CAMP. Well, thank you very much.

We are pleased to welcome the excellent panel of experts assembled before us today. And as we tackle the special challenges faced by small and closely-held businesses, I believe their experience and insight will help us to shed some light on this complex area of the Tax Code.

To introduce our first witness, from Naperville, Illinois, I yield to the chief deputy whip, Mr. Roskam.

Mr. ROSKAM. Thank you, Mr. Chairman. And Mr. Chairman, I want to thank you for extending an invitation at my request to Mr. Mark Smetana. Mark is the chief financial officer of Eby-Brown, a 100-year-old family-owned business, that is a wholesale distributor to the convenience store industry. And they are located in Naperville, Illinois, and they operate out of seven locations throughout the United States. They employ roughly 2500 employees, distribute goods to over 13,000 retail locations, and have $4.5 billion in annual sales.

Mark previously served as the chairman of the Private Company Policy Committee of Financial Executives International, a 15,000-member company organization. And of course, he is a proud graduate of the University of Notre Dame.

Chairman CAMP. All right. Thank you, Mr. Roskam, and welcome, Mr. Smetana.

Second, we will hear from Mr. Dewey Martin. Mr. Martin is a licensed CPA, the sole owner of a public accounting practice, and the director of the School of Accounting at Husson University in Maine. He is testifying today on behalf of the National Federation of Independent Business.

Third, we welcome Mr. Stefan Tucker, a partner at Venable LLP here in Washington, D.C. Mr. Tucker is a former chair of the ABA Section of Taxation and has lectured as a professor at the George Washington University Law School and the Georgetown University Law Center.

Fourth, I would like to yield to Mr. Gerlach to welcome our next witness.

Mr. GERLACH. Thank you, Mr. Chairman. I appreciate it very much. We are pleased to have today Dr. Jeffrey Kwall with us on the panel. Dr. Kwall is the Kathleen and Bernard Beazley Professor of Law at the Loyola University School of Law in Chicago, Illinois. He also teaches at Northwestern University School of Law.

He specializes in corporate and pass-through taxation, and has authored many publications on the subject. He is an undergraduate from Bucknell University in Pennsylvania, as well as getting his J.D. and his Masters in Business Administration from the University of Pennsylvania.

But what is extra-special about the opportunity to introduce Dr. Kwall this morning is that he and I grew up in the same home town in Western Pennsylvania. We are boyhood friends. We were in the same Cub Scout troop, and we have many memories of our childhood. And I have sworn him to secrecy on any of those stories, Mr. Chairman.

[Laughter.]

Mr. GERLACH. But we are really pleased to have Dr. Kwall with us, and I appreciate the opportunity to introduce him this morning. Thank you.

Chairman CAMP. Well, thank you, Mr. Gerlach. And you come very well credentialed, Dr. Kwall.

Fifth, we will be hearing from Mr. Thom Nichols. Mr. Nichols is a shareholder at Meissner Tierney Fisher & Nichols in Milwaukee, Wisconsin, and serves as the vice chair on the Committee on S Corporations for the ABA Section on Taxation.

And finally, we do like to welcome back Mr. Martin Sullivan. Mr. Sullivan has served at the Treasury Department, the Joint Committee on Taxation, and since 1995 has been a contributing editor for Tax Analysts.

Thank you all again for your time today. Thank you for being here. The committee has received each of your written statements and they will be made part of the formal hearing record. Each of you will be recognized for five minutes, and I will hold you pretty tightly to those five minutes, for your oral remarks.

So Mr. Smetana, we will begin with you. You are recognized for five minutes.

STATEMENT OF MARK SMETANA, CHIEF FINANCIAL OFFICER, EBY–BROWN COMPANY, NAPERVILLE, ILLINOIS

Mr. SMETANA. Good morning, Chairman Camp and Ranking Member Levin and Members of the Committee. It is a privilege to testify at today's hearing regarding the treatment of privately-held businesses in the context of tax reform. This hearing comes at an important time as America's businesses continue to struggle with lingering economic uncertainty. This proves especially true for the thousands of privately-held and family-owned businesses in the United States.

As Mr. Roskam noted, I currently work for a privately-held company. The current family ownership is in its second generation, and it employs about 2500 people. The longevity of the company has largely resulted from the family's reinvestment of its after-tax earnings and traditional financing.

America's privately-held businesses are the backbone of our economy. Forbes Magazine estimates that the 441 largest private companies in the United States employ 6.2 million people and account for 1.8 trillion in revenue. Recognizing the importance of private companies is vital since any workable tax reform must address businesses, regardless of their form of organization.

All forms of business use GAAP-based financial statements to measure financial performance and the financial position of the business. However, there are fundamental differences between privately-held businesses and corporations.

Owners of privately-held companies are typically limited in number and have long-term investment horizons, years to generations, whereas investors in publicly-held corporations are short-term renters of the securities they own, frequently trading them for cash. Capital used to finance privately-held businesses are after-tax cash earnings and transactional forms of debt financing. Public corporations raise capital via offerings of debt and equity-traded securities to the public.

The owners of privately-held businesses typically measure the value of their business in terms of free cash flows the business generates, EBITDA or earnings before taxes, interest, depreciation, and amortization, times a market multiple; whereas public companies measure valuation in terms of market capitalization, price-to-earnings ratio, and earnings per share.

Most privately-held companies evaluate investment opportunities on an after-tax cash flow basis, whereas public companies evaluate the impact on the price of its stock. Tax policy plays a material role in evaluating those investment decisions for privately-held businesses.

The recent framework for business tax reform released jointly by the Administration and Department of Treasury strongly implies that those organized as pass-through entities are advantaged in the current Tax Code over corporations. This is simply not the case.

According to a report from Robert Carroll and Gerald Prante of Ernst & Young, America's pass-through businesses reported 36 per-

cent of all business net income but paid 44 percent of all Federal business income taxes.

Furthermore, the pass-through tax regime recognizes that there is a fundamental difference between closely-held businesses enterprises and corporations, especially publicly traded ones. Among them are:

Owners of pass-through privately-held companies are taxed on business income, whether distributed or retained in the business, at one level of taxation, whereas corporations pay taxes on all income; and their owners pay a second tax on after-tax earnings that are distributed to its owners, creating a double-tax event.

Pass-through entities are flexible, allowing a disproportionate allocation of earnings to its owners based upon the agreed-upon equity contribution among them. Corporations are inflexible in the allocation of earnings to its stakeholders.

In order to fairly treat all businesses and provide a consistent policy with which business can operate in the U.S. economy, tax reform must address both forms of organization. The stated goal of providing a competitive business tax environment is important. However, it should not result in discriminating against closely-held businesses by widening the amount of marginal taxes the pay on business source income, forcing them into an inappropriate investor/owner relationship with their business, double-taxing their business income as if they were merely an investor trader of the business, or forcing them to pay a second level of tax on the sale of their business.

Financial professionals are already making decisions based on increases in marginal rates set for January 2013, expiring AMT fixes, increases in the tax rate on investment income, and an increase in death taxes on closely-held companies. Certainly none of these prospects can be welcome at a time when our economy desperately needs increased private sector investment.

In closing, it is vital that private companies are recognized as critical for America's economic future. When tax reform does take place, we hope that their importance in our economy is understood and not penalized.

I want to thank the chairman and ranking member for giving me the opportunity to speak before the committee today. I am happy to discuss these issues further and answer any questions you may have.

[The prepared statement of Mr. Smetana follows:]

Mark Smetana – House Committee on Ways and Means, March 7, 2012

Good morning Chairman Camp and Ranking Member Levin and members of the committee. It is an honor and privilege to be invited to testify at today's hearing regarding the treatment of privately-held businesses in the context of tax reform. This hearing comes at an important time as America's businesses continue to struggle with lingering economic uncertainty. This proves especially true for the thousands of privately-held and family-owned businesses across the United States.

My name is Mark Smetana and I am Chief Financial Officer for Eby-Brown Company, a 100 year old family-owned broadline distributor to the convenience store industry. The current family ownership is in its second generation and employs about 2,500 people. The longevity of the company has largely resulted from the family's reinvestment of its earnings into the business coupled with traditional bank financing.

I am also an active member of Financial Executives International (FEI). FEI's 15,000 members represent companies from every major industry, half of which are privately-held companies. As part of my involvement with FEI, I have previously served as Chairman of the FEI's Committee on Private Company Policy. This committee has helped Congressman Peter Roskam and Congressman Jason Altmire form the *Privately-Held and Family-Owned Business Caucus*.

America's privately-held businesses are the backbone to our economic success story. Forbes Magazine estimated that the 223 largest private companies in the United States employ 4.4 million people and account for $1.3 trillion in

Testimony embargoed until 3/7/2012 at 10am.

revenues.[1] Recognizing the importance of private companies is vital since any workable tax reform must address businesses regardless of their form of organization.

All forms of business use GAAP based financial statements to measure financial performance and the financial position of the business. However, there are fundamental differences between privately-held businesses and corporations in that holders of privately-held companies are typically limited in number and have longer term investment horizons – years, decades, generations – whereas investors in publically-held corporations are short-term renters of the securities they own, frequently trading them for cash. Capital used to finance privately-held businesses post start up are after-tax cash earnings and traditional forms of debt borrowings. Public corporations raise capital via offerings of debt and equity-traded securities to the public. The owners of privately-held businesses typically measure the value of their business in terms of the cash flows the business generates – EBITDA, or earnings before taxes, interest, depreciation and amortization – times a market multiple. Whereas public companies measure valuation in terms of market capitalization, price to earnings ratio and earnings per share. Most privately-held corporations evaluate investment opportunities on an after tax cash flow basis whereas public companies evaluate the impact on the price of its stock.

Tax policy plays a material role in evaluating those investment decisions for privately held businesses. The recent framework for business tax reform released jointly by the Obama Administration and the Department of Treasury strongly

[1] DeCarlo, Scott, Andrea D. Murphy and John J. Ray, *America's Largest Private Companies*, Forbes Magazine, Nov. 3, 2010.

implies that those organized as pass through entities are advantaged in the current tax code over corporations. This is simply not the case. According to a report from Dr. Robert Carroll and Gerald Prante of Ernst and Young, America's pass-through businesses reported 36 percent of all business net income but paid 44 percent of all federal business income taxes. [2] Furthermore, the pass-through tax regime recognizes that there is a fundamental difference between closely-held business enterprises and corporations, especially publically-traded ones. Among them are:

- Owners of pass through privately-held companies are taxed on business income whether distributed or retained in the business at one level of taxation whereas corporations pay taxes on all income and their owners pay a second tax on after tax earnings that are distributed to its owners creating a double tax event.
- Pass-through entities are flexible, allowing a disproportionate allocation of earnings to its owners based on the agreed upon equity contribution among them. Corporations are inflexible in the allocation of earnings to its stockholders.

In order to fairly treat all businesses and provide a consistent policy with which businesses can operate in the US economy, tax reform must address both forms of organization. The stated goal of providing a competitive business tax environment is important, however, it should not result in discriminating against closely-held businesses by: widening the amount of marginal taxes they pay on

[2] Carroll, Dr. Robert and Gerald Pronte, *The Flow-Through Business Sector and Tax Reform*, Ernst & Young, April 2011.

Mark Smetana – House Committee on Ways and Means, March 7, 2012

business sourced income; forcing them into an inappropriate investor/owner relationship with their business; double taxing their business income as if they were merely an investor trader of the business; or forcing them to pay a second level tax on the sale of their business.

Financial professionals are already making decisions based on increases in marginal rates set for January 2013, expiring AMT fixes and increases in the tax rates on investment income. Certainly none of these prospects can be welcomed at a time when our economy desperately needs increased private sector investment.

As I close, it is vital that private companies are recognized as critical for America's economic future. When tax reform does take place, I hope that their importance to our economy is understood and not penalized.

I want to thank the Chairman and Ranking Member for giving me the opportunity to speak before the committee today. I am happy to discuss these issues further and answer any questions you may have.

Testimony entered into the record 3.7.2012 at 10am.

Chairman CAMP. Thank you very much.

Mr. Martin, you are recognized for five minutes.

STATEMENT OF DEWEY W. MARTIN, CPA, HAMPDEN, MAINE, TESTIFYING ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. MARTIN. Good morning, Chairman Camp, Ranking Member Levin, and Members of the Committee. I am very pleased to be here on behalf of NFIB as the committee continues its series of hearings on tax reform. I appreciate that the committee invited me here today to discuss tax reform from the perspective of someone

who is a small business owner, a tax advisor to many closely-held businesses, and a university professor of taxation for 32 years.

I would like to discuss how taxes affect small business structure and propose a number of ideas for reform. Additionally, I will lay out some goals that I believe the committee should adopt when considering the impact of tax reform on small businesses.

Nearly 75 percent of small businesses choose the pass-through business structure. And, by the way, that occurred because of the Tax Reform Act of 1986; prior to that time, you could have one level of taxation at the time of liquidation of a C corporation. The Tax Reform Act of 1986 enforced double taxation that pushes everybody towards S corporation status.

From a from a tax perspective, the pass-through model makes sense for the typical small business. But while many small businesses start as sole proprietors or as partnerships, the liability protection that a corporation offers is not available to these business structures. As a small business grows in size, they are very likely to elect to change to an LLC or a corporate form.

While there are important liability protections offered to incorporated businesses, taxation that pushed C corporations toward ongoing costs associated with that structure versus non-corporate structures, such as filing articles of incorporation, paying registration fees with States, drawing up corporate bylaws, and establishing a board of directors.

Incorporation makes sense for some businesses and would serve as a barrier to entry for other businesses. The various models provide the business owner with more flexibility and choice to organize their business in a way that best suits their needs.

As I discuss in my written testimony, I believe that three changes to the current law would provide additional flexibility to small businesses in choosing that alternative:

First, allow corporations to own shares in S corporations, or at the very least, allow S corporations to own shares in S corporations.

Second, allow owners of S corporations to have fringe benefits, just like employees of C corporations can have fringe benefits.

And finally, reduce the holding period for built-in gains. For 2011, it is five years, 2012 going back to 10 years. Reduce it. Eliminate it. But take care of it. It is a difficult problem for conversions.

Regarding tax reform, as the committee considers various proposals, I would encourage you to keep these goals in mind: Permanent reduction of tax rates. Do not create disparities between the various forms of entities. Reduce complexity—big one for me, especially in the classroom. And do not separate the business owner from the business; they are really one and the same.

Small businesses need permanency in the Tax Code to make important business decisions, such as when to hire workers and when to make capital investments. And one of the main sources of capital for expanding a business is earnings retained from business profits.

While small businesses would no doubt welcome the opportunity to reduce individual income tax rates from their current levels, at a minimum, NFIB members overwhelmingly support extending the current tax rates. In addition, NFIB members strongly support repeal of the AMT and the estate tax.

Pass-through businesses must be included in any reform of the Internal Revenue Code. If the rates were to go down for C corporations but remain unchanged for pass-through businesses, it would put pass-through businesses at a competitive disadvantage or encourage businesses to change to a less favorable business structure simply for tax reasons. Additionally, this could lead to higher taxes for pass-throughs, perhaps as much as $27 billion a year.

NFIB strongly recommends that tax reform be pursued comprehensively, addressing both individual and corporate taxes. The typical small business spends about $18 billion on tax compliance costs, some of it to me, a small piece. There are some areas of the tax law that are significantly more complex than necessary, such as the small business health insurance credit, which requires me to do a five-page worksheet in a tax return before I can even tell whether the business qualifies for the credit or not. Ridiculously complex, in my opinion.

Additionally, in recent years, the IRS and Congress have attempted to close the tax gap by forcing small business owners to become information collectors for the IRS or through increased withholdings. Two such efforts, the 1099 paperwork mandate in the health care law and the 3 percent withholding requirement, were so onerous that they were rightly repealed in 2011 before even going into effect. Both of those requirements would have significant impact on my clients.

Congress can build on the success of some reforms to the code that have made tax filing easier for small business. Two examples are the increased Section 179 deduction to the $500,000 level, making it permanent, and expanding the use of cash accounting, making it available to any business with less than $10 million in sales. That would be a big help to my clients.

Finally, do not think of the business owner as separate from the business itself. Attempts to tax small business or pass-through income and salary income at different tax rates would have a significant problem for small business owners. The recordkeeping required to determine qualified income and to allocate expenses would increase the cost and burden of compliance for small businesses.

Thank you very much for the opportunity to testify here today. I very much appreciate the fact that the Committee on Ways and Means is taking a serious look at reforming the Internal Revenue Code, and I urge you to keep in mind the unique challenges that face small businesses. And I very much look forward to hearing your questions at the end of our presentations. Thank you.

[The prepared statement of Mr. Martin follows:]

Testimony of Dewey W. Martin, CPA

House Committee on Ways and Means

March 7, 2012

The Treatment of Closely-Held Businesses in the Context of Tax Reform

Good morning, Chairman Camp, Ranking Member Levin, and members of the Committee. I am pleased to be here on behalf of the National Federation of Independent Business (NFIB) as the Committee continues its series of hearings on tax reform. The current tax code impacts small and closely-held businesses in several important ways, so I appreciate that the Committee invited me here today to discuss these important issues from the perspective of someone who is both a small business owner and a tax practitioner for many closely-held businesses.

The NFIB is the nation's leading small business advocacy organization representing over 350,000 small business owners across the country. I have been a member of NFIB since 1990, and have also served on NFIB's Tax Advisory Board since 1996. I have been a full-time professor at Husson University in Bangor, Maine for 32 years. In addition, I have had an accounting practice for the same 32 years, which provides services to 125 small business clients. They range in size from $10,000 to $30,000,000 in sales and from 1-125 employees. Prior to this segment of my life, I was a tax manager at PricewaterhouseCoopers in Boston.

The typical NFIB member employs about 8 to 10 employees with annual gross receipts of about $500,000. All of NFIB's members are independently owned, which is to say that none are publicly traded corporations. While there is no one definition of a small business, the problems our members confront relative to the tax code are representative of most small businesses. A few consistent concerns are raised regardless of the trade or industry in which the small business is engaged.

As part of representing small business owners, NFIB frequently conducts surveys of both the NFIB membership and small businesses as a whole, and taxes consistently rank as one of their biggest concerns. In the most recent publication of the NFIB Research Foundation's *Small Business Problems and Priorities*, 4 of the top 10 small business concerns are tax-related.[1] In addition, the monthly Small Business Economic Trends survey consistently ranks taxes as among the most important problems facing small businesses.[2]

Business Structure

One of the first organizational issues encountered when forming a business is its legal form. The legal form chosen has implications for taxes, liability, startup costs, continuity, composition of ownership, and other matters of concern for the business owner. Critical to the business owner is the total cost to operate over the life of the business, including succession or termination. The owner cares about the variety of tax costs (income, payroll, return filing, etc.) that will be incurred as well as the cost of compliance with the related laws. A first meeting with a client would include all those topics.

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[1] William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC, series.
[2] In the latest Small Business Economic Trends Survey, taxes ranked third among important problems. *Small Business Economic Trends*, NFIB Research Foundation, Washington, DC, February 2012.

The vast majority of small businesses are taxed as pass-through entities, with nearly 75 percent choosing a pass-through business structure.[3] This means that most small businesses will pay their taxes at the individual level rather than the corporate level. From a tax perspective, the pass-through model makes sense for the typical small business.

Small businesses are also overwhelmingly privately held and independent. Nearly 60 percent of small (employing) businesses are owned by one individual, and publicly traded small businesses amount to only one-tenth of 1 percent of small employers.[4] Moreover, small employing businesses are also overwhelmingly *not* held by another entity—only 4 percent are even partially owned by another business or non-profit.[5]

While most small businesses start off as sole proprietorships or partnerships, the liability protection that a corporation offers is not available for these business structures. If the business is liable for a debt, the business owner's personal assets are also at risk. The Tax Reform Act of 1986 made several changes to the taxation of S-Corporations, reducing the tax liability for small businesses, but also providing the liability protection of a C-Corporation. The passage of those changes has led to an explosion in the number of S-Corporations. In 1985, 22 percent of all corporations were S-Corporations, by 1990 the figure has risen to 43 percent, and today the majority of corporations are S-Corporations.[6]

Businesses change their structure very infrequently and the tax code contributes to this.[7] For example, there can be tremendous costs when an S-Corporation elects to convert to a C-Corporation, particularly the built-in gains tax, which subjects assets which are appreciated at the time of conversion to a corporate level tax if sold within five years (10 years beginning in 2012). There are several instances where this tax would be due in the year following conversion when there is not necessarily the cash on hand to pay it.

Additionally, it should be noted that, while there are important liability protections offered to incorporated businesses, there are also both startup and ongoing costs associated with that structure versus non-corporate structures. Filing articles of incorporation, paying a registration fee with the state, drawing up corporate bylaws, changing all signage and corporate correspondence to indicate the new type of entity, setting up a board of directors, and filing an additional tax return are just a few possible examples of administrative startup costs. In addition, while most state laws require establishing a board

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[3] Firms of all size responded that 20.9-percent organized as sole proprietors, 5.8-percent as partnerships, 25.6-percent as C-Corps, 30.9-percent as S-Corps, 12.4-percent as LLCs, and 4.2-percent as other/DNK. *Business Structure* – NFIB Small Business Poll, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004.

[4] *Ibid.*

[5] *Ibid.*

[6] SOI Bulletin, Internal Revenue Service, U.S. Department of the Treasury, Selected Historical and Other Data – table 13, Winter 1999-2000.
Also see: SOI Tax Stats – S Corporation Statistics, Internal Revenue Service, U.S. Department of the Treasury, available at: http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96405,00.html

[7] In an NFIB survey, only 7 percent of businesses had changed their legal form within the previous 3 years. Of the small businesses that did change their business structure, 39 percent changed to avoid liability, and 27 percent changed for tax reasons. *Business Structure* – NFIB Small Business Poll, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004

of directors, more than two-thirds of small employers, virtually all of whom are privately held, say that their board exists primarily to fill legal requirements and not necessarily as an entity to govern the business.[8] In other words, incorporation makes sense for some businesses and would serve as barrier to entry for others.

While the variety of business structures might lead to additional rules in the code, various models provide the business owner with more flexibility and choice to organize their business in a way that best suits the needs of the business. Entities such as sole proprietorships and S-Corporations can ensure that a small business is not overburdened with extra layers of taxation. In other cases, structures like C-Corporations, S-Corporations, and Limited Liability Corporations (LLCs) can protect the business owner from personal liability. In the end, the structures promote the maximum amount of flexibility to allow the business owner to make decisions based on the fundamentals of their business. If the business grows or changes, the different structures allow the business owner to adapt in such a way that the business continues to operate effectively.

In addition, we recommend making three changes to current law that could provide additional flexibility to small businesses.

First, other than certain non-profits, corporations are currently not allowed to own stock in S-Corporations.[9] Allowing such ownership would be helpful to small business owners and would prevent the involuntary termination of S-Corporation status, which is usually a surprise to the business owner. At the very least, it would decrease administrative costs if one S-Corporation could own shares in another S-Corporation.

A second issue with business structure choices that could make owners' lives simpler is in the area of fringe benefits. If a business owner is employed by a C-Corporation, he or she can have fringe benefits like other employees. If the S-Corporation or partnership forms are elected, the owner can have no fringe benefits.[10] This would result in complex planning to help these owners have similar coverage, and the tax results differ as well. This is needlessly complex. We should require that the fringe benefits be non-discriminatory, but they should be allowed no matter what form the business entity is.

Finally, reducing the holding period for the built-in gains tax would do much to promote flexibility for small businesses. The built-in gains tax locks-in capital assets if a C-Corporation elects to change to S-Corporation status, and reduces economic efficiency. NFIB appreciates that the holding period has been reduced from 10 years to 5 years, and, at the very least, this should be extended.

Goals for Small Business Tax Reform

As the Committee considers tax reform, I would encourage you to keep these most important goals in mind. Achieving these goals will greatly enhance the ability of small and closely-held businesses to thrive in the 21st century: 1) permanently keep the tax rates low, 2) do not create disparity between the

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[8] *Ibid.*
[9] 26 USC § 1361 (b)(1)(B)
[10] 26 USC § 1372

corporate rate and individual rate, 3) reduce complexity, and 4) do not separate the business owner from the business.

Permanently Keep the Tax Rates Low

According to a February 2012 Small Business Economic Trends survey, 18 percent of small businesses reported that taxes was the single most important problem facing them today.[11] Small businesses need permanency in the tax code to make important business decisions, such as hiring workers and making capital expenditures. While small businesses much appreciated the work done in late 2010 to keep rates low for another two years, we are again faced with the possibility that that rates will increase for individual income taxes, estate taxes, capital gains taxes, and dividends taxes at the end of 2012. Without knowing what their tax liability will be at the end of this year, business planning becomes very difficult for our nation's number one job creators.

Individual income tax rates are paid by pass-through businesses, which are responsible for 54 percent of our nation's private sector workforce.[12] One in five small businesses experiences a continuing cash flow problem and one in two businesses face regular cash flow problems, which is exacerbated by higher taxes. Higher individual income taxes eat away at the ability of small businesses owners to spend money on their business. One of the main sources of capital for expanding a business is earnings retained from business profits (i.e. the amount of money available after taxes have been paid). As businesses are faced with the threat that taxes will go up next year, they may suspend plans to hire and expand their businesses.

The annual congressional tax extenders game, which for several years has included the Alternative Minimum Tax (AMT), creates even more uncertainty for business planning. This is especially true for tax preparers and makes tax planning for a client even more of a challenge and increases the potential for errors. A more certain tax code will help to promote prudent business planning and decisions and improve compliance.

The uncertainty of the estate tax is major problem for family owned businesses. The planning costs associated with this tax are not only a drain on business resources, but also take money away from the day-to-day operations and investing in the business. Between 2002 and 2012, the exemption and tax rate have changed nine times, which makes it especially hard to plan for family businesses. Next year, the rate is set to increase to 55 percent with only a $1 million exemption.

While small businesses would no doubt welcome the opportunity to reduce individual income tax rates from their current levels, at a minimum, NFIB members overwhelmingly support permanently extending the current 2001 and 2003 tax rates.[13] In addition, NFIB members strongly support repeal of the AMT.

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[11] *Small Business Economic Trends*, NFIB Research Foundation, Washington, DC, February 2012.
[12] Carroll, Robert and Gerald Prante, *The Flow Through Business Sector and Tax Reform: The Economic Footprint of the Flow-Through Sector and the Potential Impact of Tax Reform*, April 2011.
[13] In a 2010 Member Ballot, 89% of NFIB Members supported extending all the individual tax rates. *NFIB Member Ballot, vol. 559, November 2010.*

and estate tax, but if this is not immediately possible, providing a long term solution to protect small businesses would be very beneficial to them.

Address Tax Reform Comprehensively and Do Not Create Disparity between the Corporate Rate and Individual Rate

Pass-through businesses, and the many small businesses that choose a pass-through structure, must be included in any reform of the tax code. The current tax rates for pass-through businesses are similar to a C-Corporation's. If the rates were to go down for C-Corporations but remain unchanged for pass-through businesses, it would put pass-through businesses at a competitive disadvantage. A similar outcome would be reached if, as has been proposed in the President's budget for the past 3 years, the top marginal tax rates on individuals are allowed to return to pre-2001 levels. At the very least, the tax rate paid by pass-through businesses should be the same rate that applies to C-Corporations.

If a significant disparity between tax rates for C-Corporations and pass-through businesses was enacted, this would be particularly harmful to small businesses and might lead them to change the form of their business solely for tax reasons. The change in cash outflows resulting from a change in the form of business could save one or more jobs in the business. If the current individual tax rates are allowed to rise in 2013, this will cost an even greater number of jobs. I would expect a number of my clients to change their legal form solely for that reason even if it costs them in the long run at the time of sale or dissolution of their business. Short term decisions win when it comes to cash flow.

Finally, if Congress pursues a "corporate-only" reform that eliminates deductions and credits for a lower corporate rate, many small businesses could end up paying additional taxes without any corresponding benefit. A 2011 study found that, in total, pass-through businesses benefited from 23 percent of the approximately $116 billion in annual business tax expenditures.[14] Repeal of these provisions could entail substantial tax increases for pass-through businesses that could negatively impact employment and growth in the pass-through sector. The study found that eliminating all businesses tax expenditures would increase the income taxes paid by individual owners of pass-through businesses, on average, by 8 percent or $27 billion annually.[15]

For all these reasons, NFIB strongly recommends that tax reform be pursued comprehensively, addressing both individual and corporate taxes.

Reduce Complexity in the Tax Code

The typical small business spends annually between 1.7 billion and 1.8 billion hours on tax compliance and $18 billion to $19 billion on compliance costs.[16] The result is that 88 percent of small business

[14] Carroll, Robert and Gerald Prante, *The Flow Through Business Sector and Tax Reform: The Economic Footprint of the Flow-Through Sector and the Potential Impact of Tax Reform*, April 2011.
[15] *Ibid.*
[16] Donald DeLuca, Scott Silmar, John Guyton, Wu-Lang Lee, and John O'Hare, *Aggregate Estimates of Small Business Taxpayer Compliance Burden*, Proceedings of the 2007 IRS Research Conference.

Testimony Submitted 4/18/2012 at 10:00 a.m.

owners now hire a paid tax preparer to complete their returns.[17] Small business owners also spend on average $74.24 per hour on the paperwork associated with tax compliance— the highest paperwork cost imposed on small business by the federal government.[18] Unlike a larger business, small business does not have a finance department or a staff of accountants and lawyers to focus on the nuances and changes in the tax laws. Nor does the typical small business have a full-time human resources specialist to keep up with the tax changes impacting health care and retirement plans. In fact, I function very much like a part-time chief financial officer for my clients.

There are some areas of the tax law that are significantly more complex than necessary. For example, the health insurance credit requires a 5-page worksheet in a tax return, and you do not know if there is a credit available until you have spent the time on the worksheet. Various credits for hiring employees have so great a paperwork burden that clients rarely take advantage of any of them; small businesses hire employees because they need them, not because of any credits they get from hiring them. And in general, most clients are not even aware they are getting a number of deductions in the code and certainly are not managing their business in a way to generate deductions.

The complicated and, in many ways unpredictable tax code, places a heavy burden on small business owners. In the end this leads to additional costs and takes money away from the day-to-day business operations or investing in and expanding their business. The confusing tax code leads to more errors, which we believe is the main cause of the so-called "tax gap" amongst small business owners.

While the Internal Revenue Service (IRS) recently calculated that the tax gap grew between from $345 billion in 2001 to $450 billion in 2006, it is very important to note that the compliance rate stayed virtually unchanged.[19] No one disputes that we should all strive to achieve the highest possible level of tax compliance, but the recent repeal of two high-profile provisions intended to reduce the tax gap illustrate the difficulties associated with doing so.

In 2010, a provision in the Patient Protection and Affordable Care Act would have expanded 1099 reporting for businesses that purchased more than $600 in goods and services from all other businesses.[20] Before that, in 2005, the Tax Increase Prevention and Reconciliation Act created a new requirement that federal, state, and local governments withhold 3 percent from payments for goods and services.[21] Both of these measures were strongly opposed by NFIB and others, and for good reason. The burdens that these provisions would have placed on small businesses were much higher than the additional income that the IRS would have potentially collected. Fortunately for everyone, these provisions were never allowed to go into effect and were repealed in 2011.[22] Future efforts to close the

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[17] *Tax Complexity and the IRS – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 6; Issue 6; 2006.
[18] *Paperwork and Record Keeping – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 3; Issue 5; 2003.
[19] *Tax Gap for Tax Year 2006*, Internal Revenue Service, U.S. Department of the Treasury, Jan. 6, 2012
[20] Section 906, P.L. 111-148
[21] Section 511, P.L. 109-222
[22] H.R. 674, which repealed the 3 percent withholding requirement became P.L. 112-253 on November 21, 2011. H.R. 4, which repealed the 1099 reporting requirement became P.L. 112-15 on April 14, 2011.

tax gap by forcing small businesses to be "information collectors" for the IRS, or by increasing federal withholding, will also be met with stiff resistance.

The tax gap is a symptom of a tax code that has grown far too complex. Fortunately, by taking concrete steps to simplify the code through tax reform, Congress can increase compliance, while also reducing the burdens on small businesses.

Congress can also look to a few successful reforms to continue to simplify the code for small businesses. Section 179 expensing is a good example of simplification and providing the small business with an immediate source of capital. Since 2003, Congress has steadily increased the allowable expensing amount from $25,000 to $500,000 for tax year 2011. Additionally, Congress expanded Section 179 expensing to include real property with the passage of the *Small Business Jobs Act*.[23] With these efforts, Congress has provided the majority of small business owners with an immediate deduction for almost any investment they make in their businesses. While increasing the Section 179 deduction over $500,000 might not benefit many small businesses, the $125,000 limit (plus indexing) that is in effect for 2012 should be increased and should include real property.

Expensing also reduces the complexity of the tax code. Instead of following complicated depreciation schedules and keeping the paperwork associated with the investment, the business owner can simply claim the deduction in the year the item is purchased. As Congress considers specific issues in the code, making the higher Section 179 amounts permanent would go a long way to reducing complexity and providing an important tax benefit to small business owners. When considering the stress of my clients on the topic of expensing the cost of long-lived assets, making the law permanent and eliminating the roller coaster of the maximum deduction would ease their minds considerably.

Another example of simplification is allowing the expanded use of cash accounting. Under the current law, a taxpayer with less than $5 million in gross receipts is able to use cash accounting rather than accrual accounting. The cash accounting method is much easier for small business owners to follow and more closely matches the way that a small business owner will keep his books. Allowing any business entity with revenues less than $10 million to use cash basis accounting, as long as the cost inventories are not deducted until sold, would be a small but important change that would benefit small businesses.

Do Not Separate the Business Owner from the Business

A small business owner is inexorably tied to his or her business; no matter what business structure the small business owner chooses, you cannot separate the business owner from the business. While this is most apparent for businesses structured as pass-through entities, it is true even in the case of small businesses organized as C-Corporations. For many small business C-Corporations, the corporation pays down its annual receipts in business expenses and salary, such that the corporation itself has almost no tax liability.[24]

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[23] P.L. 111-240

[24] *Business Structure* – NFIB Small Business Poll, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004.

Attempts to tax small business or pass-through income and salary income at different tax rates would create many new problems for small business owners. It is also counter to the goal of simplifying the tax code. The required recordkeeping to determine qualified income and to allocate expenses would increase the cost and burden of compliance for small businesses and likely require professional accounting services to oversee and handle potential audit inquiries by the IRS and/or state tax authorities (for states that conform to the federal tax code).

Conclusion

Small businesses truly are the engine of economic growth. This isn't just a slogan, as small businesses created two-thirds of the net new jobs over the last decade. Small business owners are risk takers and entrepreneurs. They are the last businesses to lay off employees when business declines and slow to rehire when business picks up. The owner works additional hours until they can take it no more. When small business hires an employee, it is their intent to keep them on for the long run.

The current tax code has become a confusing and unpredictable challenge for the vast majority of small business owners. Our tax laws should not deter or hinder the ability of small business owners to create or expand their businesses. Taxes are a major issue for all small business owners. Tax law can dictate the business decision that an owner will make, whether it is the type of structure to adopt or whether to make an investment.

After decades of patchwork changes to the tax code, Congress needs to make major adjustments to our tax laws to reduce complexity and confusion and encourage business growth. I appreciate that the Committee on Ways and Means is taking a serious look at reforming the tax code and urge you to keep in mind the unique challenges that face small businesses.

Testimony Submitted on 3.7.2012 at 10am.

12 at 10am.

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Chairman CAMP. Thank you, Mr. Martin.

Mr. Tucker, you have five minutes, and your written statement is part of the record.

STATEMENT OF STEFAN F. TUCKER, PARTNER, VENABLE LLC, WASHINGTON, D.C.

Mr. TUCKER. Chairman Camp, Ranking Member Levin, and Members of the Committee, thank you very much for the oppor-

tunity to appear before you today to testify in an area to which I have devoted my professional career for almost five decades—that is, the legal aches and pains that are facing closely-held business owners.

I am the senior tax lawyer at the Venable law firm in Washington, D.C. My practice specializes in closely-held businesses, from the inception to the end of the business. I have a teaching career; I have been teaching at law schools for 42 years, since 1969. I am currently an adjunct at the Georgetown University Law Center and at the University of Michigan Law School, and I teach business planning at Michigan.

By the way, Chairman Camp and Ranking Member Levin, I am a Michigan native. I was born in Detroit. (Mr. Levin: You may remember the Richton and Dexter intersection in Detroit; that is where I lived.) I grew up in Flint, Michigan. I am a graduate of Flint Community College, which is now Mott Community College, the University of Michigan Business School, and the University of Michigan Law School.

I have absolutely no political agenda today. My purpose is to share with you the concerns that, in my experience over the decades, closely-held business owners face on a daily basis, and suggest Federal tax reform that you should consider to address these concerns.

In my experience on an everyday basis, closely-held business owners are particularly concerned with four issues: first, growing their businesses, specifically capital access and capital formation; secondly, protecting their personal assets from business risk; thirdly, protecting the business and its personnel from adversity; and fourthly, business succession. And in fact, Federal tax policy impacts on all of these concerns.

I would suggest that this committee consider four fundamental reforms of the tax system that would enable owners of closely-held businesses to concentrate on what they do best, which is actually running their businesses. And these are: a single-tax regime for all electing entities; secondly, an entity-level tax for non-electing entities, with dividends paid deduction; thirdly, simplify compensation rules; and fourthly, tax rate parity. And everything else is detail. Let me amplify. Okay?

First, on the single-tax regime, I would make this elective integration. I would have it apply to any entity, whether a corporation, a limited liability company, or a partnership. And I would leave the choice of entity to be determined by the business owner based on non-tax considerations such as State law issues. Effectively, we would have a check-the-box. And this is because many of them are concerned about State law concerns, and should not be concerned about tax law concerns.

The guidance for all of these pass-through entities would be the partnership rules under subchapter K. And in fact, I would eliminate subchapter S altogether and, therefore, eliminate all the traps under subchapter S of the Internal Revenue Code.

I believe that anyone who works for the entity and is an owner of an interest in the entity, irrespective of the size of the ownership, should be subject to withholding, FICA and FUTA, and receive a W–2 and not a 1099. And of course there would need to be

a transition period to move from that taxable corporation into the single-tax entity.

Secondly, on the entity-level tax for non-electing entities with a dividends paid deduction, I would let every entity decide not to elect affirmatively to be a single-tax entity but to be a taxable entity. But I would give them a dividends paid deduction for dividends passed through to shareholders, which is effectively what REITs do today but with special rules governing REITs.

It would apply only to dividends paid out of the current year's income. To the extent income is retained, I believe the following should occur. If it is retained to acquire assets, tangible assets to be used in the trade or business within the United States, I believe that they should have a fast write-off on those assets, no more than five years or the current useful life, if shorter, thus giving them an inducement to grow their business within the U.S., not outside of the U.S.

If the retained income is used to acquire tangible assets in the trade or business outside the U.S., let them use the longer current useful lives. And if it is later distributed, there would be no dividends paid deduction, and it would be taxed to the shareholders at their level.

I think there should be simplified compensation rules. I think you should not have to worry about reasonable compensation because, in a pass-through entity, you would not have that issue. It would be a single-tax entity, and in big entity. And, in big double tax entities, golden parachutes and the like could be eliminated because that should be a shareholders concern, not a tax/IRS concern.

Finally, there should be tax rate parity. The top rate for corporations that are taxed and for pass-through entity owners should be exactly the same. You should not have a gaming issue as to where you are and come up with deductions that you do not need.

Thank you very much for your time, and I am glad to answer questions at any point.

[The prepared statement of Mr. Tucker follows:]

HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

Testimony embargoed until 3.7.2012 10am.

HEARING ON THE TREATMENT
OF CLOSELY-HELD BUSINESSES
IN THE CONTEXT OF TAX REFORM

MARCH 7, 2012

Submission by:
STEFAN F. TUCKER
VENABLE LLP
WASHINGTON, DC

PROPOSALS FOR TAX REFORM FOR ENTREPRENEURIAL CLOSELY HELD (AND OTHER) BUSINESSES

There are four basic concepts that I believe would reform the Internal Revenue Code for entrepreneurial closely held (and in fact all) businesses, thereby enabling business owners to concentrate on (i) access to and accretion of capital, (ii) protecting their personal assets from business risks, (iii) protecting the business and personnel and (iv) providing for business succession, and not to expend significant dollars and human capital in dealing with the Internal Revenue Code:

A. Single Tax Regime for All Pass-Through Entities

1. This would apply to any corporation, limited liability company, general partnership or limited partnership.

(a) This would leave the choice of entity to be determined by the entrepreneur, based on state law issues.

(b) There would be a "check-the-box" election available for all entities.

2. This would eliminate traps within the S corporation for the unwary (and even the wary) person:

- Two classes of stock
- Number of shareholders
- Types of shareholders
- Basis and adjusted basis
- Reconciliation of inside and outside basis

3. Anyone who works for the entity and is an owner, irrespective of the percent of ownership, would be subject to withholding, FICA and FUTA, and receive a W-2, not a 1099.

4. The guidance for such pass-through entities would be subchapter K, eliminating the need for subchapter S.

5. There would need to be a time period to move to the single tax regime without adverse tax consequences. (This would be similar to the end of 1986 when C corporations could elect to become S corporations without adverse tax consequences.)

B. Taxable (C) Corporations

1. These entities would be taxable at standard corporate income tax rates on their income, depending on taxable income.

2. There would be a dividends paid deduction for dividends passed through to their shareholders. This is similar to the current taxation of REITs, but without the requisite distribution requirements.

3. The dividends paid deduction would apply only to dividends paid out of the current year's income. To the extent that any such income is retained, the following would occur:

(a) If the retained income is used to acquire tangible assets used in the trade or business within the United States, the cost basis of such tangible assets would be depreciable over 5 years, thus giving an inducement to grow the business within the United States.

(b) If the retained income is used to acquire tangible assets used in the trade or business outside the United States, the cost basis of such tangible assets would be depreciable over the current established lives under the Code.

(c) If the retained income is later distributed, there would be no dividends paid deduction, and such income would be taxed to the shareholders at their individual rates.

C. Simplify the Compensation Rules

1. There would be no reasonable compensation concerns for any pass-through entity, inasmuch as all taxable income would pass through to the entity owners.

2. There would be no "golden parachute" or similar issues for executives of taxable C corporations, leaving concerns about executive compensation in the hands of the shareholders, where such concerns should be.

D. The maximum individual income tax and the maximum corporate income tax rates should be put on a par, so that there is no inclination to game one form or the other.

A Continuing Battle: FLPs and FLLCs vs. S CORPORATIONS

Testimony embargoed until 3.7.2012 at 10am

Stefan F. Tucker, Esq.
Venable LLP
Washington, D.C.

March 2012

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Text not available until 3.7.2012 at 10am.

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	S Corporation	LLC
A. STRUCTURE		
Organizational structure	• A corporation may be treated as an S corporation only if it is a small business corporation • The corporation must be a domestic corporation that: 1. is not ineligible 2. does not have more than 100 SHs 3. does not have any SH that is other than an individual, estate, certain trusts or charitable organizations 4. does not have any SH that is a non-resident alien; and 5. does not have more than one class of stock (can have differences in voting rights)	• A limited liability company which has more than one member is a state law entity that is taxed as a partnership unless it makes an election otherwise • Any organizational requirements would be imposed under state law. For purposes of this chart, it is assumed that it is taxed as a partnership
Management structure	• Management is periodically elected by the owners • State law usually provides that the board of directors is to govern the affairs of a corporation	• Limited only by the owner's imagination (can be managed by managers or members, or both) • Can have representative management in a manager-managed LLC with elected managers • Managers do not have to stand for election • Managers may not have to be natural persons • Manager does not have to be a member • Can allocate different functions of the LLC to different managers • May cause member to become subject to self-employment tax

	S Corporation	LLC
Scope of managerial authority	• Function of state law	• Function of state law, but manager's authority is generally limited to that set forth in the operating agreement
Formalities / operational requirements	• New corporation must file S election with IRS within 2½ months after the earliest of the following: (i) the corporation has shareholders, (ii) acquires assets, or (iii) begins doing business. • Same state law requirements as a C corporation • Must have officers and directors • Annual meeting typically required (held at a time designated in the bylaws) – this is where shareholders vote to hire and fire directors and to vote on fundamental changes • Shareholder votes require unanimous written consent or a meeting that satisfies notice, quorum, and voting requirements • Officers are selected and removed by the Directors • Director action requires unanimous written consent or a meeting that satisfies notice, quorum, and voting requirements • Books, records of account, and minutes from shareholder meetings must be kept as part of the normal course of business • Annual reporting required	• Few legal requirements

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	S Corporation	LLC
Limitations on types of owners	• Nonresident aliens and entities other than certain trusts, estates, and tax-exempt shareholders may not own interests	• There are no limitations on who may be a member or manager
Number of owners	• No more than 100 shareholders	• One-member LLC allowed, but disregarded for Federal tax purposes. At least 2 members required to be taxed as partnership
Classes of ownership	• Limited to one class of stock	• No limit
Subsidiaries	• Wholly-owned corporation may elect QSub status • Wholly-owned LLC will be disregarded	• Wholly-owned LLC will be disregarded
Governing documents	• Articles of Incorporation, bylaws, shareholder agreement	• Articles of Organization or Certificate of Formation and Operating Agreement or LLC Agreement
Persons entitled to participate in ordinary decisions	• Directors and officers	• Members or managers, depending on state law and the operating agreement
Persons with authority to bind the organization	• Officers	• Members (member-managed LLC) or managers (manager-managed LLC), depending on state law and the operating agreement
Permissible participation in management	• Shareholders participate in management by electing directors	• Members or managers may participate in management, depending on state law and the operating agreement
B. TAXATION		
Taxation of the owner	• Each shareholder takes into account a pro rata share of the S corporation's items of income, deduction, loss and credit in the shareholder's taxable year in which the S corporation's taxable year ends • The character of any such item is determined at the entity level • The determination of	• Single member (disregarded entity) – net income from a single member LLC would be subject to self-employment tax unless one of the exceptions to taxation applied • Multiple Member – taxed as a partnership, and each member takes into account the allocated share of the LLC's items of income, deduction, loss and credit in the member's taxable year in which the LLC's taxable year ends

	S Corporation	LLC
	whether income from the discharge of an S corporation's debt is excluded from a shareholder's gross income because of insolvency or bankruptcy (under Section 108) is also determined at the entity level • Generally, the shareholders are directly taxed on the income of a corporation, whether distributed to them or retained by the corporation, and distributions are generally not taxed	• The character of any such item is determined at the entity level • However, the determination of whether income from the discharge of an LLC's debt is excluded from a member's gross income because of bankruptcy or insolvency (under Section 108) is determined at the member level • Generally, the members are directly taxed on the income of an LLC, whether distributed to them or retained by the LLC, and distributions are generally not taxed
Taxation of the organization	• Pass through • Generally not subject to tax, but an S corp. that was a C corp. and has C corp. earnings and profits must pay tax on excessive passive investment income and net recognized built-in gains • S corp. must file an information return – taxable income generally computed as though the S corp. is an individual, but any item that may have different tax treatment for different shareholders must be separately stated	• Pass through • Single member – disregarded for tax purposes • Any other LLC – subject to partnership taxation under Subchapter K unless a different classification is elected • LLC must file an information return – taxable income generally computed as though the LLC is an individual, but any item that may have different tax treatment for different members must be separately stated
Ability of owners to use losses of the organization	• Loss deductions are limited to the shareholder's stock basis and loans made by the shareholder to the corporation • Losses are deductible by the shareholders in proportion	• Single member – owner may use losses to offset other income, except as limited by at-risk rules and passive activity rules • Any other LLC – member may use losses of the LLC to offset other income as limited by basis, at risk

	S Corporation	LLC
	to their shares of ownership • Shareholder must satisfy at risk rules and passive activity loss rules • Shareholder may carry forward disallowed losses, which are treated as incurred by the S corporation in the next taxable year • Disallowed losses and deductions are personal to the shareholder and cannot be transferred	rules, and passive activity loss rules • A member interest is not treated as a "limited partner" interest for purposes of applying the passive activity loss rules
Assets that may be owned	• If an S corp. has earnings and profits from a prior year in which it was a C corp., and passive income in excess of 25% gross receipts, then its excessive passive income is subject to a 35% penalty tax. If the condition exists for 3 years, S corp. election terminates at the beginning of the 4th year	• An LLC is expressly authorized to hold real or personal property
Computation of basis	• Basis is initially the amount of cash contributed and the basis of property contributed • Increased by contributions to the corporation and loans to the corporation, BUT no increase in basis for debts of the corporation to any creditor, even if the shareholder is liable on the debt (however, the shareholder can take out a loan and then loan to the S corporation to get a basis increase)	• Basis is initially the amount of cash contributed and the basis of property contributed • Increased by contributions • Increased by member's share of the LLC's debts • No basis for contribution of promissory note until payments made on note (question as to whether this is applicable for the contribution of a personal promissory note)
Dealer property	• An S corp. is better suited to insulate owners from the	• By contrast, an LLC (like a partnership) is sometimes treated as an

	S Corporation	LLC
	taint caused by dealer property since the treatment of a corporation as an entity distinct from its shareholders is firmly entrenched in the law	aggregate of its partners rather than a separate entity
Sale of an interest in the organization	• Generally stock sales are treated as giving rise to capital gains and losses • Beginning in 2013, generally, a 3.8% Medicare investment tax will be imposed on the income earned on the disposition of an interest in an S corporation to the extent of the net gain that would be taken into account by the transferor if all property of the entity were sold for its FMV immediately before the disposition of such interest	• The sale of an interest in an LLC is generally treated as the sale of a capital asset • The sale of withdrawing member's interest will create a technical termination for the LLC, if 50% or more of the interest in the LLC is sold within a 12-month period. • Beginning in 2013, generally, a 3.8% Medicare investment tax will be imposed on the income earned on the disposition of an interest in an LLC to the extent of the net gain that would be taken into account by the transferor if all property of the entity were sold for its FMV immediately before the disposition of such interest
Sale of substantially all assets	• Gain or loss realized by the S corporation will pass through to its shareholders. Gain will increase a shareholder's basis so that no gain should be realized with respect to the receipt of sale proceeds by the shareholder. • Potential for two levels of tax, if any of the sold property is subject to built-in gains. • Generally, gain is eligible for the installment method	• Gain or loss realized by the LLC will pass through and be taxed to its members. A member's basis in its interest is increased by this gain, so that the distribution of sales proceeds is not subject to a second level of tax. • Generally, gain from the sale is eligible for the installment method
Disposition of ownership interest at a loss	• May yield ordinary loss under Section 1244	• Generally yields a capital loss

	S Corporation	LLC
Allocations	• Allocations of income, loss, deduction, or credit must be pro rata among shareholders • The profits and losses are allocated on a strict per share, per day basis	• Allocations may be made in any manner agreed upon by the members, so long as the allocations have substantial economic effect or are otherwise in accordance with the members' interests in the LLC
Contributions of property	• A contribution of property is taxable to the shareholder unless control tests are met and liabilities do not exceed the adjusted basis of the transferred property • Receipt of stock for services is taxable as compensation	• Generally tax free, unless "disguised sale" or member relieved of debt in excess of basis • Receipt of membership interest for services may be taxable as compensation for services rendered or may be treated as a "profits interest" or "promote interest" ultimately taxable as capital gain
Contributed property with a built-in gain or loss	• Unrecognized gain or loss from contributed property is shared by the shareholders on a per day, per share basis	• Built-in gain or loss must be allocated to the contributing member (who has the book/tax disparity)
Distributions of property	• Must be proportionate to stock ownership • A distribution of appreciated property will generally cause gain to be recognized at the corporate level (gain is recognized as if the property were sold for its fair market value on the date of distribution); such gain is shared pro rata among shareholders • The corporation does not recognize any realized loss for distributions of loss property • If an S corporation has no earnings and profits (from existence as a C Corp), amounts received by shareholders in distributions are tax free to the extent of the shareholder's basis;	• Need not be proportionate to LLC ownership. • Generally tax free, unless member is relieved of debt in excess of basis in partnership interest or money received by member is in excess of adjusted basis of membership interest or is a "disguised sale"

	S Corporation	LLC
	amounts received in excess of basis are treated as gain from the sale or exchange of an asset	
Tax-free reorganization	• Tax-free corporate reorganization provisions apply	• Tax-free corporate reorganization provisions do not apply
C. ESTATE PLANNING		
Owner's default right to payment on death	• The death of a shareholder does not require the corporation to repurchase the deceased shareholder's shares	• On the death of a member, if the business of the LLC is continued, the legal representative of the deceased member may have the value of the member's interest at the time of dissociation, or, if later, at the expiration of the term
Basis adjustment under Section 754	• Not applicable	• If a 754 election is not made, the sale of an appreciated LLC asset by the LLC causes the LLC, and therefore successor member (or estate of the deceased member), to recognize gain on the sale, even though the successor member or estate has a stepped up outside basis in his/her/its LLC interests • If a 754 election is made, the basis of the LLC's assets will be adjusted with respect to the successor member (or estate of the deceased member) thereby avoiding gain (on the difference between the old/deceased member's basis and the new member's stepped up basis) on the sale of the LLC asset • The outside basis for the new member/estate may be stepped down if the value of the asset has fallen below its basis; the 754 election would thus prevent the new member/estate from taking a loss on the sale of the asset
Non-tax reasons for entity ownership of real	• Non-voting stock can be used to shift ownership among family members without shifting control	• LLCs (like FLPs) allow the owner to control the management of real estate and establish a plan for succession, no matter who the members are

	S Corporation	LLC
estate		• Entities, like LLCs, protect the real estate from creditor claims that are made against any of the members or against any other real estate owned by a member in a different entity
Continuity of life / period of duration	• A corporation has perpetual duration unless limited in the Articles of Incorporation	• LLCs typically will have continuity of life in that the personal representative of the last remaining members may elect to continue the LLC

II. BUSINESS USE OF FLPs AND FLLCs

Real estate owners use entities such as Family Limited Partnerships ("FLPs") and Family Limited Liability Companies ("FLLCs") for several reasons, the most important of which are not tax related. These entities allow the owner to continue to control the management of the real estate and establish a plan for the succession of that management, no matter who the limited partners or members may be, which is imperative, given the specialized nature of real estate management and development. Furthermore, the entities protect the real estate from creditor claims that are made against any of the entity's owners or against any other real estate the individual owns, which presumably are held in separate entities. Finally, these entities provide many non-tax estate planning benefits, such as probate avoidance.

A. Retain Control over the Business.

1. The use of an FLP or FLLC allows older family members to transfer their property interests to younger family members while still retaining control over the transferred assets by acting as (i) the general partner ("GP") of an FLP (preferably through ownership of a separate limited liability entity), or (ii) the Manager of an FLLC.

a. Some older family members may not be ready to hand over control of the transferred property to younger family members.

b. Some younger family members may not be ready to assume control of the transferred property, either (i) because they are not old enough or (ii) because they lack the business knowledge and skills necessary for managing the transferred property.

2. The older family members will still be able to control the assets of the FLP or FLLC as the GP or Manager, even as they continue to transfer their interests in the FLP or FLLC through annual gift giving.

B. Provide Continuous Ownership of Property within the Family Unit.

1. The use of an FLP or FLLC allows the older family members to restrict the younger family members' ability to sell or transfer his or her interests.

2. Examples of these restrictions are:

a. Rights of first refusal;

b. Buy-sell provisions; and

c. Prohibitions on selling or transferring FLP or FLLC interests in a manner that is disruptive to (i) the entity or (ii) the family.

3. In all events, the entity agreement should provide that the other owners and the entity should have the first right to purchase the interest, if it is to be sold.

4. Older family members can continue to manage the assets while they adopt a plan for the succession of (i) ownership, (ii) management and (iii) control of the assets, regardless of who the limited partners or members may be. This is especially important when dealing with the specialized nature of real estate management and development.

C. Protect the Owners from Liability and Creditors of the Entity.

1. Owners of FLP and FLLC interests will be protected from the liability or creditors of the entity unless:

a. The owners are personally responsible for the act or omission that resulted in the liability;

b. The owners personally guaranteed the debts of the FLP or FLLC; or

c. The owners are liable as owners or operators under environmental law.

2. The use of more than one entity to hold ownership interests in real estate should be considered for the following reasons:

a. Claims against an entity's property (such as environmental claims) will only extend to the assets held in that entity, to the general partner's assets (if it's a partnership), or, if the general partner is a corporation or other entity, to such entity's assets.

b. Accordingly, if assets are held in different entities, the claims against one entity will not "taint" the assets in a separate entity.

c. As a result of the general partner's liability, consideration should be given to using a separate entity general partner for each partnership, since the entity general partner's interest in the other partnerships could be reached because of the claims against one partnership's assets.

D. Protect the Assets of the Entity from the Owners' Liability and Creditors.

1. FLPs and FLLCs protect the transferred property from creditor claims that are made against any of the entity's owners or against any other property the individual owns, which presumably is held in separate entities.

2. FLP and FLLC assets generally cannot be directly attached to satisfy the personal debts of the partners or members. The owners' creditors are typically left to the following three options:

a. Charging Order: A charging order is the court-ordered remedy of a creditor if the creditor is unable to force a partner or member to assign his or her interest. A charging order is neither an assignment nor an attachment. It is a court order that directs the entity to make any distributions to the owner's creditors that it otherwise would have made to the owner. Under many limited liability company statutes, a charging order is the only remedy a creditor possesses.

b. Assignment of partnership or LLC interest to a creditor: This occurs when a creditor is able to force an owner to assign his or her interest in the entity to the creditor. The creditor could become a partner or member (and, if a general partner interest or Manager interest is so assigned, control the entity) unless the entity's agreement provides otherwise.

c. Power to sell interest: If a creditor can establish that the claim may never be paid, a court may consider an order forcing the sale of the debtor's entity interest, although such an order is rare since a sale could cause a material adverse disruption to the entity. Even if such an order is obtained, the interest will have little value to an outside party, especially since the purchaser will merely become an assignee.

3. The use of more than one entity to hold ownership interests in real estate should be considered.

a. Creating more than one entity and choosing different jurisdictions for each entity will make it much more difficult on the part of a creditor to reach all of the assets, so that the creditor may decide to attempt to reach the interests in the entities closest to the creditor or to seek to reach only certain entities, leaving the rest undisturbed.

b. A creditor may be more likely to settle with a debtor who owns most of his or her assets in one or multiple FLPs or FLLCs in one or multiple jurisdictions.

c. However, there may be an adverse income tax consequence of creating more than one entity and holding different assets in different entities.

4. Owner's Right to Receive "Fair Value" upon Withdrawal or Dissolution.

a. Notwithstanding the right of an owner to receive fair value upon liquidation, the ambiguity of the term "fair value" may well provide protection against creditors. For creditor purposes, the agreement determines what rights the owners have to withdraw and liquidate his or her interest, and, further, the value such owner will get for his or her interest upon withdrawal.

b. The valuation of the interest to which an owner is entitled is binding on creditors as well. As a result, the agreement should address two goals: (i) making the entity interest as unattractive as possible to a creditor by imposing a method of valuing the interest that will result in the lowest value possible, and (ii) establishing a value that the family can afford to pay when buying the owner out of the entity. Generally, the basis on which value can be determined is either "going concern" value, under which the entity is valued as a ongoing business with no disruptions, including the element of goodwill, or "liquidation" value, which is the value the assets would bring if the owners were to sell all of the assets at one time for whatever they could obtain, without any element of goodwill. Obviously, valuing the interests by using the liquidation value method will result in a lower value. Furthermore, the agreement will either give the owner a pro rata percent of the entity assets, as valued either on a going concern or liquidation basis, or an amount after discounting the pro rata percent of the assets for the owner's minority interest in the entity. Again, the second alternative will result in a lower value for both creditor attachment purposes (thereby forcing the creditor to look elsewhere for repayment) and family repurchase purposes.

c. The disadvantage of these valuation alternatives is that they cannot be used only for creditor protection purposes if they are to withstand court scrutiny. As a result, there may be reasons that a owner wants to withdraw that have nothing to do with financial issues, but the entity must (in the absence of new negotiations) pay the owner this lower value, thereby forcing the owner to remain in the entity so that he or she may recoup his or her investment.

5. Convert Real Property to Personalty.

a. Being able to change the situs of personal property can also have creditor and tax advantages, although it is recommended that there be some ties to the jurisdiction selected so that the choice of jurisdiction is not perceived as shopping for the most favorable situs for creditor, probate or tax purposes.

b. As a result, it is possible to change the situs of real property by placing it into a partnership and moving the situs to a more favorable jurisdiction for probate (at least to the extent of moving the situs from the location of real estate to the decedent's domicile), state transfer tax and creditor purposes.

E. Litigation Avoidance.

1. The use of FLPs and FLLCs allow families to negotiate with each other to determine a means of managing the property without intra-family litigation. If the family members are beyond negotiation, then the entity agreement allows the parents/older generation a means of imposing a system of management on future owners.

2. The Partnership Agreement of an FLP or the Operating Agreement of an FLLC will typically include a provision requiring that arbitration will be used to settle family disputes over the entity's assets.

3. The operative Agreements can also include a provision that requires the losing party to the pay legal fees and costs incurred by the winning party during litigation or arbitration.

F. Probate Avoidance.

1. The use of FLPs and FLLCs may allow for probate avoidance.

a. A partnership or LLC interest is personalty; as a result, the situs of the entity may be established in any jurisdiction, including a foreign jurisdiction.

b. Real property not held in an entity is probated in the place where it is located.

c. Personal property, however, is subject to probate in the decedent's domicile and may even avoid probate all together, if the personal property is converted into a non-probate asset, such as transferring it to a revocable trust or into joint ownership.

d. As personalty, the real estate may, depending on state law, be subject to state estate tax in the descendant's state of residence and not in the state where the real estate is located.

G. More Advantageous Annual Gifting by Parents.

1. Giving undivided interests in real property directly to younger family members, compared to giving interests in an FLP or FLLC, is a simpler method of transfer. However, there are far greater disadvantages to direct giving.

a. As a tenant in common, the donee's interest will be subject to his creditors, who will at the least have the right to compel the sale of that tenant in common interest, and may have the right to compel the sale of the entire property, in order to satisfy their claims.

b. The property interest can be gifted or devised to any person, thereby leaving the remaining co-tenants with no control over their future co-owners.

c. Such interests will pass through probate upon each co-tenant's death with the resulting delay or other impediments in conveyancing.

H. More Flexible than Trusts.

1. The older family member will have greater management flexibility as a GP of an FLP or a Manager of an FLLC then they would if they were the trustee of a trust holding assets for the benefit of younger family members.

2. An FLP or FLLC is much easier to modify than a trust.

3. Transferring property to a trust would not provide for lack of control and lack of marketability discounts.

4. Trustees are held to a much higher standard (prudent person) than a GP in an FLP or a Manager in an FLLC.

Testimony embargoed until 3.7.2012 at 10am.

Chairman CAMP. Well, thank you, Mr. Tucker. And I think your personal background might even trump Dr. Kwall's.

Dr. Kwall, you are now recognized for five minutes.

STATEMENT OF JEFFREY L. KWALL, KATHLEEN AND BERNARD BEAZLEY PROFESSOR OF LAW, LOYOLA UNIVERSITY SCHOOL OF LAW, CHICAGO, ILLINOIS

Mr. KWALL. Chairman Camp, Ranking Member Levin, and distinguished Members of the Committee, thank you for inviting me to testify at this hearing. I would like to make a couple of suggestions today, with a goal of trying to reduce the extent to which the tax law distorts business decisions, and to simplify the law.

As you are aware, there are three principal closely-held business entities, corporations, partnerships, and limited liability companies. In addition, there are three alternative tax regimes that these enterprises can select from—two pass-through regimes, subchapter S, the S regime, and subchapter K, sometimes known as the partnership regime. I am going to call it the K regime.

And pass-through entity treatment, of course, means that the business does not pay tax. Instead, the income of the business is allocated among the individual owners. Each owner reports his or her share and pays tax at his or her marginal rate.

In addition to the two pass-through regimes, we also have a separate entity regime, the C corporation regime, that publicly traded companies are taxed under. But in addition, closely-held enterprises can also elect that regime, whereby there is a corporate-level tax, an entity-level tax on the business when it earns its income, and then a second tax on the owners of the business when profits are distributed.

I want to focus on the two pass-through systems, the S regime and the K regime. They both impose a single owner-level tax, but accessibility and the operation of the two systems are very different.

The S regime is a very restrictive regime. It only accommodates businesses where the owners agree to share economic profits consistently. In other words, each ownership interest has to have identical economic rights, meaning identical rights to distributions as well as liquidation proceeds. As a consequence, it is relatively easy to allocate the income of an S corporation among the owners. It is just a straight proportionate allocation. Everybody picks up their percentage share.

By contrast, the K regime, the partnership regime, accommodates any economic arrangement regardless of what the owners agree to. The owners can agree to splice and dice profits and losses however they want to do it. As a consequence, the K regime imposes on the tax law the burden of unraveling the economic arrangement of the owners to figure out what the proper tax reporting should be. That is difficult, if not impossible, because the partnership does not distribute its profits each year. You have got to be guessing in terms of how those profits would get distributed based on difficult agreements.

The tax rules attempting to ensure that the tax reporting matches the economic arrangement are complex and difficult to comply with. So by virtue of this situation, my proposal is that rather than having two pass-through systems, the tax law should have a single pass-through regime that applies to what I call simple enterprises, and a single entity-level tax, imposed on complex enterprises.

Now, ideally, all business income should be allocated among the owners and taxed at each owner's individual marginal tax rate. That ideal can be accomplished for simple enterprises, meaning a business entity with one class of ownership interests, regardless of whether that entity is a partnership, a corporation, or a limited liability company.

In the case of a simple enterprise, all you have to do is allocate the income and deductions proportionally among the owners unless the owners elect out; I would allow them to elect out of that system. And you would implement that system by simply refining the existing S corporation regime, which works reasonably well and has a long history.

The ideal of taxing the income to the owners, though, cannot be accomplished for complex enterprises, meaning any business entity with more than one class of ownership interests, regardless, again, of whether the entity is a corporation, a partnership, or a limited liability company.

In the case of a complex enterprise, my suggestion is that you tax the income to the entity when it is earned. If you tax the entity, then the tax law does not have to be concerned with how the owners are going to split up the profits and losses. And you can implement that by creating an entity-level tax and effectively eliminating the partnership regime.

So in conclusion, I would suggest replacing the current system of three elective alternative regimes with a pass-through system for simple enterprises and an entity-level tax on complex enterprises because I believe that would both reduce the impact of the tax law on the choice of business form decision—it would make it purely a business decision—and simplify the law.

Thank you for inviting me to participate in this hearing. I welcome your questions.

[The prepared statement of Mr. Kwall follows:]

Statement of Jeffrey L. Kwall
Kathleen and Bernard Beazley Professor of Law
Loyola University Chicago School of Law

Before the United States House Committee on Ways and Means
Tax Reform and Closely Held Business Entities

March 7, 2012

Chairman Camp, Ranking Member Levin, and distinguished members of the Committee, thank you for inviting me to testify at this hearing.

The income taxation of closely-held business entities is clearly in need of reform. The principal closely-held business forms are corporations, partnerships, and limited liability companies.[1] Under current law, these enterprises may be taxed under one of three alternative regimes.

Most closely-held business entities are taxed as "pass-through" entities. As such, the income of the entity is taxed once, directly to the owners with each owner reporting his or her share of the entity's income. No further tax is generally imposed when the entity distributes its profits. Pass-through entity treatment is conferred by two alternative regimes ("Subchapter S" and "Subchapter K"). The Subchapter S regime is potentially available to all business forms, provided its eligibility requirements are satisfied. By contrast, only unincorporated enterprises can access the Subchapter K regime.

Other closely-held business entities are not taxed as pass-through entities. Rather, these entities are taxed like publicly-traded companies under the "Subchapter C" regime. As such, their income is subject to both an entity-level tax when it is earned and an owner-level tax when profits are distributed. Under current law, the Subchapter C regime generally imposes disproportionately high tax costs and is therefore not desired by closely-held entities. As explained below, most of the closely-held businesses that use this regime are either trapped in it or endeavoring to exploit its rate structure.

The existence of three alternative regimes, each with different tax effects, causes business owners to be unduly influenced by tax considerations when deciding how to organize and operate a business. This results in unfairness, inefficiency and complexity. I have previously written at length on how these effects might be ameliorated[2] and would like to focus on four recommendations today:

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[1] The majority of small businesses are sole proprietorships which are not business entities.
[2] Jeffrey L. Kwall, *"Taxing Private Enterprise in the New Millennium,"* 51 Tax Lawyer 229 (1998).

1. The manner in which closely-held business entities are taxed should depend on the complexity of the business arrangement, not the legal form of the business.

2. A single, *owner-level* tax should be imposed on the income of "simple" closely-held businesses under a pass-through system resembling current law's "S regime."

3. A single, *entity-level* tax should be imposed on the income of "complex" closely-held businesses to relieve the tax law of the burden of allocating the income of a "complex" entity among its owners. This entity-level tax would replace current law's "K regime."

4. Closely-held businesses should be excluded from current law's, double-tax "C regime."

Background

Historically, corporations and partnerships were the principal forms in which businesses, other than sole proprietorships, were conducted. Corporations have long been treated as separate legal entities under state law and as separate taxpaying entities under federal law. By contrast, partnerships were historically small, informal arrangements regarded as mere extensions of their owners, and accordingly, partnership income was taxed directly to the partners. Little overlap existed between the types of businesses that organized as corporations or partnerships. From a state law standpoint, however, a major factor distinguished corporations from partnerships. The liability of corporate shareholders was limited to their investment in the corporation. By contrast, partners had unlimited liability for claims against the partnership.[3]

Both large and small corporations were subject to the C regime through the first half of the twentieth century. The C regime has always been highly controversial because of its double taxation feature. Commentators have long called for the corporate tax and the shareholder tax to be integrated so that the C regime imposes the same tax burdens as the single individual tax imposed on pass-through entities.[4] Integration, however, has yet to be adopted, and it appears the C regime in its current form will continue to govern almost all publicly-traded entities.

During the 1950s, the pass-through alternatives to the C regime advanced dramatically. Prior to 1954, partnerships and partners had been taxed under rudimentary rules. As part of the 1954 Internal Revenue Code, a detailed pass-through system was enacted for partnerships in the

[3] Limited partnerships, however, conferred limited liability on all partners except for at least one partner with unlimited liability.

[4] See, e.g., Michael J. Graetz & Alvin C. Warren, Jr., eds., INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS (1998).

form of the K regime. Access to the K regime was broadly granted provided the enterprise had at least two owners and was not incorporated. Implicitly, it appeared that unlimited liability for at least one owner was the price imposed to gain access to the K regime. Beyond that, however, the partnership regime accommodated virtually any business arrangement regardless of its level of complexity. For the tax reporting of partnership income and loss to be respected, it had to be consistent with the economic arrangement of the partners. Because most partnerships involved relatively simple arrangements at this time, the flexibility of the system did not pose major difficulties.

In 1958, the S regime was enacted as a pass-through alternative for closely-held corporations. Unlike the K regime, the S regime was extremely restrictive. Originally, a corporation could have no more than 10 shareholders to be eligible for the S regime.[5] More significantly, the S regime was only accessible to a corporation that issued a single class of stock, i.e., all shares of stock issued by the corporation were required to confer identical economic rights on the owner. This restriction dramatically simplified the operation of the S regime by necessitating a straightforward proportionate allocation of all corporate income and loss among the shareholders of the enterprise. Corporate shareholders who opted to use multiple classes of stock were relegated to the double taxation of the C regime.

The passage of time took a toll on this system. Until the latter part of the 20th century, limited pressures were imposed on the boundaries of the S and K regimes. During this period, the C regime, notwithstanding its double taxation, was the regime of choice. At this time, the corporate tax was a relatively low tax and the much higher shareholder tax was not imposed until dividends were paid. Hence, the second and more costly tax under the C regime could often be deferred or avoided. As a result, profitable closely-held enterprises normally aspired to the C regime. Thus, the S regime was not heavily utilized at this time.

Beginning in the 1960s, tax shelter activity took off and the K regime was utilized in a more aggressive fashion. The flexible loss allocation rules of the K regime were exploited by partners who disproportionately allocated deductions to investors desiring to shelter income from taxes. Although voluminous complex regulations governing income and loss allocations were promulgated to deter this conduct, it has proven extremely difficult to devise a system that ensures proper tax reporting when partners enter into complex allocation arrangements.

Even greater pressures were imposed on both the S and K regimes when, in the 1980s, individual tax rates were dramatically reduced. As a result of these individual rate reductions, corporate tax rates exceeded individual rates for the first time ever. This relationship created undue pressure to avoid and escape from the C regime. Closely-held corporations flocked to the S regime and the number of enterprises operating under that regime has exploded in the past few

[5] The shareholder limit has since been increased to 100 shareholders.

decades. In addition, the K regime that had been serving as the bastion of tax shelter activity was now besieged by profitable enterprises hoping to escape the higher corporate tax. Congress quickly prohibited publicly-traded enterprises from utilizing the K regime[6] but did nothing to staunch the exodus by profitable closely-held enterprises.

In a burst of activity during the late 20th century, state legislatures created a myriad of new business forms that conferred limited liability on all owners of the enterprise, most notably the limited liability company. Within a short period of time, all fifty states enacted limited liability company legislation. As a result, business owners no longer needed to incorporate to achieve limited liability. Hence, the historic connections between the C regime and limited liability, and the K regime and unlimited liability had disappeared. As such, regulations were promulgated in the late 1990's to allow eligible unincorporated enterprises to access the "C" and "S" regimes by electing such treatment. Efforts to permit incorporated enterprises to elect access to the "K" regime, however, have been rebuffed to date.[7]

As a result of all these developments, a hodge podge of tax alternatives for closely-held entities now exists. Consequently, tax considerations significantly influence the choice of business form decision. This leads to unfairness, inefficiency and complexity that could be mitigated with a series of incremental steps that are discussed below.

1. The manner in which closely-held business entities are taxed should depend on the complexity of the business arrangement, not the legal form of the business.

Historically, access to the different tax regimes depended on the legal form of the business. Corporations utilized the "C" and "S" regimes and partnerships utilized the "K" regime. Limited liability was the original hallmark of this distinction. With the advent of the limited liability company, an unincorporated enterprise that bestows limited liability on all of its owners, it makes no sense to allow the legal form of the business to impact the tax regime that governs that business. The Treasury's decision to allow unincorporated business entities access to the "C" and "S" regimes recognizes this reality. However, incorporated enterprises remain legislatively blocked from accessing the "K" regime. That block cannot be justified, and if the status quo is maintained, it would be sensible for Congress to allow closely-held corporations elective access to the "K" regime.[8]

The different legal forms in which a business might be conducted no longer create a need for multiple tax regimes. It nevertheless remains unlikely that a single tax regime could be

[6] I.R.C. § 7704 (relegating most non-corporate publicly traded entities to the C regime).
[7] See, e.g., H.R. 4137, 108th Cong. (2004) (permitting certain non publicly traded corporations to elect to be taxed as partnerships under Subchapter K).
[8] The need for this change would be eliminated if an entity-level tax is imposed on complex closely-held entities (recommendation 3, below), because in that event, the K regime will no longer exist.

designed to accommodate the endless variety of economic arrangements that the owners of closely-held entities might use. These arrangements range from a straightforward proportionate sharing of profits and losses to complicated special allocations of individual items of profits and losses. Rather, two tax regimes should be applied to closely-held business entities: one primary regime that governs the "simple" entity, and an alternative default regime that governs the "complex" entity.[9]

2. A single, owner-level tax should be imposed on the income of "simple" closely-held businesses under a pass-through system resembling current law's "S regime."

An equitable income tax imposes equal burdens on similarly situated individuals. Hence, an equitable income tax should cause the income of any business, regardless of legal form, to be taxed directly to the individual owners of the business with each owner reporting his or her share on the owner's personal tax return. This treatment would cause the income attributable to each owner to be taxed at the individual marginal tax rate of the owner. It would create a level playing field and minimize the influence of the tax law on the choice of the form in which to conduct a business.

Unfortunately, it is not practical to tax all business income to the owners of the enterprise. In the case of publicly traded enterprises where many different classes of stock might be issued and where stock is changing hands every second, it would be virtually impossible to allocate the income of the business directly to the owners of the enterprise. As will be explained in greater detail below, even in a non-publicly traded enterprise, where the owners enter into an economic arrangement that creates ownership interests with differing economic rights, the process of allocating the enterprise's income among the owners is extremely difficult. However, when an enterprise issues a single class of ownership interests and each share confers identical economic rights, the process of allocating the enterprise's income among the owners is relatively straightforward.[10]

Hence, a somewhat modified version of the S regime should serve as the normal regime for all closely-held business entities that issue a single class of ownership interests, regardless of whether the business is conducted by a corporation, partnership or limited liability company.[11]

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[9] Other commentators have advocated a similar dichotomy. See, e.g., George K. Yin, *"The Future of Private Business Firms,"* 4 Florida Tax Review 141 (1999); Lawrence Lokken, *"Taxation of Private Business Firms: Imagine a Future Without Subchapter K,"* 4 Florida Tax Review 249 (1999). For a recent compilation of the commentary on this subject, see Martin A. Sullivan, "Business Tax Reform from the Bottom Up," 133 Tax Notes 263 (2011).

[10] Transfers of ownership interests during the year create some complexity but mechanisms exist to deal with these situations. See I.R.C. § 1377(a)(2).

[11] Owners of simple businesses should be permitted to elect out of the modified S regime and instead be subject to the entity-level tax imposed on complex businesses, discussed below. This election might be made if the business needs to reinvest all profits and cannot make cash distributions to owners who would not otherwise have the liquidity to pay an owner-level tax.

The S regime should be expanded beyond its current limits to the extent that doing so does not undermine the simplicity with which the regime can be administered or jeopardize tax collection.[12] The S regime is extremely popular[13] and works well.[14] It is desirable to build on that success by applying a modified S regime to all closely-held enterprises with simple ownership arrangements.

3. A single, entity-level tax should be imposed on the income of "complex" closely-held businesses to relieve the tax law of the burden of allocating the income of a "complex" entity among its owners. This entity-level tax would replace current law's "K regime."

Ideally, all closely-held business entities would be subject to a single owner-level tax. Unfortunately, the history of the K regime has shown that devising a system to ensure that income and losses are properly allocated among owners who utilize multiple classes of ownership interests is extremely difficult, if not impossible. Some commentators believe that the K regime can be reformed to accomplish this goal.[15] Even if such a system could be devised, it would be extremely complex and undoubtedly difficult to administer.

The formidable nature of the problem is readily apparent. Clearly, the owners of an enterprise should be allowed to reach whatever economic arrangement they desire, regardless of how complex or convoluted the arrangement might be. Just as clearly, the income of such an enterprise must be taxed at the time it is earned just like the income of any other enterprise. Hence, if an owner-level tax is to be imposed, the tax law is burdened with the task of unraveling the economic arrangement to determine how much of the profit or loss is attributable to each of the owners. The law cannot wait until the profits are actually distributed and follow where they go because they frequently will not be distributed in the year they are earned.

The tax law should not be burdened with the task of unraveling complex economic arrangements. Even if it were capable of doing so, it is unlikely the resulting system would be administrable. This can be seen from the current operation of the "K" regime. Cautious taxpayers attempting to comply are faced with immense burdens. Aggressive taxpayers can utilize the complexity of these rules as an excuse for non-compliance.

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[12] For example, the issuance of preferred ownership interests that closely resemble debt should not bar an enterprise from access to the simple regime. On the other hand, a U.S. enterprise with foreign owners outside the U.S. taxing jurisdiction should be taxed at the entity level, rather than the owner level.

[13] In 2010, roughly 4.4 million enterprises reported under the S regime, 3.4 million reported under the K regime, and 2 million reported under the C regime. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME BULLETIN 365 Table 22 (Spring 2011).

[14] The current S regime is not without its flaws. For example, employee-owners of an S Corporation sometimes camouflage compensation for services as a distribution of previously taxed profits to avoid liability for Social Security and Medicare payroll taxes. Various proposals have been made to address this problem.

[15] See, e.g., Yin, *supra* note 9.

The best solution to the problems of imposing an owner-level tax on the "complex" closely-held enterprise is, instead, to impose a single, entity-level tax on the income of the enterprise.[16] When the entity-level tax applies, the owners would not be taxed directly on the income of the business. The entity-level tax would be a relatively simple way of ensuring that all income of the enterprise is taxed when it is earned. This system also allows the owners of the enterprise to use as complicated an economic arrangement as they like.

Not surprisingly, an entity-level tax like the one proposed will present a variety of operational issues. For example, the entity-level tax should probably be imposed at the maximum individual tax rate. Otherwise, the tax law would create an incentive for owners utilizing simple economic arrangements to gravitate to the entity-level tax regime and thereby avoid the higher individual tax rates imposed on a simple enterprise governed by the modified "S" regime. Imposing an entity level tax at the highest individual marginal rate might be seen as unfair to the owners of a complex entity who are not subject to the highest marginal tax rate. However, the entity-level tax is clearly a default regime – it applies when the owners choose a more complex economic arrangement.[17] As such, any additional tax burden resulting from an entity-level tax would represent a predictable cost imposed on those owners opting to utilize a complex economic arrangement.[18]

4. Closely-held businesses should be excluded from current law's, double-tax "C regime."

If Recommendations 2 and 3 are accepted, Recommendation 4 will automatically result. Pursuant to Recommendation 2, "simple" closely-held entities will be governed by a modified "S" regime. Pursuant to Recommendation 3, "complex" closely-held entities will be governed by the default regime which imposes a single, entity-level tax on the income of complex enterprises. As a result, no closely-held business would be governed by the C regime.

Even if Recommendations 2 and 3 are not accepted, the C regime should no longer be offered as an option to any closely-held entity. Most new businesses will routinely avoid the C regime in light of the current corporate and individual rate structure, and the fact that corporate capital gains are not taxed at a lower rate than other corporate income. Utilizing the C regime effectively locks in a 34% or 35% corporate tax on the sale of a successful business, in addition to a 15% shareholder capital gains tax. By contrast, the sale of a similarly situated pass-through

[16] See, e.g., Lokken, *supra* note 9 (favoring an entity level tax on complex enterprises); but see Yin, *supra* note 9 (favoring an owner level tax on these businesses).
[17] The entity-tax regime would also apply if a simple entity elected such treatment. See *supra*, fn 11.
[18] Additional rules would be needed to ensure that a U.S. tax could be collected from U.S. owned, foreign enterprises

entity generally results in a single, 15% capital gains tax. Thus, new business owners anticipating great success will not normally choose the C regime.

The closely-held businesses that currently utilize the C regime fall primarily into one of two categories. First, some closely-held corporations are not eligible for S regime status. Moreover, they cannot access the K regime because of their status as corporations. If they disincorporated, the same high tax costs resulting from a sale of the business would occur; namely, a 34% or 35% corporate tax and a 15% shareholder tax. Hence, these businesses are trapped in the C regime.

Other closely-held businesses use the C regime to exploit the lower marginal tax rates that apply to the first $75,000 of corporate income. Specifically, the first $50,000 of corporate income is taxed at a 15% rate and the next $25,000 of corporate income is taxed at a 25% rate. By contrast, business owners are taxed at a maximum individual rate of 35% in 2012. Thus, owners expecting their business to generate a low level of income might be induced to incorporate the business to reduce the immediate tax otherwise imposed on that income. This practice would cease if closely-held enterprises were denied access to the C regime.[19]

Eliminating the C regime as an option for closely-held businesses would help level the playing field and thereby advance fairness and efficiency. It would also allow for significant simplification.[20]

Conclusion

The impact of the three alternative tax regimes that apply to closely-held business entities is largely the result of random historical developments. As such, the current system often distorts business decisions and creates needless complexity.

Quite clearly, a pass-through regime for all closely-held enterprises would be the ideal. In light of recent developments, the time is ripe for establishing this result where such a system can be effectively administered. Specifically, the income of any closely-held enterprise, regardless of its form, should be taxed directly to the owners of the enterprise when the economic relationship among the owners accommodates this result. As such, all "simple" enterprises, enterprises where all ownership interests confer identical economic rights, should be taxed under a pass-through system. A single owner-level tax would be assessed against the income at the time it is earned, and each owner's share would be taxed at his or her own marginal rate.

[19] The practice could also be stopped by simply taxing all corporate income at a flat, single rate. See Jeffrey L. Kwall, *"The Repeal of Corporate Graduated Tax Rates,"* 131 TAX NOTES 1395 (2011).

[20] For example, if closely-held entities could not operate under the "C" regime, the corporate penalty taxes could be repealed. See I.R.C. §§531-537, 541-547. Also, the redemption rules could be simplified. See I.R.C. § 302.

With regard to those closely-held enterprises with multiple-classes of ownership interests, the pass-through entity approach should be abandoned. Instead of forcing the tax law to sort out the economic relations among the owners, a single, entity-level tax should be imposed. No further tax would normally be imposed at the owner level when distributions are made. Although the entity-level tax might be imposed at a higher rate than some owners would pay if they were taxed directly on the enfity's income, the difference constitutes a predictable cost of a complex economic arrangement.

Replacing the current system of three elective alternative regimes with a general system for simple enterprises and a default system for complex enterprises would advance tax fairness, efficiency and simplicity.[21] Now is an ideal time for Congress to improve the system.

Thank you for inviting me to participate in this hearing. I welcome your questions.

Testimony embargoed until 3.7.2012 at 10am

[21] Transition issues must be addressed, but they do not seem insurmountable.

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Chairman CAMP. Well, thank you very much. Appreciate your testimony.

Mr. Nichols, you are recognized for five minutes.

STATEMENT OF THOMAS J. NICHOLS, MEISSNER TIERNEY FISHER & NICHOLS S.C., MILWAUKEE, WISCONSIN

Mr. NICHOLS. Thank you. Chairman Camp, Ranking Member Levin, Members of the Committee, thank you very much for the op-

portunity to testify today on the important topic of the treatment of closely-held businesses in the context of tax reform. My testimony today reflects the views that I have developed over 30 years as a tax professional, working with closely-held business entities, as well as my role as an advisor to the S Corporation Association.

When I first started practicing law in 1979, the top individual tax rate was 70 percent and the top income tax rates for C corporations was only 46 percent. This rate differential provided a tremendous incentive for successful business owners to elect C corporation status. The devil's bargain was that those lower taxed earnings were supposed to be taxed again when distributed out to the shareholders, resulting in an aggregate cumulative tax burden of 84 percent.

This tax dynamic set up a cat-and-mouse game between the IRS and taxpayers, whereby shareholders sought to pull money out of their corporations in transactions that avoided the ordinary income tax rates, or to accumulate wealth inside corporations and indefinitely delay the second layer of tax. This is described in more detail in my written comments. The only winner in this struggle was the tax lawyers.

The bipartisan Tax Reform Act of 1986 changed all this. It altered the relative C corporation and individual rates so that businesses were no longer forced into C corporation double-tax status.

This allowed most closely-held business owners to migrate into the more rational single-tax pass-through system, which eliminated the need for all of that gaming that I described. This system has worked well for businesses and the country in the intervening years, and retaining these benefits will be critical to the success of any future tax reform efforts.

Unfortunately, this favorable relative rate structure is now at risk. Right now, the top rate for C corporation and S corporation retained earnings is 35 percent. However, unless there is a change in the law, as shown in chart 4 in my materials, the top rate for pass-throughs will rise to nearly 45 percent next year for partnerships and S corporations in certain circumstances, while the top rate on C corporations will remain the same. There are also proposals for a C corporation-only tax rate reduction, which would make the wedge between C corporations and pass-through businesses even larger.

Instead, I believe that Congress should build on the reforms started in 1986, including continuing to move businesses toward a single-tax system, keeping the top rates for corporate, pass-through and individual income the same, and implementing tax reform on a basis that is comprehensive and not piecemeal.

Focusing merely on the headline C corporation marginal rate and broadening the tax base for all businesses unavoidably increases the tax burden for closely-held pass-through entities. Since pass-through business owners employ over half the workforce in this country, lowering the marginal rate for all businesses should be the goal of comprehensive tax reform.

In light of that, it would be appropriate to facilitate the continued transition away from the C corporation double-tax system for as many entities as possible, including maintaining the holding period for the built-in gains tax at five years, as proposed in H.R.

1478, introduced by Representatives Reichert and Kind, and several other proposals that are described in my written testimony. Adopting any or all of these changes would continue the trend begun with the Tax Reform Act of 1986 toward a more transparent, less artificial single-tax system for closely-held business.

A couple of other observations. Probably the most important reform for closely-held businesses would be the possibility of extending and/or expanding the option of expensing investments in capital equipment.

Most closely-held business owners intuitively evaluate their business on the basis of cash flow rather than financial statement net income; that is a matter of survival for them. For companies without access to capital markets, expensing is important.

Others have suggested forcing the double tax on large pass-through entities, say, entities with gross receipts over $50 million. My written testimony outlines a whole host of problems with trying to implement such an arbitrary rule. Here I would just observe that if the goal of reform is to make American businesses more competitive, why would you force more employers into the punitive double-tax regime?

One last tax reform proposal is the possibility of forcing all pass-through entities into a single, uniform structure. If I were designing a system from scratch, I would consider doing this.

However, we already have roughly 4 million S corporations and 3 million partnerships. Any such proposal would unavoidably impose substantial additional tax and compliance costs on a substantial number of ongoing businesses, either the partnerships or the S corporations. I do not see any benefits that would necessarily justify such substantial a cost.

That concludes my oral comments. Once again, I would like to thank the committee, and answer any questions you may have.

[The prepared statement of Mr. Nichols follows:]

TESTIMONY BEFORE THE COMMITTEE ON WAYS & MEANS UNITED STATES HOUSE OF REPRESENTATIVES

Thomas J. Nichols, J.D., CPA[1]
March 7, 2012

Testimony Submitted March 7, 2012

Chairman Camp, Ranking Member Levin and Members of the Committee, thank you for the opportunity to testify today on the important topic of the treatment of closely-held businesses in the context of tax reform. My testimony today reflects views that I have developed over more than three decades as a tax professional working with closely-held business entities, as well as my role as an advisor to the S Corporation Association.

A. Overview

The bipartisan Tax Reform Act of 1986 ("TRA '86") was a landmark piece of tax legislation. It allowed many closely-held business owners to migrate into a more rational single tax pass-through system, and in the process reduced their incentive to engage in expensive and sophisticated strategies in order to mitigate the onerous effects of the C corporation double tax rules. The system engendered by the TRA '86 has worked well for businesses and the country in the intervening years, and retaining these benefits will be critical to the success of any future tax reform efforts. In this regard, I respectfully submit the following general considerations regarding tax reform:

First, as much as possible, the business tax system in the United States should move toward a single tax structure, and away from the punitive double tax C corporation system. Especially for closely-held businesses, a single tax system substantially reduces complexity and eliminates the opportunity and incentive for non-productive tax planning and strategizing. Moreover, it has the benefits of simplicity and transparency.

Second, broadening the tax base and lowering and flattening the tax rates would serve all segments of society. Closely-held and other business owners respond to incentives. The lower the rate on a given amount of marginal income, the more likely it is that a business owner is going to expend the effort and take the risks in order to earn that income, and the less effort he or she will expend trying to defer or otherwise mitigate the tax consequences of having done so. Business owners will aggressively grow their businesses only if they have confidence that they can make money over the upcoming years and not be subject to punitive tax rates. They intuitively know that the country cannot generate enough revenue to solve all of its problems (much less those of the rest of the world) merely by taxing "the rich." However, they are afraid that they may be the first casualties in an ill-fated attempt to do so. This fear is depressing economic activity now.

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[1] President and Shareholder, Meissner Tierney Fisher & Nichols S.C.

Third, it is important that whatever tax reform is implemented be comprehensive. Focusing merely on the top C corporation marginal rate, and broadening the tax base for all business taxpayers in order to pay for it, unavoidably increases the tax burden for closely-held business owners, because, as I will explain, the large majority of closely-held businesses are operated through single tax pass-through entities and not as C corporations. Since pass-through business owners employ over half of the workforce in the country, lowering the tax rate for all taxpayers (rather than just the headline rate for C corporations) should be the goal of comprehensive tax reform.

In light of the above, it would be appropriate for Congress to consider proposals to facilitate the transition from double tax C corporation status to S corporation status for as many entities as possible. I understand that there has always been a reluctance to allow C corporations to convert on a tax-free basis to partnership status other than through a fully taxable transaction. However, Congress has allowed, in fact encouraged, C corporations to convert to S status over the years.

Among the steps that could be taken to facilitate such conversion are the following:

1. The shorter, five-year holding period for the built-in gains tax should be, at the least, extended as proposed in H.R. 1478, introduced by Representatives Reichert (R-WA) and Kind (D-WI) and cosponsored by several of your colleagues. The built-in gains tax was originally intended to prevent C corporations from avoiding the double tax on the sale of business.[2] However, as I will explain in more detail later in my testimony, the C corporation income tax rates have not been significantly more favorable than the individual rates during the approximately 25 years since the TRA '86, and all newly-formed business have been able to choose pass-through treatment at inception and avoid double tax C corporation treatment altogether during that period. Imposing a penalty on corporations now seeking to convert to S corporation status in these circumstances does not seem warranted. Moreover, during times of economic stress such as we are experiencing now when access to capital is impaired, forcing businesses to sit on under-utilized capital for a decade is counterproductive. In light of the above, at this point, it clearly seems appropriate to allow C corporations to convert to S status without the imposition of the additional forced double tax regime of the built-in gains tax as the price of that election. At the least, reducing that period to five years, as has recently been done by Congress on a temporary basis, clearly is warranted.

2. The restrictions on eligible shareholders of S corporations should be reduced or eliminated in return for subjecting the income attributable to such shareholders to tax, perhaps even at the top rate. The original prohibitions against foreign and tax-exempt shareholders were designed to prevent income from avoiding tax at the corporate level and then being non-taxable at the shareholder level also. Congress has already expanded the S corporation shareholder eligibility rules to include electing small business trusts and most tax-exempt entities, while at the same time subjecting the income attributable to such trusts and entities to tax at the 35 percent rate. It appears that this principle could be expanded to all otherwise ineligible shareholders, including non-resident aliens, partnerships, etc.

[2] *See, e.g.*, H.R. Conf. & Rep. No. 99-891 at 198-99.

3. This is also an appropriate time to consider increasing the S corporation numerical shareholder limitation to a more policy-based level, rather than the unavoidably arbitrary 100-shareholder cutoff. As will be noted later in my testimony, partnerships are required to apply the double tax C corporation regime only when they are publicly traded. It seems appropriate that corporations be allowed to maintain their status as a pass-through entity in the same fashion, i.e., unless and until they choose to take advantage of this country's robust public markets.

Adopting any or all of these changes to increase the availability of S corporation status would continue the trend begun with TRA '86 to a more transparent, less artificial single tax system for closely-held business.

B. Historical Perspective

When I first started practicing law in 1979, the top individual income tax rate was 70 percent,[3] whereas the top income tax rate for corporations taxed at the entity level ("C corporations") was only 46 percent.[4] This rate differential obviously provided a tremendous incentive for successful business owners to have as much of their income as possible taxed, at least initially, at the C corporation tax rates, rather than at the individual tax rates, which were more than 50 percent higher.

The problem, however, with this approach under the old regime was that those after-tax earnings at the corporate level were supposed to be taxed again at ordinary income tax rates when ultimately distributed to the individual shareholders, resulting in an aggregate cumulative tax burden of 83.8 percent,[5] and this is even before taking state income taxes into account. There were some limited exceptions to this extremely high marginal tax rate system, such as the step-up in basis upon death[6] and the sale of assets in connection with the complete liquidation of the corporation.[7] However, these alternatives generally involved the complete liquidation of either the corporation or the individual taxpayer, which, for obvious reasons, was not always the preferred alternative.

This tax dynamic set up a cat and mouse game between Congress, the Department of the Treasury and the Internal Revenue Service (the "Service") on the one hand and taxpayers and their advisors on the other, whereby C corporation shareholders sought to pull money out of their corporations in transactions that would subject them to the more favorable capital gains rates that were prevalent during this period or to accumulate wealth inside the corporations. Congress reacted by enacting numerous provisions that were intended to force C corporation shareholders to pay the full double tax, efforts that were only partially successful. These provisions included Internal Revenue Code (the "Code") Sections 302 (treating certain redemptions of corporate stock as "dividends") and 304 (treating the purchase of stock in related corporations as "dividends"), as well as Code Sections 531 (imposing a tax on earnings retained inside the

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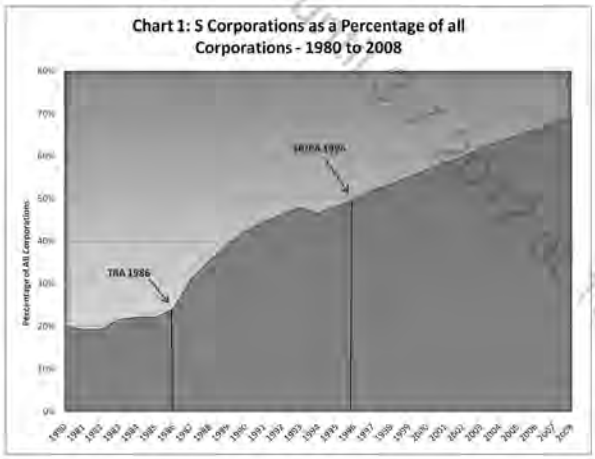
[3] I.R.C. § 1 (1979).
[4] I.R.C. § 11 (1979).
[5] 46% + 70% x (1-46%) = 83.8%.
[6] I.R.C. § 1014.
[7] I.R.C. § 337 (1986).

corporation other than "for the reasonable needs of the business") and 541 (imposing a tax on the undistributed income of "personal holdings companies" deriving most of their gross income from investments).

Since the taxes at stake could be substantial, the tax opportunities and pitfalls inherent in this system provided tax advisors with a significant source of business. For example, Section 1.537-1(b)(1) of the Treasury Regulations provides that "the corporation must have specific, definite, and feasible plans for the use of such accumulation" in order for such plans to be taken into account for purposes of justifying such accumulation and avoiding the accumulated earnings tax. This led many closely-held business owners to hire attorneys to hold meetings and/or draft corporate minutes when they would otherwise not have incurred the time and expense of documenting such plans so formally.

C. Tax Reform Act of 1986

This system started to change with the Economic Recovery Tax Act of 1981 ("ERTA"), which lowered the top individual income tax rate down to 50 percent, i.e., only four percentage points higher than the 46 percent top corporate income tax rate. The prior tax dynamic was even more permanently altered with the TRA '86, which lowered the top individual income tax rate down to 28 percent, the lowest it had been in 57 years. TRA '86 also lowered the top corporate rate, but only to 34 percent. Thus, the relative top tax rate preference for income earned inside and outside of C corporations was actually reversed. That situation did not last long, and today the top income tax rate for both C corporations and individuals is the same, namely 35 percent.



These TRA '86 changes brought about a dramatic shift in the tax structure for closely-held business owners throughout America. As shown in Chart 1, the number of corporations

electing to have corporate income passed through to the shareholders and taxed at the individual level ("S corporations") grew from a little over 20 percent in 1986 to almost 70 percent in 2008 (the last year for which such statistics are currently available). In addition, with the enactment of limited liability company statutes throughout the states during the 1990's and promulgation of the "check-the-box" Treasury Regulations in 1997, business owners were provided with the additional flexibility to have a corporate-like business entity under state law treated as a "partnership" under the Code, which also involved "pass-through" taxation at the individual, rather than at the entity, level.

Thus, closely-held business owners had two alternative "pass-through" taxation structures to choose from: S corporations (the tax rules for which were more restrictive, but much simpler) and partnerships. Chart 2 shows that substantial numbers of closely-held business owners have chosen each of these alternative tax structures, resulting in approximately 4 million S corporations and approximately 3 million partnerships as of the end of calendar year 2008. It should be noted that the partnership category covers a variety of non-corporate business entities, including limited liability companies, general partnerships, limited partnerships, limited liability partnerships and even limited liability limited partnerships, and also includes non-corporate entities formed by publicly held companies. The bottom line is that, although S corporation status appears to be more popular, a very substantial number of pass-through entities have chosen to be taxed as partnerships.

There are a number of policy reasons why S corporations are an excellent vehicle for the conduct of closely-held businesses. First, at current regular rates, the double tax C corporation regime would impose a top marginal federal income tax rate of 57.8 percent,[8] even before the consideration of state income taxes. That is a punishing tax rate for closely-held business owners who correctly perceive their business entities as the extension of their own personal business efforts.

[8] 35% + 35% x (1-35%) = 57.75%.

Second, imposing the tax at the individual level has the benefits of complete transparency in terms of who is actually paying the tax, as well as reinforcing whatever progressivity Congress decides to retain in the tax system. As Eric Toder of the Tax Policy Center told the Senate Finance Committee last summer:

> *I would... note that the ideal way to tax business income is the way we tax S corporations. We would like to attribute the income to the owners and the only reason we have a corporate tax is for large and frequently traded companies – very hard to do that and identify the owners who would pay the tax. So where you can do that, we should do that, and that is the right treatment.*[9]

While allocating taxable income among the widely-disbursed ownership of publicly-held companies may be unworkable, that is not the case with closely-held business entities.

Third, the pass-through S corporation regime eliminates the dramatic difference in tax consequences for income earned at the corporate, as opposed to the individual level, thereby obviating the need for more complicated structures and transactions designed to mitigate the heavy burden of the double taxation C corporation system.

This has been borne out in my practice. Prior to the TRA '86, successful business owners were regularly engaged in the tax planning process in order to minimize the substantial burdens under the double taxation regime. Since that time, and with the migration of closely-held business activity to pass-through taxation treatment, business owners are no longer engaged in an ongoing struggle to navigate the heavy impositions of the double tax system. They are less focused on tax planning than they were before the TRA '86, and more focused on running their business. They are keenly aware of the marginal rates that will apply to additional income, and they reserve for that. However, once they have paid that additional tax (often at the top rate), they are comfortable knowing that they can now pull the remaining after-tax earnings out to engage in another business or for their own personal welfare, or retain the money inside the corporation as working capital, to invest in new equipment and other items, or simply as a buffer against future exigencies, without having to worry about any "reasonable compensation" limitations on one hand or "unreasonable accumulations" on the other.

D. Today's Tax Structure

As noted earlier, the tax rate structure in 2012 is still quite consistent with the reforms implemented in the TRA '86. The top individual and corporate income tax rates are identical, at 35 percent. However, now the double taxation burden for C corporation shareholders has been further mitigated by a reduction in the top individual income tax rate for qualified dividends to 15 percent. The net effect of the current rate structure is to impose roughly comparable tax burdens on income earned and retained inside the business for both C corporation and pass-through enterprises. However, the 15 percent double tax on C corporation dividends adds an approximately 10 percent net additional tax burden on earnings distributed, when compared to S corporations. Also, the self-employment tax, which applies to most partnerships and sole

[9] Hearing entitled *How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?* Response to a question before the Senate Committee on Finance, March 30, 2011.

proprietorships (but not S corporations), adds an additional tax of nearly 3 percent on enterprises treated as partnerships for tax purposes. These net marginal tax rates for income earned in the top rate brackets are shown in Chart 3.

Chart 3: Top Marginal Tax Rates (2012)

Assumptions: Entity and owners in top tax bracket
Owners active in business and avoid reasonable compensation
Not personal service corporation
Partnership income not exempt from self-employment tax
No state income tax

	C Corporation	S Corporation	Partnership / Sole Proprietorship
Additional income	$ 100,000	$ 100,000	$ 100,000
Less: Entity income tax	(35%)		
Net Entity income	$ 65,000	$ 100,000	$ 100,000
Less: Individual income Tax	(15%)	(35%)	(34.50%) [a]
Less: Self-Employment Tax			(2.858%) [b]
After-Tax income	$ 55,250	$ 65,000	$ 62,642
Overall Tax Rate:	44.75%	35%	37.36%

[a] 35% x [1 - (1- 1.45%) x 1.45%] = 34.50%
[b] 2.9% x [1 - 1.45%] = 2.858%

Finally, another factor favoring pass-through tax status for many closely-held businesses is the impact of the C corporation double tax regime upon sale of the business. Most entrepreneurs seeking to sell their business hope to do so at a price in excess of the net book value and tax adjusted basis of its assets. As a consequence, buyers in such sales most commonly seek to achieve "asset sale" treatment for such transactions, whereby they will be entitled to amortize and depreciate the entire purchase price paid, rather than merely deduct the remaining tax adjusted basis inside the seller's entity.[10] However, "asset sale" treatment is particularly onerous in the C corporation context for two reasons. First, there is no capital gains tax preference at the C corporation level. This means that any gain on the sale of the business is first taxed at the top (or close to the top) C corporation tax rate. Second, there is still another tax, albeit at a lower marginal rate, when those proceeds are distributed out to the shareholders upon liquidation.[11]

[10] This can be achieved, of course, by an actual asset sale, whereby the buyer purchases all of the assets of the business directly from the business entity. Comparable treatment can usually be achieved even if the acquisition is structured as the purchase of stock or other interests in the entity itself (rather than of its assets). For C corporations, this can usually be accomplished by making an election under Section 338 of the Code. For S corporations, this can usually be accomplished by making an election under Section 338(h)(10) of the Code. For partnerships, this can usually be accomplished by making an election under Section 754 of the Code or by virtue of the deemed liquidation of the partnership upon acquisition.

[11] Code Section 1202 does provide for a 50 percent exclusion (60 percent for certain empowerment zone entities) of gain at the shareholder level in a limited number of circumstances. However, this exclusion does nothing to mitigate

Nonetheless, as shown in Chart 1, there are still some entities that continue to operate as C corporations. Although no doubt there are a multitude of reasons why specific entities might retain C corporation status instead of converting to some form of pass-through treatment, I have found that there are some recurring situations where corporations might decide to elect or retain C corporation status. The first is publicly held corporations that obviously have more than 100 shareholders, and as a consequence are simply not eligible for S corporation status.[12] Moreover, partnerships engaged in active trades or businesses are generally required to be treated as C corporations if their ownership interests are publicly traded.[13]

Another group of business entities that retain C corporation status would be those that, for one reason or another, are either not eligible for such status and/or would be subject to significant tax at the corporate level, despite S status. Examples of the former would be corporations that have a significant number of ineligible shareholders,[14] or have multiple classes of stock,[15] that are not able to be bought out or otherwise eliminated. An example of the latter would be an entity that, for one reason or another, would be subjected to either an unacceptable amount of built-in gains tax upon conversion[16] or would be subject to the tax on passive investment income and the termination of S corporation status as a result of excess net passive income at the corporate level.[17]

Finally, there are many smaller corporations where the difference between the double tax C corporation regime and pass-through tax treatment is not all that significant. For example, a medical, legal, accounting or other service corporation may regularly pay all or almost all of its profits out in taxable compensation, leaving little or no income to be double taxed inside the corporation and upon distribution, and may also not anticipate selling out at a significant profit at any point in the foreseeable future. Shareholders may buy in and be bought out at relatively modest sums over the years, because there is no anticipation that an acquirer will come in and pay a substantial premium in order to purchase the entire business. In such a case, the relatively few tax-free fringe benefits[18] that would otherwise not be available to partners and S corporation shareholders with an ownership interest in excess of 2 percent[19] can be sufficient to justify retaining C corporation status, even though that does require that all compensation paid be subject to full FICA tax.

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the non-preferential tax at the corporate level, and is not applicable to S corporations and other pass-through entities. As a consequence, it is of very little utility to the vast majority of closely held businesses. Thomas J. Nichols, *Choice of Entity Corner – Code Sec. 1202 Stock: Fool's Gold or Worse for Most Taxpayers*, Journal of Passthrough Entities (July-August, 2010).

[12] I.R.C. § 1361(b)(1)(A).

[13] *See* I.R.C. § 7704.

[14] Only citizens, resident aliens, estates and certain trusts and exempt organizations are eligible as shareholders of an S corporation. *See* I.R.C. § 1361(b)(1)(B), (c).

[15] An S corporation may not have more than one class of stock. *See* I.R.C. § 1361(b)(1)(D).

[16] *See* I.R.C. § 1374.

[17] *See* I.R.C. § 1375.

[18] For example, benefits under qualified health reimbursement accounts are afforded tax-free treatment for C corporations. *See* I.R.C. § 105. However, health insurance premiums are now entitled to comparable tax treatment for both C corporations and pass-through entities. *See* I.R.C. §162(l).

[19] *See* I.R.C. § 1372.

E. Future Planning

If no Congressional action is taken, the tax landscape will change dramatically as of January 1, 2013. The most significant changes, from a business tax rate perspective, will be the expiration of the tax cuts ushered in with the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and the imposition of a new tax on the net investment income[20] of high-income taxpayers under the Patient Protection and Affordable Care Act and the Health Care and Education Act of 2010 (collectively, the "Health Care Acts"). The EGTRRA expiration would cause the top individual marginal income tax rate to increase to 39.6 percent. It would also reimpose the so-called Pease reduction, which reduces itemized deductions at the rate of 3 percent for all income in excess of certain levels of adjusted gross income. The net effect of this latter provision is to increase the top marginal rate to approximately 40.8 percent for most S corporation and other pass-through business income. [21]

The new net investment income tax under the Health Care Acts is imposed on the lesser of net investment income or the excess of modified adjusted gross income over certain thresholds. The thresholds are $250,000 for married couples filing a joint return ($125,000 for married individuals filing separately) and $200,000 for all other returns.[22] This net investment income tax is generally imposed on interest, dividends, annuities, royalties, rents and gains, with one very important exception. Congress recognized that this new imposition should not apply to income derived by owners directly involved in active businesses. Therefore, Congress excluded from the tax base all income derived from a trade or business unless the income was reported by a person who did not "materially participate" under the passive activity rules or the trade or business consisted of trading in financial instruments or commodities.[23] There are still quite a few open issues regarding the application of this tax in various commonplace circumstances, such as the treatment of electing small business trusts, which are special trusts allowed under the Code to be S corporation shareholders. There are also significant unanswered questions regarding the impact of this tax on the sale of stock or interests in an S corporation or other pass-through entity.[24]

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[20] Although this new tax on net investment income is contained in new Chapter 2A of the Code entitled "Unearned Income Medicare Contribution," my understanding is that the proceeds of this tax will not be allocated to the Medicare Trust Fund, but will instead be included in general government revenues. Therefore, in order to avoid any misconceptions, I do not refer to it as the new Medicare Tax as some commentators do.

[21] This is because state income tax and other deductions usually increase proportionally with income, and so taxpayers never run out of deductions to be reduced.

[22] These thresholds are not inflation-adjusted.

[23] The Health Care Acts also raised the FICA/self-employment tax rate on wages and self-employment income above the $250,000/$125,000/$200,000 thresholds mentioned earlier by .9 percent. Since such wages and self-employment income were already subject to FICA/self-employment tax at the rate of 2.9 percent, the net effect of this change was to increase the gross rate of tax on such wages and income to 3.8 percent, the same as the new tax on net investment income. However, the net effective rate of this new FICA/self-employment tax should usually be somewhat lower than the 3.8 percent tax on net investment income, given the deductibility features of the FICA/self-employment tax system.

[24] *See* Thomas J. Nichols & Joshua L. Cannon, *Impact of the New Health Care Bills on Closely held Business*, New York University 69th Institute on Federal Taxation, Ch. 2 (2011). Updated versions of this article reflecting subsequent developments and analysis are available from Meissner Tierney Fisher & Nichols S.C.

As shown in Chart 4, the net effect of these changes would be to drastically increase the top marginal rate on an additional $100,000 of earnings and to create a significantly more complicated system. The marginal rates would increase from a range of 35 percent to 44.8 percent in calendar year 2012 up to a range of 40.8 percent all the way up to nearly 64 percent in 2013. From past experience, I can assure you that any such drastic increase in rates will result in substantial income tax planning regarding the timing of both income and deductions at the end of this year. The only thing preventing the devotion of substantial resources toward this effort now is businesses' confidence that Congress will do something to mitigate this sudden and drastic increase in rates for next year.

From a choice of entity standpoint, this new tax on net investment income will significantly increase the double tax on shareholders of C corporations, because the law seems clear that the trade or business of the C corporation will not be attributed to its shareholders and so no exemption will be available.

Chart 4: Top Marginal Tax Rates (2013)

Assumptions: [illegible]
Active owners materially participate
Exemptions fully phased out, itemized deductions still limited
Not personal service corporation
Partnership income not exempt from self-employment tax
Not portfolio, non-TCIB income
No state income tax

	C Corporation	S Corporation		Partnership / Sole Proprietorship	
	Dividends	Passive / Trading	Active Non-Trading	Passive / Trading	Active Non-Trading
Additional Income	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000
Entity Income Tax	(35,000) [a]	[illegible]	[illegible]	[illegible]	[illegible]
Net Entity Income	$ 65,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000
Individual Income Tax	(26,512) [b]	(40,788) [b]	(40,788) [b]	(40,788) [b]	(40,205) [d]
Individual Net Inv Inc. / SE Tax	(2,470) [c]	(3,800) [c]	[illegible]	(3,800) [c]	(3,745) [e]
After-Tax Income	$ 36,018	$ 55,412	$ 59,212	$ 55,412	$ 56,050
Overall Tax Rate:	63.98%	44.59%	40.79%	44.59%	43.95%

a. 35%
b. 1.03 x 39.6% = 40.788%
c. 3.8%
d. 40.788% x [1 - (1.45% + 1.0145)] = 40.205%
e. 3.8% x (1-1.45%) = 3.745%

This new tax also adds a level of cost and complexity for S corporations and other pass-through entities. For example, if an S corporation has a mix of active and passive shareholders, right now the top tax rates applying to both groups are the same – 35 percent. Starting next year,

however, the tax rate on active shareholders would be 40.8 percent, while passive shareholders would face a top rate of almost 45 percent (after taking into account the 3.8 percent tax on net investment income). Not only does this higher rate reflect a higher tax burden on the business, it also has the effect of draining resources from the business. S corporations typically try to distribute enough earnings for their shareholders to pay the tax on the income passed through from the business. With the single class of stock restriction, these distributions must be proportional, which means that, starting in 2013, many S corporations will need to distribute 45 percent of their earnings just to pay the business' taxes, compared to 35 percent today.

Probably the most detrimental aspect of this new tax structure is the fact that it would eliminate the relative parity in top marginal tax rates for both individuals and C corporations. The 45 percent top individual tax rate will once again be substantially higher than the 35 percent (or even lower) top tax rate inside C corporations. If nothing is done, this 10 percentage point or greater difference would reverse the extremely important reform first introduced in TRA '86, and the resulting trend toward the single tax regime that is both more transparent and less subject to manipulation.

F. Tax Proposals

In addition to addressing the issue of tax rates, I understand that there are a number of proposals relating to the tax treatment of closely-held business that are being considered.

1. Expensing

Probably the most important of these proposals for most closely-held businesses would be the possibility of extending and/or expanding the option of expensing investments in capital equipment under, among other provisions, Sections 179 and 168(k) of the Code. Most closely-held business owners intuitively evaluate their business on the basis of cash flow, rather than financial statement net income. This is especially important for them because they often do not have access to substantial cash reserves or credit, especially in times of stress where cash flow is threatened.

I learned this lesson early in my career. A client, who had just earned his first million dollars, had then spent the money on equipment and other capital expenditures that were sorely needed in his rapidly-growing business. He called me after the end of the year to discuss the "problem" raised by his accountant that he now owed income tax. Trained as I was in tax law and accounting, I calmly explained to him that the reason he owed tax was that these capital expenditures still had value at the end of the year and would be depreciated for tax purposes only as they were consumed in the business over the next several years. Less calmly, he said to me "Tom, you don't understand. I have no cash."

Over the years, I have come to more fully appreciate the wisdom of his statement. Most closely-held business owners correctly think of money spent on equipment and other capital expenditures as still at-risk in the business, and as not "earned" until it comes back to the business in the form of collections upon sales. From a tax policy perspective, allowing businesses to deduct their equipment and other capital expenditures makes more intuitive sense

when you consider the fact that the seller of the equipment or other item will be required to take the entire sales proceeds into income. This is consistent with the perspective of many closely-held business owners, i.e., that it is the seller that experiences the income in this transaction.

That same principle applies to inventory, for those businesses that are required to maintain an inventory for tax purposes. However, this disadvantage is significantly mitigated by the provisions relating to last-in, first out ("LIFO") inventory accounting under Code Section 472 and following. At least under LIFO, the business owner is entitled to expense his or her most recent inventory expenditures, rather than what, to him or her, is a more artificial number based often on much older historical costs.

2. Cash Basis

Although I am sure there are additional examples of where cash basis accounting for tax purposes would better match closely-held business owners' realistic perception of their actual income, my guess is that equipment and inventory purchases constitute the two primary expenditures causing problems for businesses required to use accrual accounting for tax purposes. Accounts receivable can be a problem in that, in some cases, a business must wait years to actually collect receivables that are required to be taken into income immediately. To a certain extent, this acceleration is offset by the fact that accrual basis taxpayers can also deduct accounts payable for expenses that have not yet been paid by the end of the year, but the Code contains "economic performance" and other requirements to prevent significant time gaps between deduction and payment, and well-run businesses obviously pay their liabilities on a relatively prompt basis in any event.

Also, not all closely-held businesses are required by the Code to use accrual accounting. In general, pass-through entities and sole proprietorships are not required to be taxed on the accrual basis, unless they maintain inventories[25] or constitute tax shelters.[26] Thus, most closely-held entities that are on the accrual basis have voluntarily elected such treatment.

Many do elect such treatment simply because they are already required, for bank lending or other purposes, to prepare and maintain financial statements on the basis of generally accepted accounting principles ("GAAP"), which also require accrual accounting, and it is easier for them to do accrual accounting for both book and tax purposes. In summary, raising the limit on the exemption for required accrual basis accounting from $5 million to $10 million under Code Section 448 is not likely to benefit the vast majority of closely-held businesses. This is in stark contrast to the equipment/capital expenditure expensing rules, which would impact both cash and accrual taxpayers.

3. Base Broadening

I also understand that there are proposals to broaden the business tax base in order to lower the C corporation income tax rate on a revenue neutral basis. While lowering that 35 percent rate (which puts the United States at the very top of the industrialized countries in terms

[25] *See* Treas. Reg. 1.471-1.
[26] *See* I.R.C. § 448.

of marginal rates) is an extremely laudable goal, it is important to recognize that, if this is done in the context of only lowering the C corporation income tax rate, the net effect of this "reform" would be a substantial overall tax increase for the vast majority of closely-held businesses. This is because, as indicated earlier in my testimony, the large majority of closely-held businesses are operating as pass-through entities, which means they would be unaffected by any reduction in the C corporation income tax rates.[27]

An Ernst & Young study conducted on behalf of the S Corporation Association earlier last year made clear the challenge corporate-only tax reform presents to pass-through businesses. According to the study, a broad policy of eliminating business tax expenditures while cutting only corporate rates would raise the tax burden on pass-through businesses by approximately $27 billion per year.[28] This is important because pass-through businesses employ over 54 percent of the private sector workforce, and, as my earlier testimony indicates, anything that affects the cash flow of closely-held businesses (and taxes certainly do) will unavoidably have a depressant effect upon their contribution to the economy.

4. Forced C Corporation Treatment

There have also been proposals to force double tax C corporation treatment on large pass-through entities, say those having gross receipts over $50 million. In addition to imposing a substantial additional compliance and tax burden on the most productive members of the pass-through sector of our economy, such a provision would require a detailed and complicated system of inter-related rules. For example, how would an entity be treated that hovers both above and below the $50 million trigger point? Would the built-in gains tax apply when the entity re-elects S status after having been forced into C corporation status as a result of having extraordinarily good receipts during the testing period? Would an entity be trapped in C corporation status even though it no longer had $50 million of gross receipts, because of higher receipts during the testing period? If not, would closely-held business owners not be in a position to know whether they will be subject to a C corporation or S corporation tax regime until after the end of the year in question?

Also, I am assuming that there would have to be some type of aggregation rules so that closely-held business owners could not simply split their business into two or more entities and avoid the C corporation regime in that fashion. As you can imagine, such aggregation rules are extremely difficult to administer. For example, if various business entities were to constitute a series of overlapping aggregated control groups or affiliated service groups, how would that be handled? If one of the groups was below the threshold and another of the groups was above the threshold, would the owners of the group that was below the threshold be forced into double tax C corporation status, even though some of them owned only an interest in a relatively small business?

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[27] Moreover, as pointed out earlier, many closely held C corporations do not retain a substantial amount of income at the corporate level, and even fewer of them retain income subject to the top marginal rates.

[28] Robert Carroll and Gerald Prante, *The Flow-Through Business Sector and Tax Reform*, Ernst & Young (April 2011). Available at: http://www.s-corp.org/2011/04/13/links-to-s-corp-study-and-press/

Even in the absence of multiple overlapping groups, how would you handle the numerous complexities that are involved when multiple entities are treated as a single unit? The consolidated return regulations span over 440 pages in the standard edition of the CCH Income Tax Regulations, dealing with issues such as inter-company transactions, stock investment accounts, calculation of credits, allocation of income tax liabilities and numerous other matters. These complexities are difficult enough for groups of business entities that voluntarily choose to treat themselves as a single affiliated group, but this level of complexity would be multiplied many times by forcing aggregate treatment for all tax purposes on an amalgamation of corporations, partnerships, limited liability companies and other entities that happen to be linked by common ownership or activities.

This forced amalgamation might also have the unintended consequence of opening up opportunities for aggressive tax planning and tax shelters. For example, if dividends are treated as coming from the aggregate earnings and profits of the amalgamated entity, could the C corporation owners of one of the amalgamated entities drain off all of the earnings and profits on a tax-preferred basis, while allowing the remaining individual owners to achieve the equivalent of S corporation treatment as a result of non-dividend distributions? If not, would the individual owners of one of the separate entities with separately treated earnings and profits be able to achieve S corporation-type treatment by carefully managing the operations of that entity?

In addition to these workability concerns, making an arbitrary and involuntary cutoff for pass-through tax treatment is simply not good tax policy. For the reasons indicated at the outset of this testimony, the double tax C corporation system is not preferred tax policy. Moreover, the $50 million trigger (or whatever number is chosen as the trigger) would clearly discourage growth in companies that are approaching that level, and such companies would be incentivized to engage in a great deal of sophisticated and expensive tax planning to avoid being involuntarily subjected to the double tax system. Such maneuvers might nonetheless be justified if such a proposal were enacted, because one additional dollar of gross receipts could literally trigger millions of dollars of federal tax consequences. Such cliff-like triggers are obviously not favored for policy purposes.

Finally, just because an entity has $50 million of gross receipts does not mean that it is profitable. There are many such entities (or amalgamations of such entities) that actually have losses, which, under current law, are appropriately taken into account (and if necessary carried over) at the individual level. Forcing individual owners at that level of activity to forego the ability to deduct these losses would unavoidably impact their willingness to continue to fund these enterprises, with the concomitant impact on the jobs and financial security of their employees. Even profitable entities would not seem to merit such draconian treatment. For example, a low-margin 1 percent-of-sales business could easily have $50 million of gross receipts, but have only $500,000 of actual taxable income. Triggering C corporation status in these circumstances seems entirely unwarranted.

5. Buffett Rule

Another proposal that should be considered in this context is the so-called "Buffett Rule." While the Administration has not fully articulated its Buffett Rule proposal, legislation has been introduced in both the House and the Senate (H.R. 3903 and S. 2059) to impose a version of the Rule. As introduced, this provision would generally impose an effective tax rate of 30 percent on adjusted gross income without taking any itemized deductions (other than charitable contributions) into account for individuals earning over $2 million, including a phase-in for taxpayers making between $1 million and $2 million.

In effect, this legislation would impose a third tax on high income taxpayers – first the individual income tax, next the Alternative Minimum Tax, and then finally the Buffett Rule tax – and would raise numerous fairness and administrative complexity issues. For example, the marginal rates incurred by individuals earning between $1 million and $2 million could, in some circumstances, be as high as 60 percent. The Buffett Rule would also exacerbate the C corporation double tax problem I outlined earlier by imposing a minimum tax rate of approximately 55 percent[29] on distributed C corporation earnings, an increase of approximately 10 percentage points from this year's rate.

As for S corporations, earlier I discussed the challenge of appropriately distributing sufficient earnings for S corporation shareholders to pay taxes on the business' income. The Buffett Rule would exacerbate this challenge by forcing an S corporation to calculate and distribute additional earnings, even if only one of its shareholders has (or might have) income subject to the Buffett Rule. The result would be to drain additional capital and resources from S corporations seeking to build up their equity and working capital.

Finally, perhaps the most dramatic and unfair consequence of the Buffett Rule for closely-held business owners would occur in the context of a sale of the business. The current federal tax rate for sale transactions is 15 percent and is scheduled to increase to 20 percent starting next year (before taking into account the 3.8 percent additional tax on net investment income under the Health Care Acts). The Buffett Rule would increase this tax rate for taxpayers making more than $1 million, even if that higher income was triggered by a "once in a lifetime" transaction involving sale of a business built up over decades.

6. Forced Single Pass-Through Treatment

One last tax reform proposal that I understand has been considered is the possibility of forcing all pass-through entities into either S corporation or partnership tax treatment. If I was designing a system from scratch, I would consider doing this. However, as shown in Chart 2 earlier, we now have over 7 million pass-through businesses operating in the country, approximately 4 million of which are taxed under the S corporation regime and the remaining approximately 3 million of which are treated as partnerships. Thus, any forced channeling of all pass-through activity through either one of these vehicles would unavoidably impose substantial additional tax compliance costs and other consequences on a substantial number of ongoing

[29] 35% + 30% (1-35%) = 54.5%

businesses. It is important to balance that unavoidable disruption against the likely benefits of any such forced uniformity.

In this regard, it important to note that the vast majority of costs involved in establishing and maintaining such a two-track system have already been incurred. The Treasury Department has already promulgated comprehensive regulations for both partnerships and S corporations, and the Service has developed detailed tax forms and instructions for both types of entities. Moreover, individual taxpayers have already made their choice of entity, and they will not need to learn another system unless they voluntarily elect to change their tax treatment.[30]

As a consequence, the bulk of the ongoing cost of this two-track system is effectively borne by law and accounting students and tax advisors who have to learn and apply both sets of rules. However, no significant long-term benefit would seem to accrue to the economy as a whole by forcing all pass-through taxpayers into a single regime.

Testimony embargoed until 3.7.2012 at 10am.

[30] This is assuming that no forced conversion to C status is ever enacted.

Chairman CAMP. Thank you, Mr. Nichols.
Mr. Sullivan, you are recognized for five minutes.

STATEMENT OF MARTIN A. SULLIVAN, PH.D., CONTRIBUTING EDITOR, TAX ANALYSTS, ALEXANDRIA, VIRGINIA

Mr. SULLIVAN. Mr. Chairman, Ranking Member Levin, Members of the Committee, thank you for this opportunity to testify. It is a great honor for me to be here today.

Mr. Chairman, over the last three decades, we have seen a fundamental transformation in how America does business. Pass-through businesses have grown rapidly in number and in size. This growth is almost entirely due to an exploration in the use of limited liability companies and subchapter S corporations. Here are the facts.

In 1992, LLCs were virtually nonexistent. By 2008, there are 1.9 million of them. Between 1980 and 2008, partnership revenue grew from 4 to 14 percent of all business revenue, and over the same period, the share of total business revenue claimed by S corporations grew six-fold, from 3 to 18 percent.

The United States has an unusually large non-corporate sector compared to other countries. A recent study found that the United States ranks second only to Mexico in the size of its non-corporate sector.

On April 1st, when Japan cuts its corporate tax rate, the United States will have the highest statutory corporate rate in the world. There is widespread agreement that we should lower our rate; the issue is how to pay for it.

One approach would be to eliminate some or all business tax expenditures. This approach, however, would hurt pass-through businesses that would lose their tax breaks and not receive any benefit from the rate cut.

Pass-throughs depend most on two tax expenditures: accelerated depreciation, worth about 8 billion a year, and the Section 199 manufacturing deduction, worth about 4½ billion. Eliminating these tax benefits would be particularly harmful to smaller pass-throughs for which cash flow is critically important.

Many pass-through businesses are large businesses. Here are the facts. In 2009, there were 14,000 S corporations with more than 50 million in sales. They accounted for 29 percent of all S corporation profit. There were 18,000 partnerships with more than 100 million in assets. They accounted for 64 percent of all partnership profit. Clearly, we can no longer equate pass-through businesses with small businesses.

As the search continues for revenue to pay for lower corporate rates, we should consider extending corporate taxation to large pass-throughs. It is really no different than any other base-broadening option. It would level the playing field and raise revenue that we could use to lower the corporate rate.

Now, some tax experts worry about the effect on small business job creation if current rates are not extended for the top two brackets at the end of 2012. I believe, however, that the question of extending high-end rate cuts should not pivot on the effect they will have on small business owners, but on larger issues such as the need for deficit reduction, the effect on tax fairness, and their effect on the overall economy.

If I could call your attention to the screen. Well, I am sorry, we are having technical difficulties. But the chart I am referring to is on page—oh, thank you. Thank you very much. Sorry about that.

The figure on the screen shows a box. The box represents all the income affected by a rate change on the top two brackets. Only 30 percent is pass-through income. Only 21 percent is related to pass-through employers. And only 8 percent is related to small business employers.

If we want to promote small business job creation, providing tax relief to all income in that big box is a very inefficient way to do it. By targeting tax relief to pass-through employers, we can promote small business job creation at a lower cost.

Now, to this end, Majority Leader Cantor is proposing a 20 percent cut for pass-through businesses with fewer than 500 employees. Unfortunately, this proposal has some serious technical shortcomings, as I explain in my written testimony. A better way to spur small business job creation would be to provide a permanent tax credit equal to a percentage of wages with a cap on the number of employees who can qualify. That would create more small business jobs than a rate cut for high bracket taxpayers at a fraction of the cost.

Finally, a recent IRS study confirms what most of us already know: Small businesses are subject to a massively disproportionate compliance burden. I think all of us on this panel agree that Congress should aggressively modify provisions of the code that impose a large compliance burden on small business. That would provide significant tax relief, with little impact on the budget deficit. And I believe the proposals by Professors Kwall and Tucker on my right, about choice of entity, would be an excellent place to start.

Thank you, Mr. Chairman and Members of the Committee, for allowing me this opportunity.

[The prepared statement of Mr. Sullivan follows:]

Testimony of Martin A. Sullivan, Ph.D.

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Before the Committee on Ways and Means
U.S. House of Representatives

March 7, 2012

Passthrough Business, Small Business, and Tax Reform

Good morning Chairman Camp, Ranking Member Levin, and members of the Committee. Thank you for this opportunity to share my views on the important topic of passthrough business taxation.

I. The Importance of Passthrough Business in the American Economy

Over the last three decades, a rapidly increasing number of America's businesses have organized their affairs so that they are entirely free of the corporate income tax. There are three major no-corporate-tax alternatives: S corporations, partnerships, or sole proprietorships. Collectively these three tax classifications are referred to as "passthrough" entities because, unlike C corporations where profits can be bottled up until they are distributed, the profits of these businesses are passed through immediately to owners who must report this income on their individual tax returns.

As shown in Table 1, passthrough businesses accounted for 83 percent of all business returns in 1980. By 2008, that figure had increased to 94 percent. Their share of total receipts, only 13 percent in 1980, grew to 34 percent by 2008. Their share of profits grew from 20 to 47 percent.

Because the corporate tax is being "hollowed" out from below, the corporate tax more than ever is now a tax on big business. This development is the result of two phenomena: the dramatic increase in the size and number of Subchapter S corporations and the surge, mostly in the 1990s, in the number of limited liability corporations (LLCs), which are taxed as partnerships.

Subchapter S Corporations. The dramatic rise in the popularity of Subchapter S status is shown in Figure 1. There were half a million S corporation returns filed in 1980. That number rose to 1.6 million in 1990, 2.9 million in 2000, and 4.0 million in 2008. S corporations grew in size as well as number. As shown in Table 1, profits of Subchapter S corporations in 1980 were just 1 percent all business profits. In 2008 that figure had risen 15 percent.[2]

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[1] The views expressed here are my own and not those of Tax Analysts. Founded in 1970 as a nonprofit organization, Tax Analysts is a leading provider of tax news and analysis for the global community. By working for the transparency of tax rules, fostering increased dialogue between taxing authorities and taxpayers, and providing forums for education and debate, Tax Analysts encourages the creation of tax systems that are fairer, simpler, and more economically efficient.

[2] Subchapter S corporations are essentially taxed liked partnerships. Subchapter S of the Internal Revenue Code was enacted into law in 1958. At the time there was growing concern that big corporations were becoming too dominant in the American economy. The intent of Subchapter S was to strengthen America's small and family-owned businesses.

Table 1. Business Shares by Filing Status, 1980-2008				
	1980	1990	2000	2008
S Corporations				
Returns	4%	8%	11%	13%
Receipts	3%	13%	15%	18%
Net Income	1%	9%	17%	15%
Partnerships				
Returns	11%	8%	8%	10%
Receipts	4%	4%	9%	14%
Net Income	3%	4%	22%	22%
Sole Proprietorships				
Returns	69%	74%	72%	72%
Receipts	6%	6%	4%	4%
Net Income	18%	30%	18%	12%
All Passthrough Businesses (sum of above)				
Returns	83%	89%	91%	94%
Receipts	13%	23%	29%	35%
Net Income	22%	43%	57%	49%
C Corporations				
Returns	17%	11%	9%	6%
Receipts	87%	77%	71%	65%
Net Income	78%	57%	43%	51%

Source: Statistics of Income Division, IRS. For further details see Appendix A of Martin A. Sullivan, *Corporate Tax Reform: Taxing Profits in the 21st Century*, Apress, 2011.

Limited Liability Corporations and Other Partnerships. The size and number of partnerships has also grown rapidly over the last three decades. Table 1 shows that their share of total business profits has risen from 3 percent in 1980 to 22 percent in 2008.[3] At the same time, their share of total returns fell by one percent. This increase is almost entirely due to the sky-rocketing growth of a new form of business organization, the limited liability corporation.

In the early 1980s LLCs barely existed. Now they are available under the laws of all 50 states and the District of Columbia. Figure 2 shows IRS data on business filing tax returns as LLCs as well all other partnerships. The "other partnerships" category includes plain old general partnerships with unlimited liability. And it also includes limited partnerships (different from limited liability partnerships) where some partners have limited liability and some (general partners) have unlimited liability. The first year the IRS collected data on LLCs was in 1993. About 20,000 existed at the

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Subchapter S corporations could have the best of both worlds: the legal privileges of a corporation—limited liability, free transferability of shares, unlimited life—without paying any corporate tax. From the perspective of state law, Subchapter S corporations are no different than other corporations. "Subchapter S" is a tax filing status, not a separate type of legal entity. Under the original statute, if a corporation had 15 or fewer shareholders, and those shareholders were individuals and U.S. residents, the profits of the corporation would not be subject to corporate tax. The allowable maximum number of S corporation shareholders was increased to 35 in 1982, to 75 in 1996, and to 100 in 2005. For most S corporations, the number of shareholders limitation is not an issue. In 2008 S corporations with 3 or fewer shareholders accounted for 95 percent of S corporation returns.

[3] Unlike Subchapter S corporations, owners of partnerships may include corporations. In 2007 the Treasury Department reported that about 36 percent of total partnership income goes to corporate partners with an unknown split between C and S corporations (Treasury Department, "Approaches to Improve the Competitiveness of the U.S. Business Tax Systems for the 21st Century," Dec. 2007). In its 2010 study, the President's Economic Recovery Advisory Board, advised by the Treasury Department, reported that between 15 and 20 percent of partnership income was taxed at the corporation level. President's Economic Recovery Advisory Board, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," Aug. 2010.

time compared to 1.45 million other partnerships. Subsequently, while other partnerships slowly declined, LLCs rapidly grew in numbers – 720,000 in 2000 to 1.9 million in 2008.

Sole proprietorships. When it comes to sheer numbers, you can't beat sole proprietorships. There were 22.6 million in 2008. Approximately one out of every six individual tax returns filed includes sole proprietorship income. Figure 3 shows that instead of becoming obsolescent, the number of sole proprietorships has grown steadily in every year from 1980 to 2007. The growth from 9 to 23 million sole proprietorships has occurred despite the simultaneous increase in the use of Subchapter S corporations with only one owner. In 2008 there were 2.4 million Subchapter S corporations with a single shareholder.

Unlike Subchapter S corporations and partnerships which on average have grown in size, the size of the average sole proprietorship (adjusted for inflation) has been cut in half between 1980 and 2008. That is probably due to an increase in self-employed consultants, an increase in the number of workers formally classified formed as "independent contractors," and an increase in access to high-speed internet, which allows almost anybody to become an entrepreneur overnight.

Decline of the Corporate Tax. While the passthrough sector has grown, both the absolute number of taxable corporations and their share of total business income have shrunk. In 1994, there were 2.3 million Subchapter C corporations subject to the corporate tax. By 2008, the number had declined to 1.8 million. Because most smaller businesses are switching from Subchapter C to passthrough status large corporations account for an increasing share of corporate tax revenue. In 1994, the top

Electronically filed with Tax Court on 3.7.2012 at 10am.

Figure 1. Growth in S Corporations, 1980-2008
(in millions)

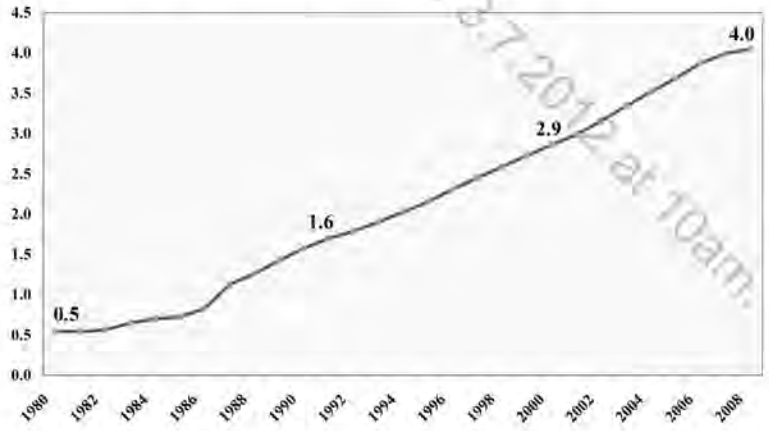
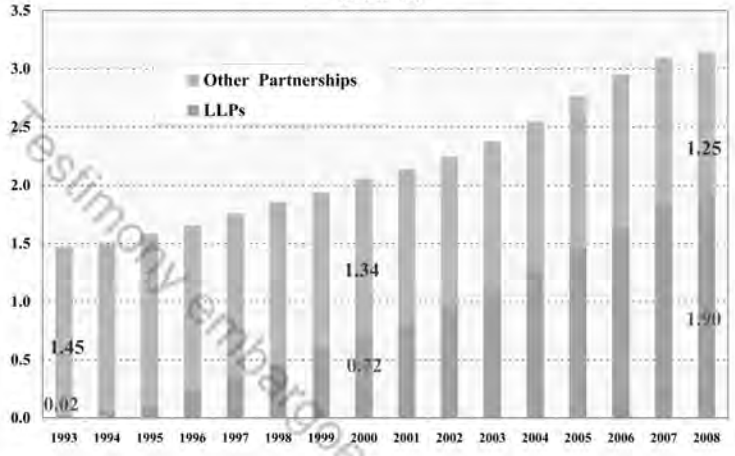
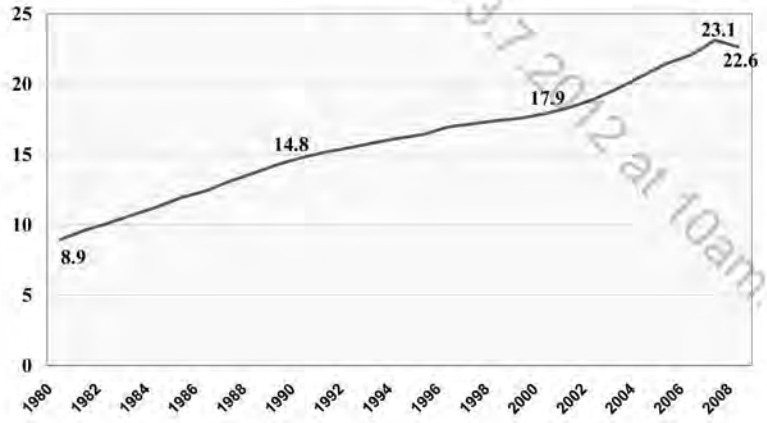


Figure 2. The Rapid Rise of LLCs, 1993-2008
(in millions)



Testimony embargoed until 3.7.2012 at 10am.

Figure 3. Sole Proprietorships, 1980-2008
(in millions)



1,500 corporations paid 70 percent of corporate tax revenue. In 2008 it only took the top 600 corporations to account for 70 percent of corporate revenue.

International comparisons. As noted by the Treasury Department in 2007, non-corporate businesses play an unusually important role in the U.S. economy. Survey data collected by the OECD shows that among 15 OECD countries for which data are available, the United States (at 82 percent) had the second highest percentage of unincorporated businesses in 2004, 13 percentage points above the OECD average. More important for their influence on general economic activity is the size of U.S. non-corporate businesses; they are more heavily represented among large businesses than in other countries reporting to the OECD. For businesses reporting profits of at least $1 million, the United States (at 66 percent) had the highest share of unincorporated business among reporting OECD countries.[4]

II. Potential Pitfalls of Corporate Tax Reform for Passthrough Businesses

A quarter century ago, the United States had one of the lowest corporate tax rates in the world, but it has not reduced its corporate tax rate since 1986. On April 1 of this year, when Japan will reduces its corporate rate, all of our major competitors will have reduced their corporate tax rate, leaving the United States—with a combined federal-state tax rate of 39.2 percent—with the highest statutory corporate tax rate in the world.

In general, economists agree that significant rate reduction will increase investment in the United States, reduce the use of costly tax planning and convoluted tax shelters, reduce the incentive to shift profits to foreign tax havens, and reduce the incentive to increase debt. But while it is easy for tax economists to agree about the desirability of a lower corporate rate, the hard part is paying for it. Under current budget constraints tax reform almost certainly will needs to be at least revenue-neutral. The additional revenue from increased long-run economic activity that would follow a corporate tax cut will not be nearly enough to offset the revenue loss. Rate reduction for Subchapter C corporations must be paid for with offsetting tax increases.

There is a wide range of possible revenue sources to pay for a corporate rate cut. A commonly suggested approach is eliminating some, or even all, business tax expenditures. According to Treasury Department estimates, eliminating *all* domestic-only tax expenditures would allow a revenue-neutral rate reduction to 28 percent. Eliminating all business tax expenditures—including the research credit—would be extremely difficult. Moreover, if this approach is adopted, it would adversely impact passthrough businesses that would only lose deductions and credits and not get any benefit from the lower corporate rate.

By far the two most important tax expenditures for passthrough businesses are accelerated depreciation (including section 179 expensing) and the section 199 deduction for domestic manufacturing. According to the latest tax expenditure budget from the Joint Committee on Taxation, $8.3 billion out of total of $23.7 billion (35%) of the projected average annual benefit of accelerated depreciation goes to passthrough business. With respect to the deduction for domestic

[4] See, U.S. Treasury Department, Treasury Department, "Treasury Conference on Business Taxation and Global Competitiveness: Background Paper," July 26, 2007; Peter R. Merrill, "The Corporate Tax Conundrum," *Tax Notes*, October 8, 2007; and Organization for Economic Co-operation and Development, "Survey on the Taxation of Small and Medium-Sized Enterprises: Draft Report on Responses to the Questionnaire," revised 25 July 2007, Table 1.

manufacturing, $4.6 billion out of total of $14.4 billion (32%) of the projected average annual benefit goes to passthrough business.[5] Manufacturers are the major beneficiaries of these provisions, so eliminating these tax benefits would be particularly harmful to manufacturers organized as passthrough businesses.

According to background documents provided by this committee, Chairman Camp's draft proposal for international tax reform is intended to be revenue-neutral.[6] Given our enormous budget deficits, and the generosity of current U.S. international tax rules, that is a reasonable approach. However, as tax reform progresses, there will be tremendous pressure from multinational businesses for international reform to include an overall tax cut on foreign-source income. Just as a corporate rate cut provides no benefit to passthrough businesses, tax cuts on foreign profits provide little or no benefit to most passthrough business. And, to the extent foreign tax benefits reduce revenue, there will be increased pressure to raise taxes on passthrough benefits.

It is important to keep in mind that a tax hike is more painful for a small business than a large business -- especially since the financial crisis. Cash flow is important to all businesses. But it is usually much more critical to a small business -- which may not even be able to obtain a bank loan -- than it is to a large business --which can borrow directly in bond and commercial paper markets at low interest rates.

There is also another reason for lawmakers not to take their cue only from large publicly traded corporations when assessing the effect of some tax changes. With respect to accelerated depreciation (and certain other tax benefits that arise from timing differences), the tax benefit does not translate into a lower *reported* effective tax rate and higher profits *reported* to shareholders. CFOs can obsess about their reported effective tax rate, and CEOs can pay an inordinate amount of attention to reported profits. Because less accelerated depreciation does not affect those measures, publicly traded corporations and other businesses using GAAP accounting may be far less resistant to such a change than a small business using cash accounting.

III. Large Passthrough Businesses

In the past, when there were not so many self-employed consultants, and not so many people working as independent contractors, before the loosening of Subchapter S requirements, before the invention of LLCs, it was not so terrible to use the data on passthrough businesses as a measure of all small businesses. But today's passthrough entities are an extremely heterogeneous lot. As technology, work relationships, and business organization have evolved dramatically, we can no longer think of that mass of income tax filings as providing us with a picture of small business.

Many large businesses are Subchapter S corporations and limited liability companies. As shown in Table 2, there were 14,000 S corporations with more than $50 million in receipts in 2008. They accounted for 29 percent of all S corporation profit. Their average level of profit was $6.4 million.

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[5] Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015," January 17, 2012.

[6] "Summary of Ways and Means Discussion Draft: Participation Exemption (Territorial) System" October 26, 2010. The document states: "The discussion draft is intended to be revenue neutral in and of itself when considered as part of comprehensive tax reform legislation. The Committee does not believe that domestic base broadening should be used to finance international tax relief, and vice versa."

Other IRS data (not shown in the table) indicate that more than 8 percent of Subchapter S corporation profits were earned by businesses with over $250 million in assets.

Table 2. Subchapter S Corporations with $50 Million or More in Receipts, 2008

	Number	Total Profit (billions)	Avg. Profit (millions)	% of Total (all size) S Corp. Profit
All Industries	**14,192**	$ 90.7	**$ 6.4**	**29%**
Agriculture, Forestry	147	$ 0.7	$ 4.7	25%
Mining	122	$ 3.9	$ 31.9	28%
Utilities	25	$ 0.4	$ 14.3	58%
Construction	2,201	$ 13.1	$ 6.0	36%
Manufacturing	2,363	$ 20.0	$ 8.5	47%
Wholesale, Retail Trade	7,031	$ 24.0	$ 3.4	44%
Transportation, Warehousing	405	$ 1.7	$ 4.1	23%
Information	148	$ 2.3	$ 15.6	44%
Finance and Insurance	153	$ 7.1	$ 46.4	23%
Real Estate, Rental, Leasing	81	$ 0.3	$ 4.2	3%
Professional, Technical Services	515	$ 6.5	$ 12.6	13%
Holding Companies	95	$ 4.6	$ 48.9	72%
Administrative, Support Services	450	$ 3.2	$ 7.1	26%
Educational Services	32	$ 0.5	$ 16.0	19%
Health Care, Social Assistance	192	$ 0.8	$ 4.2	3%
Arts, Entertainment, Recreation	76	$ 0.8	$ 10.5	22%
Accommodation, Food Services	115	$ 0.5	$ 4.2	13%
Other Services	39	$ 0.3	$ 8.5	5%

Table 3 looks at large partnerships. It presents 2008 data on the 18,000 returns of those partnerships that had assets of $100 million or more. Even though these partnerships were only 0.6 percent of the 3.1 million total partnerships, they accounted for 64 percent of the profits of all partnerships. For this group, the average number of partners was 300 and the average profit was $16.2 million.[7]

To summarize, because of tremendous growth in the use of LLCs and Subchapter S corporations, it is a serious mistake to conflate the terms "passthrough" and "small business."

As the determined effort continues for revenue to pay for lower corporate tax rates, there is growing interest in taxing large passthrough businesses as corporations. If base-broadening is the means of paying for lower rates, it is only logical to include, as an option, subjecting large passthrough businesses to the same tax as their Subchapter C competitors.

Ideally, all businesses should be subject to only one layer of tax. But *as long as there is a corporation tax*, the most economically efficient way to collect it is over a broad base and over the broadest number of businesses with as low a rate as possible. Taxing large passthrough businesses removes their unfair competitive advantage over taxable corporations, and the revenue raised can

[7] Between 15 and 20 percent of partnership profits is subject to corporate tax. See footnote 3.

reduce the corporate rate. Just like other base-broadening measures under consideration as part of tax reform, this proposal will help promote economic growth.[8]

Table 3. Partnerships with $100 Million or More in Assets, 2008					
	Number	Avg. # of Partners	Total Profit (billions)	Avg. Profit (millions)	% of Total (all size) Partner-ship Profit
All Types	**18,180**	**300**	**$ 294.3**	**$ 16.2**	**64%**
By Legal Form:					
LLC	6,899	82	$ 27.9	$ 4.0	51%
Other	11,281	434	$ 266.4	$ 23.6	66%
By Broad Industry Class:					
Finance	9,884	222	$ 146.8	$ 14.9	67%
Real Estate	4,403	116	$ 1.2	$ 0.3	29%
Other	3,893	708	$ 146.2	$ 37.6	62%

IV. About Individual Tax Rates and Small Business

Without congressional action, individual income tax rates will rise at the beginning of 2013. Although there is general consensus that the so-called Bush tax cuts should be extended for low- and middle-income taxpayers, there is disagreement about whether the two top rates should be allowed to continue at their 33 and 35 percent levels or revert to their pre-2001 levels of 36 and 39.6 percent. Proponents of the lower-rate option argue that raising the top two rates would impede job creation by passthrough businesses.

Although only a small fraction (about 3 percent) of passthrough businesses would be affected by this individual income tax rate hike, the portion of passthrough business profits affected would be much larger. There are many issues with interpreting data on passthrough businesses, and there is no one correct way to present them. However, a new technical paper from the Treasury Department has greatly increased our understanding of passthrough businesses and the tax situation of their owners.[9] Based on data disclosed in this study, we can estimate that 44 percent of income generated by small business owners would be affected by a change in the top two rates.[10] If we look at the income generated by all -- not just small -- business owners, 61 percent of that income would be affected by the rate change.

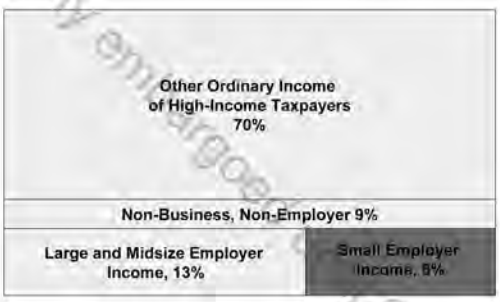
[8] Martin A. Sullivan, "Why Not Tax Large Passthroughs as Corporations?" *Tax Notes*, June 6, 2011.

[9] Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce, and Richard Prisinzano, "Methodology to Identify Small Businesses and Their Owners," Office of Tax Analysis, Technical Paper 4, Aug. 2011. For more discussion of this data, see Martin. A. Sullivan, "Should We Raise Taxes on Wealthy Employers?" *Tax Notes*, Sept. 12, 2011 and "The Myth of Mom and Pop Business," *Tax Notes*, Sept. 12, 2011.

[10] The Treasury study defines small passthroughs as those with less than $10 million of gross receipts. The tax return data Treasury uses does not include the number of employees at passthroughs. According to Census Bureau data for 2007, employers with between $7.5 million and $10 million of gross receipts had an average of 52 employees. This seems reasonable. (See Table 3, Receipt Size of Employer Firms, 2007, http://www.census.gov/econ/smallbus.html.)

Does it follow that because rate increases would affect a significant portion of passthrough business income that the Bush tax cuts should be extended to all upper income taxpayers? I would strongly argue that it does not. Let me begin by calling your attention to Figure 4. It shows that of all the high-bracket income subject to regular tax rates (that is, excluding capital gains and qualified dividends) about 30 percent is related to passthroughs. Only about 21 percent of ordinary high-bracket income is from passthrough employers. And only about 8 percent of ordinary high-bracket income is generated by *small* business employers. The bottom line is that most income affected by the rate change has nothing to do with small business employment. If the goal is to promote employment at small businesses, providing tax relief to *all* income in high brackets is an extremely inefficient way of achieving that objective.

Figure 4. Composition of Income Affected by High-Bracket Rate Changes



Because (as discussed below), there are alternative methods of providing tax relief to small business employers, there is no reason for the debate on extension of the Bush tax cuts for high-income households to pivot on its impact on small business employment. The merits of extending high-end rate cuts should be judged with relation to larger issues, such as: the need for deficit reduction, their impact on fairness, and their impact on the *overall* economy.

The best way to provide tax relief for small business is not through broad-brush policies like changes in high-end rates, but through tax relief targeted toward small business. Along those lines, House Majority Leader Eric Cantor is proposing a deduction equal to 20 percent of passthrough income for businesses with less than 500 employees.[11] Although this proposal is a far more cost-effective method of providing assistance to small business than a rate cut, it suffers from two major problems.

[11] Eric Cantor, "Memorandum to House Republicans—First Quarter Legislative Agenda," Feb. 1, 2012.

First, it would require complex anti-abuse rules to prevent high-bracket taxpayers from shifting non-business income into these new tax-advantaged vehicles. Without those rules, passthrough businesses would become tax shelters for the wealthy. Second, the proposal is not well targeted for encouraging job creation. For example, a small law firm with $10 million of profit and only 10 employees would get half the tax benefit received by a small service firm with $5 million in profit and 100 employees. Moreover, the new deduction would provide no marginal incentive to increase employment. If either of the firms in this example hired more employees, it would not receive any additional tax benefit.[12]

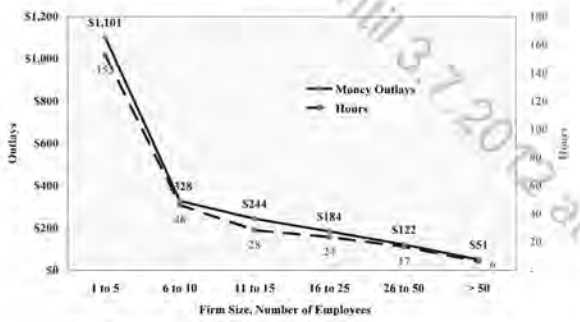
If we wish to use the tax code to promote small business job creation, the best approach would be to provide permanent deductions or credits equal to a percentage of each employee's payroll with a limit on the number of employees that can qualify. This would provide a simple and easy-to-understand incentive to increase and retain employees. Under this proposal, adding jobs would reduce taxes. Businesses with few employees and large profits would not receive large windfalls.

V. Conclusion: How to Really Help Small Business

According to the latest estimates, small businesses spent about 1.75 billion hours and $15.5 billion on income tax compliance.[13] Most of the time burden is for record keeping. And most of the financial burden is in paying for professional help. What about differences in cost by firm size? Estimates shown in the Figure 5 confirm what common sense would have us assume: small businesses face significant fixed compliance costs, and cost per employee decreases with firm size.

The figures demonstrate the need for small business tax simplification. The inordinately large

Figure 5. Business Federal Tax Compliance Burden, Per Employee



Source: DeLuca, Guton, Lee, O'Hare and Stilmar (2007), Table V

[12] It is also possible that passthrough employers approaching the 500-employee threshold would be discouraged from increasing employment, and that firms above the threshold might actually cut employment to qualify for the new deduction.

[13] Donald DeLuca, John Guton, Wu-Land Lee, John O'Hare, and Scott Stilmar, "Estimates of U.S. Federal Income Tax Compliance Burden for Small Businesses," *IRS Research Bulletin*, 2007.

Hearing Embargoed until 3.7.2012 at 10am.

compliance costs faced by small businesses place a tax penalty on them that is the economic equivalent of a tax surcharge for being small. That distorts the allocation of capital away from small businesses and reduces economic growth.

Of course, everybody wants a simpler tax system. But lawmakers need to understand that tax simplification is especially important to small businesses. In particular, the instability of the code caused by frequent tax changes and expiring tax provisions is a drain on the limited resources of a small business.

Simplification of provisions that particularly affect small businesses should also be a priority. Along these lines, Congress should consider simplifying entity choices. Currently, the small business owner must consider the advantages and disadvantages of choosing among four different forms: sole proprietorship, partnership, Subchapter S, and Subchapter C. Proposals are already on the table that would give businesses the choice of a simple partnership or, if circumstances warrant, a more complicated partnership regime. Graduated corporate rates should be entirely eliminated, or small businesses simply should not be allowed to adopt Subchapter C status.[14]

Another promising approach for small business tax simplification is an expansion and simplification of cash accounting methods used to compute income tax. In a recent paper in *Tax Notes*, David Kautter and Donald Williamson propose that small business recognize income and deductions only when cash is received or expenses are paid.[15] This proposal includes the elimination of calculations for depreciation and cost of goods sold, which the authors believe will not reduce government revenue and will increase compliance among small businesses and entrepreneurs. This is just the most recent in a long line of proposals for simplified accounting for small business.[16]

In-depth examination of tax rules required to achieve small business tax simplification is neither easy nor glamorous. But it is one surefire way to reduce business costs and promote economic growth with minimal damage to the deficit.

* * *

Thank you for this opportunity to comment on this important topic.

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[14] See, George K. Yin and David J. Shakow, "Reforming and Simplifying Income Taxation of Private Business Enterprises," in Joint Committee on Taxation, "Study of the Overall State of the Federal Tax System and Recommendations for Simplification," Vol. III, JCS-3-01, 2001; Jeffrey L. Kwall, "Taxing Private Enterprise in the New Millennium," *Tax Lawyer*, Vol. 51, No. 2, 1997; Martin A. Sullivan, "Business Tax Reform from the Bottom Up, *Tax Notes*, Oct. 17, 2011.

[15] David Kautter and Donald Williamson, "A Simplified Cash Method of Accounting for Small Business," *Tax Notes*, February 13, 2012.

[16] President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," Nov. 2005;. Treasury Department, "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century," Dec. 2007; President's Economic Recovery Advisory Board, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," Aug. 2010; Nina E. Olson, "How Tax Complexity Hinders Small Business: The Impact on Job Creation and Economic Growth," (testimony of the national taxpayer advocate before the House Committee on Small Business), Apr. 13, 2011.

Chairman CAMP. Thank you very much. And again, thank you all for being here and for your testimony.

With most active business income and most of the private sector jobs coming from pass-through entities, it seems clear to me—and some of you articulated this—that for reasons of competitiveness and fairness, that tax reform should connect the corporate rate

with the individual rate, that reduction. And I think somebody used the words "tax parity."

We did that in the House-passed budget last year, and I know that the President's tax reform framework that he released recently, when connected with his budget, would raise marginal rates on pass-through entities to 40 percent while cutting the rate on corporations to 28 percent, as I said in my opening statement, which is a spread of 12 points.

I would ask each of you to respond. Do you think it is good economics to try to keep the top corporate rate and the top individual rate as close together as possible? And what are the risks of having a spread between those two? And I will start with you, Mr. Smetana.

Mr. SMETANA. Thank you. I think that we need to recognize, in the pass-through regime, you have got two sources of income on the tax report. You have the earned income, wages, and then you have the business income. And I think the big distinction in terms of pass-throughs is that that earned income is different.

It is taken out. It is used. The business-sourced income is kept in the business, typically. And, as I mentioned in my comments, it is the primary source of capital to sustain the business and to grow the business along with traditional financing.

So I think it is vitally important that whatever policy that we adopt in terms of marginal rates, we try to retain as much of the capital in the businesses to sustain and grow as we possibly can.

So therefore, any rate regime which causes an increase in the amount of taxation paid on that business source income will retard growth, and it will retard the ability for those pass-through entities to be competitive in an international and even a national scene. So therefore, I believe that one of the things we should try to make a distinction on is not where the income shows up on a tax return, but what the source of that income is. And I think that is very important.

Chairman CAMP. Mr. Martin.

Mr. MARTIN. Well, I think it would increase my fees a lot of they did that. I would make a lot of money because I would be involved in the very difficult tax planning arena of helping my clients pay the least amount of taxes. And it would really harm the form of business that they wanted to operate in.

By the way, I played golf at Oakland Hills and the country club at Detroit and couple other courses, but that is the best I can do on this.

[Laughter.]

Mr. MARTIN. I think it would be very harmful to force small businesses to operate in a form that saves them the most tax liability when it is not the form they really should be operating in. So I think that would be a huge mistake.

Chairman CAMP. Okay. Mr. Tucker.

Mr. TUCKER. I think one of the things we need to be aware of is that small business pays an enormous amount of fees to accountants and lawyers to deal with the complexities that they have to deal with—the discrepancies in the law, deductions versus capitalization, and the like.

I think a tax parity—and I am the one that used the words tax parity—would help immensely. I think the top rate for corporations that are not pass-through entities and for individuals should be the same top rate.

Chairman CAMP. Mr. Kwall.

Mr. KWALL. Chairman Camp, clearly, under existing law, I would agree that it is very important that there be a balance between the maximum individual rate and the maximum corporate tax rate or else, we have seen in the past, when corporate rates were much lower than individual rates, there is pressure to use a corporation as a tax shelter.

However, under my proposal, I would not allow closely-held businesses access to the C corporation regime. I do not think they belong in that regime. And if they are outside of that regime, then there are two independent regimes and it would not be a problem.

Chairman CAMP. Okay. Mr. Nichols.

Mr. NICHOLS. I would certainly endorse the whole tax parity approach that I think everybody is advocating soon here. I do not think there is any question that if you change the rates to be significantly different for C corporations and for pass-through entities, you are going to go back to the game-playing that I did experience at the beginning of my career between the lower C corporation tax rate, and the devil's bargain of trying to get that money out in some form or another without paying the nasty double tax.

Any system that enhances the gaming is—at the end of the day it is going to start a dynamic between the IRS and taxpayers that, frankly, just benefits the people sitting at this table but does not benefit the country.

Chairman CAMP. All right. Mr. Sullivan.

Mr. SULLIVAN. As Professor Kwall pointed out, the gaming is mainly a result of the ability of small businesses to use C corporation status. And that should be eliminated. I look at it from a different perspective.

In the rest of the world, the clear trend is to reduce corporate tax rates to improve competitiveness; and then because there are tight budget deficits everywhere in the world, they have to make up the revenues somewhere else. And where they are making up the revenue is increasing rates on individuals.

S I think we have to look at this more broadly. We have budget deficit problems. We have competitiveness problems. And the rest of the world, when they have had this problem, what they have done is lowered their corporate rate and increased their individual rates. And I believe those problems can be—the borderline can be policed with effective anti-abuse rules, and very simple rules.

Chairman CAMP. Okay. I just have one other question. We have had suggested by some, and I think it is in the President's tax framework, that certain large, closely-held entities should be subject to a corporate tax rate or the double tax that comes with that. And they use the threshold, I believe, of gross receipts.

My question is for Mr. Martin and for Mr. Nichols. Is it not better to have fewer business entities subject to double taxation than more? And if we cannot eliminate the corporate income tax, would it not be better to determine who can get pass-through treatment by using a business distinction, I think such as Dr. Kwall de-

scribed, whether the entity is complex or whether it is publicly traded. And I would like to get your thoughts on that.

Mr. MARTIN. Well, to me, the elimination of double taxation would be an answer to all kinds of simplification problems. If we allowed corporations to liquidate with one level of taxation and made dividends deductible, as has been mentioned here, many, many S corporations would go away because that is why they were created to begin with.

And certainly I do not think that we should be using the Internal Revenue Code to decide, based on a level of revenues, who should be a C corp and who should not be. As long as the tax rates have parity, I do not see any reason to have a forceful choice of an entity for anybody.

Chairman CAMP. All right. Mr. Nichols.

Mr. NICHOLS. I would have a couple of comments on that, and my written testimony deals with that in more detail. The $50 million test, for example, is extremely arbitrary. Theoretically, you could have one dollar of additional gross receipts that could trigger literally millions of dollars of additional tax because you are in the C corporation system rather than the S corporation system.

And as I go into more detail in my written testimony, you are going to have to have numerous rules to deal with simultaneous where there are multiple entities. We have something like 440 pages of regulations of consolidated return rules to deal with corporations that voluntarily group together to treat themselves as one entity.

But you would effectively have to come up with—if there were, let's say, two dozen affiliated entities in this structure you would have to come up with rules that were at least as complicated and probably many times more complicated in order to deal with that situation. That's on top of the fact that double-tax C corporation treatment is not the preferred alternative, I think, on the part of anybody here.

So I think it would turn out to be much more unworkable than it may appear on its face. And I would be happy to follow up with more detail on that.

Chairman CAMP. All right. Thank you very much.

Mr. Levin may inquire.

Mr. LEVIN. Again, welcome. And Mr. Tucker, we will not do it here, but let's compare notes; where we grew up, it was pretty close, including some of the markets we went to.

Mr. Kwall, congratulations. Your five minutes was very succinct, really, very much so. In fact, all of you have been. And I think as we proceed with tax reform, which we must, I think it is useful to have a discussion like we are having here.

I went back and looked at some of the Joint Tax materials that we received earlier, and it was really interesting. Some of it was a bit surprising. For example, on the distribution of these various entities by asset size, for C corporations, 97 percent of assets are held by those with over 100 million. So we are dealing mostly with C corporations that are rather large.

And it was interesting, that was more mixed as to S corporations, quite a bit more mixed. But as to partnerships, 75 percent

of assets are held by those with over 100 million in assets. So I think we need to look at facts like that.

In terms of business shares, it was also interesting that now pass-throughs, this is, I think, given to us by Joint Tax, have 49 percent of the net income and C corporations 51 percent. And of that, the partnerships have the larger part, though not a vastly larger part, of the business shares.

Also, there was a recent article in the New York Times, based on figures from the Bureau of Labor Statistics that I think all of us should look at that. In terms of job growth, between April 1990 through March 2011, it said that over that period, employment at larger companies rose 29 percent while employment at smaller companies rose by less than half as much.

But also, and the data will become, I think, clearer, they said, later this year, that small companies seem to be more nimble when it comes to various economic impacts. So I think as we go forth and talk about tax reform, that all of us should look at the materials from Joint Tax and the Bureau of Labor Statistics.

Let me just ask you, Mr. Martin, in terms of the position of NFIB, whose members overwhelmingly support permanently extending the current 2001 and 2003 tax rates, has the organization spelled out how it would pay for that extension?

Mr. MARTIN. If they have, they have not told me.

Mr. LEVIN. We are talking about trillions.

Mr. MARTIN. I understand that.

Mr. LEVIN. When they tell you, let us know. No, seriously, it is a major, major issue, and I think everybody has the responsibility of indicating how they would pay for these items in view of our deficit challenge. So maybe you could ask them to be in touch.

Mr. MARTIN. I will ask them to get in touch with you.

Mr. LEVIN. Thank you.

Mr. Sullivan, just quickly, I just want you to emphasize this. On page 9, and your chart shows this, you say, "Only about 8 percent of ordinary, high-bracket income is generated by small business employers. The bottom line is that most income affected by the rate change has nothing to do with small business employment. If the goal is to promote employment at small businesses, providing tax relief to all income in high brackets is an extremely inefficient way of achieving that objective."

Could you elaborate?

Mr. SULLIVAN. Yes. This data is actually—as people who work through pass-through data know, it is very hard to work with. It is very hard to interpret. There has been a new study that came out in August of last summer, a technical study from the Treasury Department, that made this type of linkage between small businesses and small business owners possible. And so we really weren't able to—this is new data. You have not seen anything like this before.

And one thing that comes out of it is wealthy, high-income households, most of their income has nothing to do with—it is wages. It is interest income. Most of it has nothing to do with small business. And that is what comes out clearly in this data.

Mr. LEVIN. Thank you.

Chairman CAMP. Thank you. Mr. Herger is recognized.

Mr. HERGER. Thank you, Mr. Chairman.

Mr. Martin and Mr. Nichols, both of you mentioned in your written testimony the importance of Section 179 expensing rules for small businesses. Coming from a small business background, I have long supported the expansion of Section 179 so small business owners can write off their investment in the current tax year rather than depreciating them over an extended period of time.

Could you comment further on why this policy is important and how small businesses would be affected if the expensing allowance were reduced to 25,000, as is currently scheduled to occur next year?

Mr. MARTIN. Well, I can address it from the perspective of my client base. I think 500,000 is high enough. I don't think it needs to be raised, even though I think NFIB would support, I think, would support an increase in that expensing election. 500,000 is high enough in my tax base.

It is not just the complexity issue. The complexity of keeping depreciation records is not a big deal. I don't have one client that knows how to calculate depreciation; I do it for every one of them. So putting it into software, it is not really a complexity issue for me, although that is argued by a lot of people.

It is the availability of capital. If you can get a deduction for equipment that you are buying, you are much more apt to buy it, for one thing. You are more apt to be more efficient in your business, generate more profits, put investment in the capital equipment industries. There are just a tremendous number of benefits to increasing that expensing election. I would be very much in favor of maintaining it at $500,000.

Mr. HERGER. Thank you.

Mr. Nichols.

Mr. NICHOLS. I think that is a critical provision. Frankly, it was brought home to me early in my practice. A client called me up. He had just made his first million bucks, and he had quickly invested that million bucks buying capital equipment and all sorts of other things he needed in his business. He called me up and said, "We have got a problem. My accountant tells me I owe taxes."

And I started to explain to him all of the depreciation rules and that he does not get an immediate deduction for all of that.

Well, he did not let me finish. He said, "Tom, you do not understand. I have no cash," and that, frankly, is for a lot of closely held business how they look at things. That is a matter of survival for them. That is what they look at. That is how they analyze their business. That is how they analyze the success of their business.

So obviously, having the expensing rules available at the current levels or maybe even increased is very important, I think, for closely held business.

Mr. HERGER. Thank you.

That is certainly my experience, and as I talk to small businesses I do not think that these points can be emphasized enough.

In looking at the data on privately held companies, one thing I found somewhat surprising is the number of very small companies that are organized as C corporations and subject to the entity level tax despite the apparent advantages of pass-through status. According to the Joint Committee on Taxation, about one in four C

corporations had less than 25,000 in total receipts in 2009. My sense is that many of these companies may be trapped in C corporation status by overly restrictive tax rules for companies who want to convert to S corporations.

I would like to get your thoughts on why so many small businesses are organized as C corporations. As part of tax reform, should we look for ways to make it easier for closely held C corporations to transition into a pass-through regime? And starting with you, Mr. Smetana.

Mr. SMETANA. My opinion is that the fundamental reason you see so many of them is that they are not getting good tax advice. Really for an entity, especially a small receipts entity, the double level taxation and the marginal rates of approximately 60 percent really are inappropriate for reinvestment.

The other cause that we typically see is just longstanding small companies that were originally formed as Cs before they had options typically do not switch. Built in gains considerations are certainly a factor if they are on the LIFO method of accounting. They have a catch-up tax payment due. So there are economic reasons as well that I believe prevent them from converting to a more appropriate tax regime for their business.

Mr. HERGER. Mr. Martin.

Mr. MARTIN. Since the Tax Reform Act of 1986, I think I have only had two clients come to me where I advised them to be C corporations, and that was because of fringe benefit reasons. There are some fringe benefits only available to C corporate level employees, not to S corporate level employees, and that was going to be a significant benefit to them.

Other than that, they have all elected to be S corporations. There was a forgiveness year when the Reform Act of 1986 was passed, which allowed people to convert without built-in gains. The built-in gains burden is significant. My policy is to ask my client are you going to retire within ten years. If they expect to retire within ten years, we try to elect S corporation and get out of it.

There are some cases, like a cash basis business, you really cannot elect to be an S corporation from being a C corporation because you have to pay tax on all of the receivables in the next year. You really cannot do it. So they are locked into that position.

Chairman CAMP. All right. Thank you. The time has expired.

Mr. Johnson is recognized.

Mr. JOHNSON. Thank you, Mr. Chairman.

Mr. Martin, you testified that an important simplification measure for small business would be to increase the threshold for cash accounting from five million to ten million in revenue. Can you explain how doing so would ease the administrative burden for small business?

Mr. MARTIN. Accrued income and accrued payables could just be completely ignored. Calculation of the wages that are due for vacation pay payable or sick pay payable, it takes me an hour at least at the end of the year to do that for a client if they are on full accrual method. If they are on cash method, we just ignore it, do not have to deal with it at all.

So simplicity-wise it is a great benefit. The IRS has been pretty, I guess, accepting of small businesses because they passed revenue

procedures for one million dollar levels for all businesses and $10 million levels for some businesses. I would like to make that $10 million for all businesses. It would save my clients a lot of cash flow.

Mr. JOHNSON. Yes. Would it require some other changes to the code or just that?

Mr. MARTIN. No, all you would have to do is just that. The phase-in last year, the last time they did it, they were very accepting in terms of how the phase-in was done. It was very easy to do, and if they did the same thing again, it would be a huge benefit to small business.

Mr. JOHNSON. Thank you.

Now, Mr. Nichols, you testified the proposal in the President's corporate tax reform framework to increase the threshold for small business to use cash rather than accrual accounting from five million to ten million in revenue would not benefit the vast majority of closely held businesses. Can you elaborate on why you think that is the case?

Mr. NICHOLS. I must admit that I am not as familiar with the President's proposal.

Mr. JOHNSON. Neither am I. Do not worry about it.

Mr. NICHOLS. But just to be honest, I think there are a lot of closely held businesses that for banking and other reasons, end up using generally accepted accounting principles anyway, and they get used to using the generally accepted accounting principles in terms of analyzing their business and their profits and losses.

I would not want to say that it would not help anybody, because there are no doubt situations where it would. On the other hand, there are many businesses for whom I do not think it would make a great deal of difference, and there are some that will actually affirmatively elect accrual basis treatment simply because it is easier to keep both their tax accounting and their regular books on the same basis.

So in terms of the list of things that would be useful and helpful for closely held business, I cannot say that this would have no value, but I do not think it would be at the top of my list.

Mr. JOHNSON. Thank you, sir.

Thank you, Mr. Chairman. I yield back.

Chairman CAMP. Thank you.

Mr. Neal is recognized.

Mr. NEAL. Thank you, Mr. Chairman.

Since 1986, the number of corporations has dropped 28 percent while the number of pass-throughs has grown by 102 percent. The 1986 pass-throughs earned 40 percent of all business income. Today they account for nearly 60 percent of the income earned by all businesses.

Some have suggested that this change is in large part due to tax considerations, as Mr. Herger noted, and others have taken a different position, indicating that multiple reasons exist for this shift, including the growth of the service sector, ease of administration, and the fact that you can get limited liability and still get pass-through treatment.

To the witnesses here, what are your views on the reasons behind this shift? Mr. Sullivan, you touched upon this. And what do you think about the trend and whether or not it is a problem?

What implications does the increasing proportion of business income that is being taxed as individual income have for an issue that is close to all of us, and that is the issue of tax reform?

We will perhaps start with you, Mr. Sullivan.

Mr. SULLIVAN. The invention of the limited liability company was in the mid-1990s or the early 1990s, and that after the 1986 Act just made it open season for larger businesses to have the advantages of limited liability and the exemption from the corporate income tax. The problem that this causes, it is a benefit for these companies, but there is a disparity. Some large businesses pay corporate tax. Some do not, and that is an arbitrary distinction with no economic basis.

Mr. NEAL. The other members of the panel? Yes, please, Mr. Nichols.

Mr. NICHOLS. I think the treatment of closely held businesses is a matter of critical importance, but if we start to focus on having different systems for the two, that is problematic.

And I would want to respond to something that was said earlier. If we start to focus and we essentially allow publicly held and larger corporations to essentially retain earnings at a lower rate, which is what I think has been suggested, and we do not allow pass-through entities to retain their earnings at that same lower rate, that to me is an arbitrary advantage that you are giving to the larger corporations, and I see no reason to do that.

Another thing is the pass-through system itself: it is the most logical one I have seen. I have seen business owners convert especially around the Tax Reform Act of 1986 convert from a double tax system to a single tax system, and they literally stopped spending as much time worrying about taxes because they paid taxes once. They pay them right away. They reserve for them, and then they are done. And then they think in terms of their business.

So from the standpoint of moving forward on tax reform, pushing toward a single tax system is very beneficial and at the end of the day constructive in my opinion.

Mr. NEAL. Mr. Kwall.

Mr. KWALL. In terms of the shift, I think a large part of it was attributable to the 1986 tax reform and two changes that occurred at that time. One was the parity between individual and corporate tax rates that was created because prior to 1986, corporate tax rates were much lower. It was aspirational to use the C corporation regime to get the advantage of those lower corporate tax rates.

Secondly, after 1986, you could no longer sell a C corporation business without the imposition of a heavy corporate tax on the gain. It used to be just one shareholder level tax on the gain when you sold a C corporation business, but now there is a big tax at the corporate level. It is a capital gain, but there is no reduced capital gains rate for corporations. So it is a prohibitive cost on any business that thinks it is going to be successful.

Mr. NEAL. Mr. Tucker.

Mr. TUCKER. I think you are seeing two things. Number one, the Internal Revenue Service recognizes the limited liability com-

pany would be taxable as a partnership, not a corporation. It started in Wyoming in 1977, but it wasn't until the late 1980s that the Revenue Service allowed it. That enabled your client to have a shield from liability as a limited liability company, even if they were managers, even if they were the business people running the business.

Corporations have enormous risk of complexity, equity versus debt, reasonable compensation, audits on a continuing basis, and you need simplicity, lack of complexity and the ability to run the business, not to be afraid of taxes at all times.

Mr. NEAL. Mr. Smetana, you had your hand up and then we will come back to Mr. Martin. Just a few seconds.

Mr. SMETANA. Quickly, again, it goes back to the fundamental economic principle of business. Privately held companies, closely held companies elect this form and it is increasingly so because they get to retain more cash in the business. That is a fundamental economic driver of growth and maintenance and jobs and economic activity at these corporations.

I would also make a comment that whether you are in a pass-through regime or a corporation, the entity is still covering the tax. So I think it is an important distinction to make that that cash does still come out of the business regardless of which regime you are taxed on.

Chairman CAMP. All right. Thank you. The time has expired.

Mr. Brady is recognized.

Mr. BRADY. Thank you.

I would like to follow up with Chairman Camp's questioning in favor of taxing income of closely held businesses only once. The White House often speaks of the pass-through business form as if it is some type of loophole that is used to avoid the double taxation business income that applies to C corporations.

In fact, in the corporate tax reform framework, the President recently proposes to double tax the income of certain unspecified large pass-throughs. So my question: in this struggling economy, as we look for companies to invest and create jobs, what would the President's proposal do by proposing double taxing some of our pass-throughs?

Mr. Smetana, and we will run down the row.

Mr. SMETANA. Sure. We actually did an analysis of the President's proposal. First of all, the increase in the marginal tax rates would cause our company to only retain approximately 40 cents of every dollar of profit we earned versus 60. That would certainly decrease our opportunities in terms of reinvestment and growth.

Secondly, the provisions related to lengthening out the depreciation schedules also moving us to the corporate regime and the elimination of the last in, first out accounting method for companies that hold inventory would create an additional five to $6 million a year in taxes to our corporation, again, reducing our ability to fund the business and invest in the business.

And certainly the LIFO impact on us, on a business that holds inventories in an inflationary environment over the last three decades would cause roughly an $18 million tax burden on our company that we would have to pay over some amount of time, again, money that we would have to find either out of future earnings or

borrow against, which again would limit our ability to grow and maintain the company.

Mr. BRADY. The President or at least the White House views LIFO as some type of accounting gimmick, some type of subsidy loophole that businesses apply to. It is a traditional form of accounting, and that change would, in my understanding, hit companies with inventories in a major way.

Your thoughts? Is that a loophole?

Mr. SMETANA. I believe that is a sound economic principle if our objective is for companies to maintain a sustained inventory investment, and simply put, the LIFO method of accounting allows a company to reinvest every dollar of profit on the increase in that inventory cost back into inventories.

Otherwise companies would have to find either 40 or 60 cents, depending on which tax regime they are, in our case 40 cents of every dollar of profit. We would have to either borrow or take out of other economic activity just to maintain the same amount of inventory investment.

Mr. BRADY. Thank you.

Mr. Martin, on the original issue of taxing pass-throughs in a double sense.

Mr. MARTIN. I have already expressed that I am very much opposed to double taxation. I like to think of the word "fairness," and when I stand up in front of my classroom and I am teaching 30 students about the tax law, I am very quick to tell them that certain things in the law are fair. Some of them have no equity at all and it does not make any sense, but are there maybe for social reasons or whatever. There have been allusions today to generally accepted accounting principles. Generally accepted accounting principles recognize what is known as the matching principle. LIFO very much adopts the matching principle which says that we match current cost with current revenues. The non-LIFO methods of accounting do not, and they are very expensive for companies to adopt. LIFO has not been a big deal because inflation has not been rampant over the last ten years or so, but there are some heavy industrial companies that have been using LIFO for a long time. If LIFO were disallowed, they would pay a heavy penalty.

Mr. BRADY. That is what I understand. Thank you.

Mr. Tucker.

Mr. TUCKER. I think one thing that people forget is in a pass-through entity, the owners are taxed irrespective of whether they receive distributions and, therefore, very often they are being taxed without receiving the cash, as somebody noted before, but the cash is being used for the business. They have elected to do that. They are willing to do that.

To penalize them either because they are bigger or to penalize them because of some other reason would result in double taxation, and they are already paying the taxes on the income. But taxing the companies that grow these businesses because the growth has been in pass-through entities is wrong. It is just erroneous.

Mr. BRADY. At the end of the day the economy suffers.

Mr. TUCKER. Everybody suffers, the economy and workers.

Mr. BRADY. Thank you.

Mr. Kwall.

Mr. KWALL. You really need a rationale for double taxation, and under current law, the rationale seems to be public trading. If you are publicly traded, you are subject to double taxation.

So if the line is to be moved, there should be a rationale for the movement, and you also want a line that is going to work well and work as a good division.

I think public trading historically has worked reasonably well. So if you are going to substitute some other standard, you need to make sure that it is going to do the job and actually——

Mr. BRADY. Rationale is not necessarily a prerequisite to policy changes as you know in Washington.

Thank you all very much, Mr. Chairman.

Chairman CAMP. Thank you.

Mr. Tiberi is recognized.

Mr. TIBERI. Thank you, Mr. Chairman.

Just two questions if the panelists could answer them quickly, and some of you talk about them in your testimony, the two questions. The Chairman has been quite clear that he believes that we should provide comprehensive tax reform or go in that direction. Some in this town believe that we could just do corporate only and that would be fine.

If we could start from the left and go to my right, what would your opinion on that be?

Mr. SMETANA. We need to have comprehensive reform, period.

Mr. TIBERI. Mr. Martin.

Mr. MARTIN. I agree we need comprehensive reform as well. We cannot have divergence of tax systems. You just add tremendous burden on small business.

Mr. TUCKER. I like being in the center. I am neither on the left nor the right. On the other hand, I truly believe we need comprehensive tax reform. It is time for it. It is really time.

Mr. TIBERI. Thanks.

Mr. KWALL. I would agree with my colleagues. We are definitely in need of comprehensive reform.

Mr. TIBERI. Mr. Nichols.

Mr. NICHOLS. My guess is we are going to have unanimity on this one. I do not think there is any question that comprehensive tax reform makes sense. Comprehensive tax reform makes sense, and anything other than that essentially risks us going back to the game playing that we had before the Tax Reform Act of 1986. There is no need to go backwards.

Mr. TIBERI. Mr. Sullivan.

Mr. SULLIVAN. Let me put it even a little more strongly than the panel has put it. I believe you should start with small businesses and then move to the larger businesses because I have been around a few years. There is a tendency to forget small businesses once the big issues come up. To prevent that bias from occurring, start with the small and the large will take care of itself.

Mr. TIBERI. Thank you.

I met with a group of farmers from Ohio yesterday. In your testimony, Mr. Smetana, you mention about privately held companies and their need for planning, long-term planning, and these farmers were talking about that. In fact, as you probably know, farmers sometimes plan not only decades but generations, and one farmer

in particular was distressed over the Tax Code and how complicated it had become to him and his family.

Can you talk about the differences in comprehensive tax reform—we can start again from my life—and how we should apply the differences between closely held family enterprises versus publicly held companies and the differences between long-term planning versus short-term planning?

Mr. SMETANA. Sure. I think it is a very important distinction because, as I said in my testimony, most privately held or closely held companies have time frames that are years or even generations, and so, therefore, there are several considerations.

One is certainly the sustainability of the business, and that is largely based on the amount of cash flow that the company can generate on an annual basis and over a period of time and retain in the business to sustain itself.

On the longer term basis, the shift in generation to generation is extremely important, and you need closely held companies, particularly family owned ones. Because of the onerous level of taxation at the time of death of an owner, we have created a situation in this country where the mere form of organization creates a distortion between a company that is one owned by a closely held family versus one that is owned in a different form of structure to the point where the family owned business, in effect, has to have enough liquidity or try to plan if they possibly can for enough liquidity to pay the tax at the time of death of one of the owners.

What typically results is that, as some of my colleagues in FEI have said, we end up doing unnatural acts to try to prevent a catastrophe at the time of death and the loss of jobs and economic activity, and that typically results in diverting economic activity away from the business to try to preserve that.

It just do not seem to make sense to me that at a time when we are trying to preserve jobs and trying to preserve economic activity that the death of an owner should cause some interruption in that activity, especially on a going concern.

Mr. TIBERI. Thank you.

Mr. Martin.

Mr. MARTIN. I think most of you received a copy of a study by Mr. Carroll who basically identified the agricultural industry as the hardest hit industry in this country if we had different tax rates for businesses whether they are owned as C corporations or are owned as pass-through entities, so a very, very unfair result I think.

My clients operate from the checkbook. Small businesses want to know if they have enough money to pay the payroll every week. They are only thinking about succession if I force them to or if they get to the age where they really have to or if they have children who are kind of pushing the issue on them to deal with it. They do not want to talk about it. They do not want to deal with it. It is a closely held situation with families.

Small businesses are on a short-run decision making process. They fire people last. They hold onto them because they believe in them. They trust them. When they hire them, they have longevity. If you work for a small business, even though there is very rarely

a union, you have longevity with that business. They support you in that position.

Chairman CAMP. All right. Thank you.

Mr. Davis is recognized.

Mr. DAVIS. Thank you, Mr. Chairman.

I would like to follow along a little on that line of questioning, just having worked in the manufacturing world and its various tiers before coming to the Congress. I think that the underlying premise in this discussion is we want to address the rate issue, which is very real, but there is another other tier of issues underlying that. I have an example I want to put out and seek some comment on how we harmonize this, knowing that our premise for discussion is a revenue neutral reform.

And it is very exciting to be part of the dialogue to try to change the underlying process to stimulate the creation of job, especially encouraging small business owners.

Let's look at the automotive industry as an example. The OEM or their Tier 1 suppliers invariably are international businesses. They will be located in multiple sites, integrated information and financial systems, supply chains that transcend the borders. Rates become a big issue. Those companies are operating on an accrual basis by and large. They are dealing with capital investment in a different way than, say, the Tier 2 or Tier 3 suppliers might be addressing the issues, to Mr. Martin's point, functioning from the checkbook.

I have worked with a lot of suppliers that, in fact, did that, very successful businesses, but they were much more cash oriented. They were often cash basis accounting. They did not like the idea of rates, but for the most part, they were pass-through entities for all practical purposes because you typically had a family or a collection of families that had started this business and grew it, where LIFO is a huge issue.

Capital investment for machine tools, I watched a number of businesses, two in particular, that walked away from, say, purchasing five axis vertical mill technology because they were uncertain about what their depreciation schedules were going to be, you know, dealing with that aspect.

England has tried some interesting approaches in harmonizing these issues at some various reforms. There is a lot of talk around the world about different schedules, you know, and how to deal with these issues. I am going to premise my question as someone who wants to see us go got a territorial system, have the ability of this rate issue to be addressed, but what I would like you to comment on in terms of reducing complexity, especially for small business: how do we address this issue of maybe giving the smaller businesses some options to address the issues like LIFO, to address the issues like depreciation, to encourage capital investment when they are functioning on the checkbook or cash basis and still hit revenue neutrality?

Maybe start with Mr. Smetana first and then open it up to the panel.

Mr. SMETANA. Sure. A couple of quick comments. First of all, I think there are a lot of allusions to the size of the corporation, and I will just say I think in the case of deciding policy, in this case

size does not matter. It is really the form of organization and what we are trying to do with the economic activity within that business.

You know, me and my colleagues compete with companies of different sizes. So I think the level playing field is to create all businesses, regardless of their form or size to be able to have the same advantage.

With respect to simplicity though, I do think that we can recognize that smaller formed companies do have some more complexities than larger ones in terms of maintaining current Tax Code and compliance, and I do think that it would be appropriate to look at levels and limits that are appropriate and typically used by smaller entities to have access to quicker deductions than perhaps larger companies with respect to recognizing that fact without changing the fundamental text related to the form of the organization.

Mr. DAVIS. Thank you.

Mr. Martin.

Mr. MARTIN. I would say that I do not know how to make it revenue neutral, but for a small business to have——

Mr. DAVIS. Let's imagine CBO actually has formularies that reflect the way you actually do business for a moment.

Mr. MARTIN. Okay. When I was a representative to the White House Conference on Small Business in 1986, the number one issue voted by the representatives there was to have no changes in the tax laws for two years. Small businesses would love to have no changes in the tax law for two years or more in terms of managing their business. That just gets it out of their mind completely. They do not have to worry about it. They do not have to call me once a month to ask me what the issues are.

I would say adopt the changes you are going to adopt, and then somehow put limitations on some future Congress. I know that is not something that is done, but small business would love to have that fixed right.

Mr. DAVIS. Mr. Tucker.

Mr. TUCKER. I would like to concur with what was just said. One of the worst things that we face every single day is not knowing what the law is going to be next year or the year after, and therefore, are you embarrassed because you made an investment this year and only got to write off 25,000, but if you had just waited until next year, it would have been 100,000 or 500,000?

You need to bring stability into the Internal Revenue Code for all business.

Chairman CAMP. All right. Thank you.

We do have the prospect that we are facing of all tax policy expiring at the end of this year. So we really do not have the option of not doing anything.

Mr. Reichert is recognized.

Mr. REICHERT. Thank you, Mr. Chairman.

So-called flow-through entities or those businesses that pay taxes through individual codes play a huge role in our economy, as you all know. Fifty-six percent of the jobs in Washington State where I am from are sustained and created by these businesses, and they account for 69 million people across the United States, and they

cannot be neglected in the tax reform effort that we are involved in here.

So, Mr. Nichols, first I want to thank you for your comments supporting the extension of the five-year built in gains holding period. This shorter, more reasonable holding period unfortunately expired along with other tax extenders at the end of last year, and as you mentioned, I have introduced bipartisan legislation, H.R. 1478, with Mr. Kind from Wisconsin, to improve many of the rules governing S corporations, including making permanent an extension of the five-year built in gains holding period.

And, Mr. Martin, you mentioned this is one of the issues that you pointed out would be very important for us to address going forward also.

The IRS statistics suggest that thousands of U.S. businesses should be sitting on appreciated assets that could be put to better use. In an economy short of capital, it just makes sense to allow these businesses increased access to their own capital.

Mr. Nichols, can you explain the purpose of the built in gains tax and why the five-year holding period is more reasonable than the ten-year holding period?

Mr. NICHOLS. Well, the built-in gains tax was originally adopted primarily to prevent people in C corporation status to convert and avoid essentially the double tax on the sale of the business, and I have never been convinced that paying only one tax is a tax loophole and paying two taxes is appropriate policy, but that was the policy, it seems, behind the built-in gains tax.

In terms of how the built-in gains tax works to free up capital, essentially I have got a situation. Fortunately it is a client who has already been an S corporation for a while, but they have got a piece of property, and they want to buy a new, bigger piece of property, expand their business, hire more employees. If they were subject to the built-in gains tax, what they would have to do is sell their old property, pay double tax on that property, and then essentially turn around and invest those proceeds in the new property.

Now, they cannot qualify for Section 1031, the like-kind exchange rules, because they have got to operate their old facility for a period of time before they can move into the new facility. And so as a consequence, if they were seriously considering doing exactly that, but if they were in a position where they would have to pay double tax, which is what the built in gains tax regime is, they would essentially be trapped into that for five years or ten years.

Obviously, five years is a heck of a lot better than ten years in terms of waiting to utilize this capital.

Mr. REICHERT. Thank you.

Mr. Martin, would you like to comment?

Mr. MARTIN. I had a client that I asked when he was going to plan to retire at age 50 and he said age 60, and then at age 55, he decided that he had had enough. He had converted on my advice at age 50 to be an S corporation, and I said to him at the time, "You know, when you convert, you cannot sell your principal piece of real estate here which is fully depreciated and worth a lot of money for ten years."

And that is what happened. He sold the rest of his business. He did not sell the real estate until the ten-year time frame was up. That was not good for him. That was not good for the economy. It was not good for the buyer who bought the piece of property, but here was the tax law dictating what would happen in his operation of his business. It was kind of crazy.

You know, five years is a whole lot better than ten years. Five years kind of takes into account unusual things that happen unbeknownst to all of us.

Mr. REICHERT. Well, thank you, gentlemen, for your answers, and I yield back.

Chairman CAMP. Thank you.

Mr. Roskam is recognized.

Mr. ROSKAM. Thank you, Mr. Chairman.

And, again, Mr. Smetana, thank you for coming at our invitation to give a perspective.

In our district in suburban Chicago, we have got a tremendous amount of pass-through entities who are job creators and employers and just a tremendous amount. I was at a company not long ago touring the plant floor, and the owner said to me, "Congressman, the smart move is for me to put three-quarters of a million dollars into this production line, but I am not going to do it, and one of the reasons, not the only reason, but one of the reasons," he said, "was Washington tells me I am rich, and I am not going to do it."

You mentioned sort of the long-term planning in terms of the pass-throughs. You mentioned the generational aspect. Could you reflect on that, just be a little bit more expansive on it?

What is the impact when Washington tells Eby-Brown you are rich?

You know, Congressional Research Service a couple of weeks ago reported that nearly 60 percent of all business income is reported through the individual income tax system, and 62 percent of that amount is reported by those that the President calls wealthy.

Can you give us the lay of the land on how that has an impact at your end of the rainbow?

Mr. SMETANA. Sure. As I said, you know, we were a family owned company for, you know, decades, and we were not big at one time, but we became big, and the reason we became big is because the family was able to reinvest its after-tax cash flows back into the business, with a little help from the banks from time to time to finance the business to grow.

So you know, the fact that we are big and the fact that the family has been able to commit to the business and grow its employee base, grow its asset base, grow economic activity, you know, is really the fundamental point about it. The fact that we are large should not really dictate whether the family can keep 40 cents or 60 cents of its profits. In fact, I would clearly tell you that if the family only got to keep 40 cents of its profits, we would be a smaller business than we are today with less employees, less assets, less economic activity.

I also think that fundamentally, as Mr. Kwall talked about, there is an important distinction between the double taxation regime over corporations which is mostly public formed corporation. An in-

vestor in a public corporation is really a trader of securities, and if the government wants to tax that trading activity as a separate economic activity, I suppose it can decide to do so.

But to try to equate that with the income derived out of a closely held business which is left in the business; closely held owners do not actively trade the business as a holder of a C corporation stock does, a publicly held C stock; so, therefore, I think you have to make that distinction in tax policy, and I think that distinction helps those privately and closely held investors make decisions to reinvest in their business.

Clearly, from our perspective as we look at our business planning, the most important things to us are the ability to retain as much cash as we can in the business on an after-tax basis and the certainty which we have when looking out forward when we make decisions. And our investment decisions in business are not typically a quarter at a time or a year at a time, but multi-year in nature.

It has been very difficult over the last several years to make those decisions, and I would submit to you that many investment decisions are not being made because the fear of the marginal rate increase, which has been delayed from time to time, but only at the last minute, which has really put a crimp in making good economic decisions for the long term.

Mr. ROSKAM. This Committee and this Congress in the coming months are going to have decisions to make as it relates to the extension of the 2001 and the 2003 tax cuts and those rates. What is the impact on your business if those individual rates go up?

Mr. SMETANA. As I mentioned before, Mr. Roskam, we are facing an increase in our marginal rates of four or five percent. Certainly under the President's proposal, if we lose AMT preferences, it could go higher, especially with sourced income from higher taxed States.

We have been able to take advantage of the faster depreciation rules over the last few years, and our owners have invested tens of millions of dollars back in the business because the after-tax cash flows of those investment decisions have been aided.

So from our perspective it would reduce our after-tax cash flows, and it would certainly make an impact on the kinds of investment decisions that we make going forward.

Mr. ROSKAM. And the employee opportunities, I would assume?

Mr. SMETANA. Absolutely. We have been fortunate that we have been able to grow our business. We are in a relatively stable industry, and our business has been successful. We have been able to add jobs over the last several years and increase that economic activity accordingly.

Mr. ROSKAM. Thank you for waving the Sixth District flag. I yield back.

Chairman CAMP. All right. Mr. Gerlach is recognized.

Mr. GERLACH. Thank you, Mr. Chairman.

My question really is sort of a follow-up to what Mr. Roskam just asked. If I heard correctly from the panel a number of minutes ago, there seemed to be some general consensus that in our tax reform efforts we ought to sort of try to align the maximum marginal rate for corporations and individuals and make that as consistent and

comparable as possible so that you do not have an inappropriate shift of entities.

If that is the case, there seems to be a developing consensus in Congress and within the Administration that perhaps the maximum tax rate for corporations ought to be around 25 percent.

The House passed a budget last spring calling for a maximum rate of 25 percent. I think just looking out ahead, perhaps we will do the same again this spring. The President just put forward a corporate reform proposal which I think is a maximum rate of 28 percent with maybe on manufacturers of 25 percent, so clearly within the same ballpark of discussion.

So based upon that, if we can have all the panelists answer the question, would you agree then that the maximum individual rate of taxation under any tax reform proposal ought to be 25 percent?

And just start maybe with Mr. Sullivan. You are the closest, and then just work up the panel.

Mr. SULLIVAN. Well, I think I am going to be the contrarian here. I think this line-up of the rates, which my attorney and CPA friends obsess on, is the tail wagging the dog. We have larger considerations: deficit reduction and competitiveness. We need to lower our corporate rate. When we do that, we have to find revenue elsewhere.

One place that you may have to look is at raising taxes on individuals to make up that difference. We do not want to do it, but there are not many options.

Mr. NICHOLS. I would go in the other direction. It is absolutely critical on a marginal basis that we have a low marginal rate, and I think we proved up until the Tax Reform Act of 1986 that if you have varying rates for varying types of income, that it is going to essentially cause tax lawyers and tax accountants to intermediate between those two rates to prevent the government from essentially getting the full benefits of the various differing rates that it wants to achieve.

The simpler the tax system you have the better. I would make one other important point, and this is virtually universal for the taxpayers that I represent. Their biggest fear is that there is going to be an attempt to essentially solve all of our fiscal problems and, frankly, many of the world's problems, by essentially, quote, taxing the rich and they today worry about how much their marginal income tax rates are going to go up.

What you need to have is a system whereby everybody is paying taxes. Everybody is paying taxes maybe not at the same rate, but at similar rates, and everybody is benefitting from government so that essentially there is buy-in both as far as revenue and also as far as expenses so that people are similarly motivated.

Mr. KWALL. I do not really have a view as to what the rate should be, but if current law continues, it is clearly destabilizing to have a corporate rate that is significantly lower than the individual tax rate. We have been there before, and what happens is it puts a heavy burden on the government to preclude taxpayers from trying to shift income to corporations and to resurrect penalty taxes that require the business to justify its needs for its earnings. The Government has to find these cases and try to pursue them to avoid the tax avoidance.

Again, in my view the better solution is to keep closely held businesses out of the C corporation form. If you do that, then you have really got two separate systems, but if you are not going to do that, then I would agree that you want to maintain that parity.

Mr. TUCKER. I am an advocate of parity. I would also like to remind everyone that we also have an estate and gift tax. Whatever these people have earned and have left after taxes is going to be subject to an estate or gift tax, and you go back, unless the law is changed rather quickly for next year, to about a million dollar exemption and a 55 percent estate tax rate, and I think you need to take that into account as well for small businesses and small business owners.

They are not rich at that kind of level. They are simply not.

Mr. MARTIN. Well, we have expressed several times that parity is important. I do not know what the rate should be either, but as close as it can possibly be I think is better for business planning, and let's have some permanency, like the extenders that we deal with every year or every two years. Let's do some things on a permanent basis so small businesses can plan.

Mr. SMETANA. I think you are in an unenviable position of having to try to correct a fiscal situation with only working at one side of the equation. As financial professionals, we can hardly ever turn around our companies and improve them if we are only dealing with revenue and not dealing with spending.

But to your point, I think the policy and goal of our Government should be to take the least amount of taxes from its people to sustain the Government for the spending that it feels it is required to do. So whether that is 25, 28, 15 percent, I think you have got to look at it on balance with the total expenditures of this Government and what we should be providing to our citizens.

Mr. GERLACH. Thank you very much.

Thank you, Mr. Chairman.

Chairman CAMP. Mr. Buchanan is recognized.

Mr. BUCHANAN. Thank you, Mr. Chairman.

I want to thank our witnesses today.

As a guy that has been in business 35 years and started in 1976, I remember my first entity was a C corporation, and then they came to me, the tax professionals, in the 1980s with an S corporation because it gave you the liability protection, and then they came to me and all of our entities lately have been LLCs because it gives you flexibility and distributions and all of the other things.

But I want to make one point that Mr. Smetana mentioned. Let's just take a bank or a lot of times you have got a lot of people who are franchisors or they are dealers, and the factories or the banks require even if you made 500 and even if you want to take it out, you cannot take it out.

Now, many people believe that in the end they might make 500, and they have got 100 employees. That is a lot of exposure and risk, but they might take 100 out and leave 400 in, but many times my experience has been that people require you to keep the capital in. So it is almost like a C corporation.

Now, all of that being said, I hear up here that, you know, all we talk about, even the White House and the Administration talk about lowering the corporate income tax to 27 percent or, our

thoughts here in terms of the corporate to be more competitive in the world 25, but again, I want to get back to the point. I do not know how you can lower the taxes for corporate entities without dealing with Sub S and LLCs because of their growth. Because people will go back and the tax professionals will come back in and tell you to be a C corporation.

So we have got all of this discussion about raising taxes, but all of these pass-through entities are going to be tied to the tax rate. So you have got them going down to 25, and you have got the guy who is running the company going up to 39, many times in the same entities.

So I guess, Mr. Martin, I will start with you. Dealing with a lot of businesses, do you see under any circumstances where you could lower C corporations without really lowering it for small businesses and medium size businesses that are pass-through entities?

Mr. MARTIN. Well, I think the lowest C corporation rate, a huge company, multinational level, probably brings more taxable income back to this country because right now big companies do their planning to ship business overseas where tax rates are lower. So hopefully that increased revenue would somehow offset that.

What we need to keep in mind is the point that was made earlier. The typical pass-through entity takes out their salary at a reasonable level; takes out of that pass-through entity the amount of money they need to pay their taxes; and leaves the rest of it in there. Sometimes that is because creditors require it. Most of the time it is because that is the only way that growth is going to come about.

If you think about an accrual basis entity, you are required to use the accrual method. You cannot grow if you do not have cash because you have got to invest in receivables and inventory. One of the biggest problems small businesses have is growing too fast. If you grow too fast, you cannot find the increased receivables in inventory and you can go out of business.

Mr. BUCHANAN. I have one thing to add to that. In today's environment, in the last three or four years a lot of banks—I am from Florida—especially in Florida, but in other parts of the country, are not lending. So they have to leave the money in there.

Mr. Tucker, anything you want to add to that?

Mr. TUCKER. Two things. One is my clients are all small business people. They all leave money in the entity even though they are taxed on the money.

The second thing is a lot of them have debt that is being paid down, and when you pay down debt, because my clients do not like to be in debt, you get no deduction. So you are doing it with after-tax dollars. To keep taxes for entrepreneurs up here and to have C corporations' taxes down here without parity is truly inequitable.

Mr. BUCHANAN. I want to add a second question. I know a lot of these guys that are in the top tax brackets. Most of them I know, most of them I have known for 30-some years. They are usually the job providers in the community. So really what are we doing if we want to grow?

The talk up here is three things: jobs, jobs, and jobs. Well, who provides those jobs? Most of the folks that, you know, have 25 to 200 employees are these pass-through entities. So if we are going

to have them pay more in taxes, all we are going to do, in my opinion, is hurt more jobs.

Mr. Kwall, do you have any thought on that? Yes, go ahead.

Mr. KWALL. In evaluating the consequences of creating a system where the corporate rate is lower than the individual rate, you really have to take account of in terms of estimating revenue, the potential fleeing from pass-through entities in that situation. In 1986 what ended up happening is everybody fled from the corporate tax when individual rates came down and heavier burdens were put on the corporate tax. So that has just got to be done.

Mr. BUCHANAN. Mr. Nichols, anything?

Mr. NICHOLS. Just a quick point, and that is there is a temptation, of course, to not essentially tax everybody all at the same rate. If you are going to raise rates, raise rates on some and not necessarily on others, but frankly, that is what got us into the hodge-podge that we have got in the Tax Code now. I think it is much better to take the courageous approach and essentially face the revenue needs we have and get a system that works over the long term.

Mr. BUCHANAN. Thank you, Mr. Chairman. I yield back.

Chairman CAMP. Mr. McDermott is recognized.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

I could not help it. I was watching this down in my office, and I came up because I wanted to ask a question. I felt like Russell Long had come out. I was looking around for his picture, but I think he is over in the Senate. His theory of taxation, as you know, was do not tax you; do not tax me; tax that guy behind the tree.

And I have a feeling that we are sitting here talking about where the guy behind the tree is. Then I thought about the fact that former Ways and Means member, who must have learned something on this Committee; I mean, I cannot assume that he sat here and did not learn a thing, Mr. Cantor, presented an interesting tax proposal that he hopes to jumpstart the economy. He says the provision would provide a 20 percent reduction on small business income.

But then I read what is going on in the press, and the Small Business Association and the independent business people, they are not throwing their arms around this proposal and saying it is a good idea.

So tell me about Mr. Cantor's proposal. Why is the small business community not just in here beating down our doors to have that happen?

Anybody can answer that.

Mr. SULLIVAN. Well, I do not have any idea why because it seems like a proposal which would be highly beneficial to them.

Mr. MCDERMOTT. Does anybody else have anything? Why are the small business organizations not endorsing this?

Mr. MARTIN. I think primarily because of—nobody has told me this—but added complexity in the tax law and how you define what that number is going to be that they get to deduct. I just do not know how that number is calculated. I have not even seen the proposed legislation. So I do not know what he is putting through.

Mr. MCDERMOTT. You took the words out of the mouth of Chris Waters. He said, "Just for our members, the top two important

issues are keeping the marginal rates low and reducing the complexity." That is NFIB, right?

And what you are saying is the Majority Leader of the House has introduced a bill that is making people more anxious because it introduces more complexity. That is his solution to this problem it sounds to me like.

I mean, I was here under Clinton when we set the Clinton rates. Okay? I was here in 1993 when we did that vote, 1994, and the country was booming, and so now everybody says we have got to reduce the rate somehow because that is the only way we can get the country going again, and what I hear also is from Mr. Buchanan and others, the banks are not lending.

I mean, let's talk about what the real problem here is. Small business people's problem is the banks will not lend to them unless they have got—I just tried to get my loan refinanced on my house because I thought a 3.9 percent interest rate was pretty interesting. They wanted to have my pay stubs for the last three months, and they wanted to have proof that I had—you know, I can see why a small businessman would go crazy dealing with this, and I do not understand why the Minority Leader would put one out to make it more complex.

I mean, what would be the purpose of that? Has anybody got an answer?

[No response.]

Mr. MCDERMOTT. I yield back the balance of my time.

Chairman CAMP. All right. Mr. Smith is recognized for five minutes.

Mr. SMITH. Thank you, Mr. Chairman.

Certainly I can appreciate this discussion about the complexity of the Tax Code and adding new preferences in the Tax Code. The last I checked, there has been more than one bill introduced or suggestions for our Tax Code that would add more complexity, which certainly does concern me.

But in a broad sense, I mean, we talk about confusion and frustration and instability of the Tax Code, but for the CPAs here on the panel, how often do you encounter someone, aside from the instability and the short-term nature of a lot of these tax policies; how often do you encounter a client who would say, "Gosh, in going back I wish I could go back and redo some planning perhaps"? But how many of them think retroactively and then would apply that moving forward?

Mr. TUCKER. I am not a CPA, but I can tell you that in my practice my clients both look back and look forward. The problem with looking forward is you cannot assure the client of any stability looking forward. It is not just complexity. It is stability, and they do not understand what is going to happen next year, for example, extenders, non-extenders, tax rates, and everything else.

So they look back and they say, "If I had done this at that time, I could have saved taxes. I could have done something different. I could have paid less taxes in the long run."

It is a balancing act, and very often my clients, being entrepreneurs, are, frankly, upset with planning we did before because the law changed, and they did not know it was going to change and we did not know it was going to change. So I think stability has

to be part of focusing on complexity. You need to provide stability for the people in this country and the entities in this country.

Mr. SMITH. Okay. Anyone else? Mr. Martin.

Mr. MARTIN. I would say that my client base does not look back. It is not profitable to look back. You cannot change things that have already happened. If they ask me about some advice that I gave them before, it is always on the basis of what we knew at the time.

It is a struggle enough to get my clients to look forward far enough to make huge business decisions that will affect them in the long run. They are operating today. Do not look back. It is fruitless to look back.

Mr. SMITH. Mr. Smetana.

Mr. SMETANA. I would concur. We are forward looking. You need to be in your business. I would say that over the last several years we have tried to make behavior by the tax policies we have instituted particularly around depreciable lives and fast expensing, and I think what we run the risk of is similar to a shopper in a retail store. They keep looking for the sale. So they defer their purchases until that sale occurs, and I have a feeling that we continue down this path of just short-term policy fixes and short-term incentives to try to change behavior and what we are really deferring are the kind of long-term investments that are necessary for business to thrive and survive and grow.

Mr. SMITH. Okay. Mr. Nichols.

Mr. NICHOLS. And I would certainly concur in everything that was said on the subject before. I would add one other thing, and that is clients, good clients that are running successful business, do not want to do tax planning. They would be very comfortable and would be delighted to have a stable system and, frankly, they want to work on that next sale. They want to get sales to go up. They want to figure out that new technique that is going to reduce cost. That is what they want to focus on, and they resist the idea of, frankly, paying people like us and others because of the complexity or the uncertainty of where things are going to be.

They want to do their business, and if we could just let them do that, we would all benefit.

Mr. SMITH. Now, I guess in light of this topic though, you know, we know that the Tax Code has so many tax preferences, hundreds, many of which are temporary in nature, and there are more proposed as we have heard several times this season. Obviously, the beauty of a tax preference is always going to be in the eyes of the beholder, aside from the rate, but perhaps a rate can impact that a little bit.

How high of a priority should reducing preferences in the Tax Code be as we tackle tax reform? Mr. Sullivan.

Mr. SULLIVAN. Thank you.

Well, it should be an extremely high priority. It simplifies the Tax Code, and it will allow much lower rates, make the system fairer and promote economic growth. As you say, the benefit is in the eyes of the beholder. The hard part is the politics. The economics are very simple.

Mr. SMITH. Mr. Kwall.

Mr. KWALL. The most stable tax would be a low rate, broad based tax. So to the extent that preferences can be reduced and rates can be brought down, that approach is the ideal.

Mr. SMITH. Perhaps we should resist adding further preferences in our Tax Code.

Mr. KWALL. Definitely.

Mr. SMITH. Okay, and Mr.——

Chairman CAMP. I think we are out of time.

Mr. SMITH. Thank you.

Chairman CAMP. Ms. Jenkins is recognized.

Ms. JENKINS. Thank you, Mr. Chairman, and thank the panel for being here today. This has been very interesting.

Mr. Kwall, your testimony calls for requiring all complex businesses, those with one or more class of stock to be taxed at the entity level potentially, stating this would eliminate their ability to pass losses through to their shareholders. This would limit the ability of start-up businesses to raise capital.

I am concerned with this rule that only the simplest of businesses be allowed to pass their income and losses through to their owners would make it harder for start-up businesses to raise capital since they can only pass the losses they incur in the early years through to their investors if they have the simplest of capital structures.

So, Mr. Kwall, I guess for you might be: Do you share this concern and could your proposal be modified to allow real economic losses to be used currently by those start-ups that are in a loss position in their early years?

And then I would be interested if anyone else would like to comment.

Mr. KWALL. Thank you, Congresswoman Jenkins.

That is actually a very good question. When I talk about simple enterprises my assumption is that system really govern the majority of closely held enterprises. In other words, a simple enterprise basically would mean that they are not going to have preferences with respect to distributions or economic preferences with respect to issuing different types of stock or membership interests so that some interests would be preferred and others would not be.

So first of all, hopefully the bulk of new enterprises would fit under that simple regime and losses would pass through.

Ms. JENKINS. Okay.

Mr. KWALL. To the extent that a more complicated ownership structure was used under my system, it is true the losses would not pass through, but that is a default regime. I guess that is a cost of choosing a more complicated economic arrangement.

So the real question would be how necessary a more complex arrangement would be to a business that thought it was in that situation.

But it is clearly something that needs to be thought through. I agree with you completely.

Ms. JENKINS. Okay. Thank you.

Mr. Tucker.

Mr. TUCKER. I really disagree. I think the concept of two classes of ownership creating a complex business rather than a simple business is not focusing on the entrepreneur. Most of my entrepre-

neurial clients are very concerned about capital formation and capital access, about protecting their personal assets from the business risk, and business succession.

All of that goes to two classes of something. I would rather bring in equity than debt because I will have somebody who will have a share of the ownership, but will not have an obligation on my part to pay them. With business succession, I may have family members who are going to run the business, and they would have a voting class of stock, and I might have people who are going to be in the business and have a non-voting class. I think the great bulk of my entrepreneurial clients would be caught under the definition of "complexity," not "simplicity," and I think we need to move away from that. We need to have pass-through entities.

Ms. JENKINS. Okay. Sure.

Mr. KWALL. One point of clarification. A simple enterprise could have voting and non-voting stock. It cannot have different kinds of economic interests, but you could have stock that was voting and stock that was non-voting.

Ms. JENKINS. Okay. That helps.

Mr. Nichols.

Mr. NICHOLS. I would second Mr. Tucker's comments, but I guess I would have a more fundamental comment, and that is I think we are clearly in a situation where we need to have rate parity. I think everybody agrees on that, and so as a consequence, that is something that we should not avoid by doing this and we should not try to avoid it by doing this.

The other principle I would apply here is "if it is not broke, don't fix it." At the end of the day I am not quite sure there is something that would be so bad policy-wise or even at all bad policy-wise, frankly, that would cause us to disrupt what people are doing today in order to get to something that might theoretically be better on the basis of theory; I am not sure how much policy consideration is behind it.

Ms. JENKINS. Okay. Mr. Sullivan, I know you made note of this in a recent Tax Notes article. Do you have any thoughts on this?

Mr. SULLIVAN. Well, I think the details need to be worked out, but the theme keeps coming up over and over again. If you are starting up a business, all you want to do is your business. These entity choices are way too complex, and Professor Kwall is offering an easy alternative for a start-up business that does not want to be concerned about taxes.

Ms. JENKINS. Okay. Thank you.

Thank you, Mr. Chairman. I yield back.

Chairman CAMP. Thank you.

Mr. Paulsen is recognized.

Mr. PAULSEN. Thank you, Mr. Chairman.

I just want to raise a couple of points because it seems like there is pretty much unanimous agreement that parity is important in terms of comprehensive approach to tax reform for both large and small businesses. You know, we are not going to pass one bill that is going to address one side of it and then you can count on us passing another bill that is going to catch up with it, right? That is just not going to happen.

We talked a little bit about family ownership, but we have not talked much about employee ownership, and I just think it is important, too, that we make sure that employee ownership is also remembered as a key component of existing tax law, and I think it is important that we keep employee ownership actually in mind as we move forward through larger comprehensive tax reform because there are huge benefits to employee owned companies.

And I know that there are some of my colleagues that go back to 1994 when the rates were raised. You know, this is 18, 20 years ago. The world has changed. It is a lot more competitive. It is a lot flatter. Small businesses, in particular, have to compete on a global scale that they have never had to compete on before as well.

But let me ask you this question. I will start with Mr. Nichols. Can you highlight some of the restrictions on S corporations? And could we consider updating some of those restrictions?

It was mentioned, I think, a little bit earlier about the importance of a five-year built in gains period, for instance, but are there any other proposals that could be considered outside of the context of larger comprehensive tax reform, such as the limits on the types of shareholders allowed for an S corporation to help open up opportunities for any businesses that are, for instance, trapped in that C corporation area?

Mr. NICHOLS. There are a number of things that could be done, and I think they could be done without dramatic, perhaps not even significant, losses of revenue. A lot of the restrictions on S corporation status, such as on the nature of shareholders and actually even the types of entities that can elect S corporation status and various other things, have been in the code for some time, but they do not really need to be policy-based and do not need to be retained.

Let me give you an example. Nonresident aliens were excluded because, when it was originally enacted, people were worried that the nonresident aliens would not pay tax. So were partnerships and corporations and various other ineligible entities.

What we have done or what Congress has done for several of those is it has essentially said, okay, we are going to let a certain type of trust, an electing small business trust, or we are going to let certain tax exempt organizations, we are going to let you be a shareholder, but in return for that what we are going to do is we are going to tax you effectively at the top rate.

So is the same is done for these other restrictions, the Government gets its revenue, but essentially the corporation is enabled to have a partnership as a shareholder or a nonresident alien as a shareholder. I am not quite sure there is any loser in that transaction. It just essentially gives more flexibility to closely held business, and I do not think it would lose a lot of revenue.

Mr. PAULSEN. Okay. Mr. Tucker.

Mr. TUCKER. What I teach my students is that there are five things you could do to reconcile S corporations with partnerships within the S corporation regime. Number one, you could take out any limit on the number of shareholders.

Number two, you could let anybody be a shareholder, including not just the nonresident alien, but a partnership or a C corporation or an S corporation could be a shareholder.

Number three is you could reconcile inside basis and outside basis. Right now in a partnership, partners share inside basis for debt, but in an S corporation you only get basis if you put money in or lend money to the S corporation.

Number four, we have something in the partnership regime which says if you die and get a step up in basis on your partnership interest, there is an election to reconcile inside basis with outside basis, and we could do that for the S corporation as well.

And finally, we could allow any kind of stockholder, preferred, non-preferred or anything, without having an issue if you wanted to do it. My proposal would be, fine, let's eliminate S corporations and let them use the partnership regime, which would be the simpler way of doing it.

Mr. PAULSEN. Mr. Martin, let me just ask this before time runs out. You represent a large stakeholder group from a small business perspective. How much time do your members spend navigating the Tax Code?

I mean, you know, what is the best story, the best anecdote that really just paints the best picture of why this is so critical to address?

Mr. MARTIN. They do not spend a lot of time because they call me on the phone.

[Laughter.]

Mr. MARTIN. And, yes, I bill them for it, but what is stressful to them is the changing tax laws. I get numerous calls in November every year about Section 179. What is it this year? Is it likely to change before December 31, because they are thinking about capital investments now for things that they need to operate their business? Should they do them now or do them in the next six months? That is a huge issue for them, is just the stability.

My clients wrestle with payroll taxes like crazy because it is an abomination of the Small Business Administration. It is a huge cost to administering payroll taxes, but not the income tax law.

Mr. PAULSEN. Thank you, Mr. Chairman. I yield back.

Mr. HERGER [presiding]. Mrs. Black is recognized.

Mrs. BLACK. Thank you, Mr. Chairman.

There I think has been a really great discussion here and a lot of good questions that were asked. When you come down to the end of us last members all of the questions have just about been asked, but I want to follow up on what my colleague was just saying about how much time this takes, and, Mr. Martin, you said the timing is not really the biggest issue with the employer. It is more just the stress.

Obviously, we have talked a lot about complexity and the fairness and the uncertainty, but I do want to go to what is the actual cost. Can you determine the actual cost of this kind of complexity and what these businesses need to go through with the complication of the Tax Code?

Can you give me an idea of what this actually costs the business, a percentage of what it might cost them?

Is there a way to be able to evaluate that?

We can just go right down the line, whoever would like to answer that question.

Mr. SMETANA. I can just speak for our situation. So we are family owned. We have two shareholders, brothers, that own the company. We operate in seven states. We are U.S. domestic only. So we are not as complex as most larger businesses, but we spend hundreds of thousands of dollars a year on federal and State tax compliance. We do it both with internal staff people and as well as hiring experts from tax accounting firms to help us deal with all of the complexities.

In addition, there is a cost to compliance and recordkeeping by deploying sophisticated accounting systems, particularly those that have to track three or four different types of depreciation, records given the various regimes that are out there.

So in our case it is a big dollar, and that is money coming out of the business in reinvestment. My colleagues at FEI have similar experiences.

Mrs. BLACK. And let me just follow up on that for just a second. Then I do want to hear from the rest of you, but just to draw to that conclusion, I think, down the line, would you be able to hire more people and expand your business?

Then ultimately I think at the end of the day what we have to consider on all of this is that the cost to the consumer of the product on the other end, and as we talk about this, I think so many times that is forgotten, that the cost of whatever the service of that product is is increased, and it is really harder for those at the lower income because the end result really impacts those at the very lowest income in purchasing that good or that service.

So would you say if you did not have this kind of complexity you could make things a little easier and you could use those dollars to grow your business and, therefore, grow jobs?

Mr. SMETANA. Absolutely. As we said, the key to business economic growth is after-tax cash flows, and whether you spend it on income taxes directly or on the cost of preparing those taxes, it reduces the amount of money you have to sustain the business.

Mrs. BLACK. Others? Mr. Martin.

Mr. MARTIN. It is difficult for me to estimate what it would cost, but there are a couple of provisions. One I mentioned, the health care credit. It is crazy for me to have to spend the time that I do because the law is so complex I cannot figure out whether I need a benefit without spending the time.

The domestic production activity deduction is another one that the guidelines that we follow are extremely loose. Again, I feel like it is malpractice if I do not get my client the $300 deduction they should be entitled to. So I have to go through the calculations for it, incredibly complex, all of the job credits that are out there. I do not have any small business clients that hire people because they are going to get a job credit. They hire someone because they need someone to help run the business.

Mrs. BLACK. Thank you. Thank you.

Others? Mr. Tucker.

Mr. TUCKER. I think there are two costs. One is the cost of planning, which takes both financial resources and human capital, which is often not measured, but two is for the clients who do not come in advance on planning. The cost of some foot fault is even

much more expensive, and I think they do not realize that a lot of times until the foot fault occurs. And we need simplicity.

Mrs. BLACK. Mr. Nichols.

Mr. NICHOLS. I had really only two points. I know there is limited time, but, number one, in terms of complexity, there is no question on several of the things that have been raised. The items that actually on an ongoing basis affect how closely held business calculate their taxes and things like that, there is no question that that complexity could be improved upon, and in particular, it would be best in terms of tax reform to resist the temptation to micromanage and to have more global rules that are essentially applicable and rely on the economy to weed things out rather than to micromanage.

The only other thing that I would say with respect to complexity is we have talked about choice of entity and forcing people, let's say, to a single pass-through regime. I am not as worried about complexity there because essentially once a business has elected a particular pass-through regime, that is its entity. It has got its entity, and you are actually adding to their complexity if you force them into a new entity.

There is complexity, but it is complexity for the law students. It is complexity for the tax advisors, but you are not helping closely held business if you force a disruption on their tax planning.

Mrs. BLACK. Thank you.

And I think I am out of time, and I yield back. Thank you.

Mr. HERGER. Mr. Berg is recognized.

Mr. BERG. Thank you, Mr. Chairman.

I really appreciate the panel being here. I started a small business from the ground up, and we worked our way through a lot of these things. The comments that we have heard today are really right on.

You have a small start-up business. I mean, you do not have an accountant full time. You do not have an attorney that is looking at the regulations, looking at the rules, and quite frankly, a lot of the decisions on what type of organization you are going to be as a tax entity kind of are made at the last minute with some advice.

And talking about those people who went through a C corporation and for tax reasons cannot get out of it and have struggled and every year the tax liability gets more and more severe, you know, as I approach tax policy for business, my goal is to say that people will make business decisions based on business principles. And very secondarily or third they would say, "What are the tax implications?"

Instead I think we have reversed that where people are saying, "Before we make this business decision, what are the tax implications?" So it is almost backwards in terms of if you want to build a better mousetrap, beat the competition to do these things. There are all kinds of barriers within the Tax Code.

The least amount or I should not say the least, but one of the biggest is the uncertainty in the Tax Code. I mean, who knows what is going to be our tax come January 1 of 2013? You know, no one.

So I do not know where we are going or where I am going with my questioning, but there is a lot of frustration I have. I think

probably the first thing would be to, you know, really look at the President's budget and what kind of an impact that is going to have on business. Probably specifically is where we have a corporate rate that is lowered and a personal rate that is increased.

I would just like the panel to respond to how do you see that impacting the small business that we are talking about.

Mr. SMETANA. Sure. As I mentioned earlier in my statements, we analyzed the President's and the Treasury's proposal, and the impact of not bifurcating, you know, business source income out of closely held from the individual regime would cost our company literally millions of dollars both in terms of the loss of certain of the current tax preferences around capital and inventory investment as well as the material increase in the marginal rates that our businesses would pay in taxes in the pass-through regime.

So it would certainly have a dampening effect with respect to the economic activity that we could plan going forward by having less capital with which to work.

Mr. MARTIN. We are talking about less job creation. We cannot afford it.

Mr. TUCKER. We are talking about more complex here. We are going to go back to the personal holding company, accumulated earnings tax, and all the other things that are done to offset this, and it is just the wrong direction to go, sir.

Mr. KWALL. I would start with an ideal income tax that would tax income to the owners at the owner's marginal rate. So whenever you are trying to duplicate like that, it is just really inconsistent with the ideal.

Mr. NICHOLS. To a great extent I am going to reiterate. When you stray from rate parity and the single-tax rate, corporate owners will respond to the incentives. They may not like them, but they will respond to the incentives, and at the end of the day if the next change incentivizes it, either as a result of complexity or otherwise, they will move to C corporation or other status just on a temporary basis. Then there is a lot of lawyer work to get them out, and if the tax rates are too high or they are different for other people, they will respond. They will adjust, and the people that will be hurt, I think, are the new entrants into the labor market or the newly unemployed, who are the last people that at the end of the day businesses would be hiring if things went well.

Mr. SULLIVAN. Well, I am going to be the contrarian again. Again, that is the tail wagging the dog. We need a competitive tax system. We need to raise revenue. We have to lower our corporate taxes because those larger corporations are internationally competitive.

If there is not enough revenue, you may have to consider raising taxes on individuals. These rules are anti-abuse rules. If businesses are not pushing the envelope, they do not have to deal with these anti-abuse rules. There is no reason for a new business to seek C corporation status. So I have no sympathy for a corporation that goes in that direction.

Mr. BERG. Clearly, in my mind if there is a 40 percent tax rate and a 28 percent tax rate, people are going to go to the 28 percent tax rate, which from my perspective, the way I started this is exactly opposite to what we want people to be doing.

I mean, I think if we want to raise revenue, we have got to grow jobs, period. And that is my concern with the President's proposal on taxes. It creates more uncertainty, and it is not growing jobs.

I have got one more question.

Chairman CAMP [presiding]. Well, your time has expired, and we have got one more person.

I would just say that lowering rates is not the same as lowering taxes. There is a difference there, and so you do not necessarily have to go somewhere else in the economy to raise taxes.

Mr. Reed is recognized for five minutes.

Mr. REED. Thank you, Mr. Chairman, and I am the last one. So that always brings a smile to the panel's face whenever I get to ask the questions.

[Laughter.]

Mr. REED. Going last here, I will say I echo the sentiments of my colleagues, and also being one of the colleagues that started a small business like myself, and we talked a lot about the time pressures, obligations of starting a business and then having to deal with these issues. I can vividly remember in the beginning when my CPA called me and asked me to get a document, and it took me two days to find the document. I was so frustrated, and he actually did not need the document at the end of the time. So I was almost firing him on the spot, but you know, the bottom line is I have been there, and small business owners across America are frustrated with this Tax Code, and I am so glad to be part of an effort to try to reform it, and we will do our part on that.

What I am hearing is a general theme from each and every one of you that we should be focusing on the certainty and the stability in the code, looking at the rates to make them competitive, and combining the individual and corporate rate.

One thing that I do not know if we spent enough time on and I am interested in exploring and going down further is does anyone feel that the underlying business activity of the taxpayer, is that something that should be taken into consideration when we are setting tax policy.

And the reason I bring that up is as a new member down here in Washington, D.C., I hear a lot of politicians talk about bad guys, oil and gas industry, and there are provisions in the code that treat folks differently just because of the business activity upon which they are engaged when it comes to their tax burden.

Can anyone tell me is that something that is good policy to advance as we go through comprehensive tax reform, or is my gut telling me the right thing and that we should avoid looking at business activity as a reason why tax policy should be set?

Mr. Tucker, please.

Mr. TUCKER. Are we not really trying to look at the ability to create jobs? Do service businesses noted create jobs just as manufacturing businesses create jobs, just as real estate creates jobs?

If that is what we are looking at, I think the type of activity is totally irrelevant. Our objective should be to create jobs, be able to collect tax from the people who are earning money and go forward.

Mr. REED. I appreciate that. Anyone else? Mr. Nichols.

Mr. NICHOLS. Well, I would say, and corresponding to and following up on that and certainly not disagreeing with it, and that

is the trick, you need to be careful, but the trick is to treat all businesses, I think, comparably. Obviously they differ, but at the end of the day, there are certain fundamental principles.

If you follow the cash, people are making money. Then that is a good time and an appropriate measure of whether or not taxation is appropriate. Now, I realize that is an oversimplification, but in general, you should not favor, you know, insurance company taxation versus oil and gas taxation versus manufacturing.

I represent some of those. I do not represent all of them. Essentially the goal should be not favoring one industry over another, not picking winners and losers, and not micromanaging. The more simple, straightforward, then the economy, the capitalistic system, will figure out who is going to invest in what industry based on actual profits rather than tax considerations.

Mr. REED. I appreciate it.

Mr. Sullivan.

Mr. SULLIVAN. Well, I know you have been lobbied, and when I was on staff, I was lobbied, and every lobbyist comes in and tells you, "How can you raise my taxes when I am creating jobs?" And everybody says that. It is jobs, jobs, jobs.

We have to have the discipline to understand that when we help one person, we are taking something away from another, and that is just the balance sheet. It is just the math, and what we want to do is not provide anybody with special privileges because in the long run what you do not see is most job creation will be created by not giving that lobbyist the special tax break.

Mr. REED. I appreciate that.

With that I will yield back, Mr. Chairman. I have got a couple of seconds left and I will let you enjoy them.

Thank you.

Chairman CAMP. All right. Well, thank you.

And I want to thank all of our witnesses. This was an excellent hearing.

I appreciate your time and your testimony today.

And with that, this hearing is now adjourned.

[Whereupon, at 12:26 p.m., the committee was adjourned.]

[Public Submissions for the Record follows:]

CARRIX, INC.

SUBMISSION OF WRITTEN COMMENTS FOR THE HEARING RECORD
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

HEARING ON THE TREATMENT OF CLOSELY-HELD BUSINESSES IN THE CONTEXT OF TAX REFORM

MARCH 7, 2012

Mr. Chairman, Ranking Member Levin and distinguished Members of the Committee:

Carrix, Inc. ("Carrix") is pleased to submit written comments for the record in connection with the March 7, 2012 hearing of the Committee on Ways and Means ("the Committee") on the critically important topic of treatment of closely-held businesses in the context of tax reform.

Background on Carrix:

Carrix is a **closely held** U.S.-based port terminal operating company that manages more cargo terminals than any other company in the world. Carrix provides a full spectrum of transportation services, from terminal management to stevedoring, in a number of U.S. and foreign ports.

As a closely-held company built on international trade, Carrix fully appreciates the topic of the hearing: how the tax code imposes a variety of burdens on closely-held companies, which public companies do not face. Carrix, like many other U.S.-based companies in all sectors of the economy, faces fierce competitive pressure from foreign-based companies. Unlike most other U.S.-based companies, many of our foreign-based competitors are large foreign multinationals, some of which are closely aligned with foreign governments, and operate under more favorable home country tax regimes.

We would like to bring to the Committee's attention a tax issue that directly and negatively impacts our ability to grow our U.S. operations: the potential application of the personal holding company (PHC) tax to earnings we would seek to repatriate in the form of dividends from our foreign subsidiaries. As will be discussed further, the PHC tax is an outmoded relic in the Tax Code that offers little, if any, compelling policy rationale for its continued existence. As the Committee considers fundamental tax reform, we believe the regime should either be repealed or substantially revised.

Background on the Personal Holding Company Tax

The PHC tax was enacted in 1934 and, at the time, represented an appropriate response to prevent individuals from sheltering investment income from individual income tax by using their closely held US corporations to hold investments, referred to as the incorporated checkbook. At the time the maximum individual income tax rate was substantially higher than the maximum corporate tax rate[1] and corporations could be liquidated on a tax-free basis.[2] Neither possibility exists today because of changes to the tax laws, yet the PHC provisions were never updated to reflect more modern circumstances, particularly closely held consolidated groups with foreign affiliates.

The PHC rules impose a corporate level penalty tax of 15% (the rate will become 39.6% in 2013 if the Bush tax cuts expire as scheduled at the end of 2012) on the undistributed PHC Income of a PHC. A corporation constitutes a PHC if 60% of its adjusted ordinary gross income is PHC income and if 50% of its stock is owned by five or fewer individual shareholders at any time during the last half of the taxable year. PHC income generally is defined as interest, dividends, royalties, rents, and certain other types of passive investment income. The PHC penalty tax can be avoided by an entity by distributing PHC income to its shareholder(s), resulting in the shareholder(s) paying the appropriate tax on the distribution.

In the case of a group of US corporations filing a consolidated return, the PHC calculations are generally conducted on a consolidated basis. However, in certain circumstances the PHC test and tax computation must be made on a separate company basis. Section 542(b)(2) provides the PHC test must be applied on a separate company basis if more than 10 percent of any corporate member's adjusted ordinary gross income is received from a source outside the affiliated group (such as foreign subsidiaries) and more than 80 percent of such adjusted ordinary gross income is PHC income. PHC income would include dividends from foreign subsidiaries.

For each taxable year, if any separate corporate entity included in the affiliated group fails the test under Section 542(b)(2), the entire corporate structure is tainted and each separate corporate entity is potentially subject to the PHC tax. Thus, when the test is conducted on a separate company basis, a US group of corporations filing a consolidated return can easily find that it has a personal holding company tax liability even though a majority of its consolidated revenue may be active trade or business income and it would not otherwise be subject to the PHC tax except for the rules requiring separate company testing.

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[1] In 1934, the highest individual tax rate was 63% and the highest corporate tax rate was 13.5%, resulting in a 49.5% rate differential.

[2] *General Utilities & Operating Company v. Helvering*, 296 U.S. 200 (1935). The *General Utilities* doctrine was repealed by Congress in 1986.

The policy rationales that led to the PHC tax regime are no longer operative. First, the top marginal tax rate for both individuals and corporations is 35%.[3] Second, with the repeal of the *General Utilities* doctrine in 1986, corporate liquidating distributions of appreciated assets are taxed at the corporate level. ***Simply put: Today's tax laws do not provide an incentive to incorporate portfolio investments to escape the individual income tax.***

Application of PHC tax to Carrix

An example will help to clarify the lack of a compelling policy justification for the application of the PHC tax. The requirement to conduct the PHC tests on a separate company basis often unfairly penalizes corporate groups that are actively engaged in business. A common fact pattern that gives rise to this unwarranted imposition of the PHC tax is where a member of the group receives dividends from foreign subsidiaries. ***In this case, the separate company PHC tax computation serves as a deterrent to the repatriation and reinvestment of foreign earnings in the United States, further exacerbating the so-called 'lockout' effect.***

In other words, Carrix would be hit by the PHC tax to the extent it repatriated dividends from its overseas affiliates simply because it is a closely held company. If Carrix were organized as a public company, the PHC penalty tax would not apply. Simply because Carrix is closely held, the tax rate on foreign earnings repatriated back to the United States would be, rather than the normal 35% rate, a 50% tax rate. Such a level of tax makes it more economical for Carrix to keep foreign earnings offshore for purposes of further developing international operations, rather than repatriating earnings from overseas operations to fund productive investments in the United States. In Carrix's case, for example, we would plan to use a portion of the repatriated cash to fund the construction of a major port terminal facility in Washington State.

Additional Policy Considerations

Carrix believes that additional policy considerations argue in favor of repealing, or substantially modifying, the PHC tax regime. The tax was enacted to prevent affluent individuals from escaping the reach of the individual income tax. Given the changes described above in our nation's tax laws, the PHC tax regime does less to deter the formation of so-called "incorporated pocketbooks" than to inhibit certain closely-held active businesses from pursuing logical business transactions that other companies are able to do because they may give rise to PHC tax consequences.

While some companies are able to evade the reach of the PHC tax through sophisticated tax counsel, other companies are not so lucky and are either unaware of the PHC tax or cannot avoid the tax unless they change their ownership structure. In addition, the PHC

[3] The top individual tax rate is slated under current law to rise to 39.6% on January 1, 2013 – resulting in less than a 5% differential between the top corporate and individual rates.

tax adds significant complexity to the Internal Revenue Code while raising a relatively nominal amount of tax revenue: approximately $38 million per year.[4]

Most importantly, from our perspective, the PHC tax unnecessarily and unfairly taxes revenues which would otherwise be available for investment in much needed infrastructure projects or other important corporate uses which would promote economic development in the United States.

Conclusion

Thank you for the opportunity to submit these written comments for the record. Carrix looks forward to working with you and your staff to ensure that the U.S. tax code is reformed in a way that makes sense, treats similarly situated taxpayers equally, and doesn't penalize certain closely-held taxpayers due to certain antiquated provisions of the Internal Revenue Code.

[4] 2008 IRS SOI data.

Comments for the Record

U.S. House of Representatives

Committee on Ways and Means

Hearing on the Treatment of Closely-Held Businesses

in the Context of Tax Reform

Wednesday, March 7, 2012, 10:00 AM

By Michael G. Bindner

Center for Fiscal Equity

Chairman Camp and Ranking Member Levin, thank you for the opportunity to submit these comments for the record to the House Ways and Means Committee. Our comments are an expansion of last month's comments and are, as always, in the context of our tax reform plan, which has the following four elements:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, personal retirement accounts, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

We have no proposals regarding environmental taxes, customs duties, excise taxes and other offsetting expenses, although increasing these taxes would result in a lower VAT. Small and closely held businesses already pay these taxes and will continue to in reform.

Small businesses will pay VAT, although they may not be a VAT collector, depending upon whether business size exemptions are included in any VAT legislation. Their impact would be merely to report the VAT they pay on the receipt so that customers may be aware of taxation while those who use the product in their supply chain can use this information for credits against their VAT collection. Larger businesses which are closely held will pay VAT in the same way public companies do.

Small businesses may likewise not have to pay the NBRT. Indeed, for consultants who work primarily for one client or sell from one supplier, NBRT rules should mandate that small firm employees be treated like employees of the larger firm for purposes of health care coverage and the Child Tax Credit, should the consultant or distributor not meet the income thresholds included for filing. Large business which are closely held will pay the NBRT in the same way public companies do.

Accounting for Employee-paid Old Age and Survivors Insurance will be no more complicated than current law, while accounting for the income surtax will be greatly simplified. Individuals who previously paid their business taxes as part of income taxation will only file the income surtax if they clear $50,000 after paying staff ($100,000 for joint filers and qualified widow(er)s). The only complexity will be accounting for sales to a qualified ESOP, which may continue to be tax exempt – although if personal accounts are enacted under OASI it may be wise to repeal the ESOP deduction so that the wave of ESOP conversions that will result will allow a substantial pay down to the national debt, which will more quickly allow the sunset of the income surtax.

Establishment of personal accounts as an offset for Old Age and Survivors Insurance will require complex accounting rules, but only for firms which pay the NBRT. Again, consultants and distributors who do not should be afforded the opportunity to accumulate personal accounts through the larger firm they deal with, buying their company stock as if they were full-time employees. For example, workers at car dealerships would have the opportunity to invest in personal accounts of that manufacturer, even if the dealership is large enough to pay the NBRT. Larger closely held firms may also wish to rethink their form of ownership to take advantage of the opportunity personal retirement accounts afford for both capital accumulation (for both firms and individuals) and for succession planning.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

Contact Sheet

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Committee on Ways and Means
Hearing on the Treatment of Closely-Held Businesses in the Context of Tax Reform
Wednesday, March 7, 2012, 10:00 AM

All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears:

This testimony is not submitted on behalf of any client, person or organization other than the Center itself, which is so far unfunded by any donations.

The ESOP Association
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Serving the entire ESOP community

March 7, 2012

House Ways and Means Committee
1102 Longworth House Office Building
Washington DC 20515

Following is a statement from The ESOP Association for the Ways and Means Committee's March 7, 2012 hearing: Hearing on the Treatment of Closely-Held Businesses in the Context of Tax Reform.

The statement is being submitted by

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The author of the statement is J. Michael Keeling, president of The ESOP Association. He can be reached at the address and phone number provided above or by email at Michael@esopassociation.org.

The ESOP Association is the national trade association for companies with employee stock ownership plans (ESOPs). The Association's primary members are U.S. corporations that sponsor ESOPs. The mission of The ESOP Association is simple: To advocate for, and educate about, employee ownership through the ESOP model.

Statement follows:

Mr. Chairman Camp, Ranking Member Levin, and distinguished members of the House Committee on Ways and Means, the 2010 General Social Survey (GSS) evidences that during the Great Recession companies that had broad-based employee stock ownership programs, such as an ESOP, laid off employees at a rate of less than 3%, whereas conventionally owned companies laid off employees at a rate greater than 12%!

Why would a spokesperson for The ESOP Association, a national 501(c)(6) trade association whose primary members are U.S. corporations sponsoring ESOPs, begin his statement to the Committee on pass-through entities for tax purposes on the results of the most prestigious survey of Americans' work and living patterns?

Because, of the Association's nearly 1,500 corporate members that are all, or partially employee-owned, approximately 70% are S corporations, and of this group of over 1,000 U.S. corporations, approximately two-thirds, are owned 100% by the ESOP on behalf of the employees.

Thus, when the Committee, when the Congress, and when the current Administration, as it set forth in "The President's Framework for Business Tax Reform," address the tax treatment of S corporations, it is a fiduciary duty of this Association to provide this Committee's history in authorizing legislation for S corporations to sponsor ESOPs.

One myth about ESOPs is that all ESOP laws were developed by the U.S. Senate due to the leadership of former Senator Russell B. Long in his roll as Chair or ranking member of the Senate Committee on Finance. Granted, as the original advocate for more ownership in America using the ESOP model, Senator Long is a revered figure among those who believe that we would have a more competitive, more fair, economic situation if there were more owners in our capitalistic society.

But, in 1997, ten years after Senator Long retired, the Ways and Means Committee adopted, with no dissent, an amendment permitting S corporations for the first time, commencing in 1998, to have broad-based employee stock ownership through the ESOP model.

Thus, while no one claims that past action by the Ways and Means Committee dictates what the Committee decides later with regard to S corporations and ESOPs, we do emphasize that S corporations and ESOPs are not something that just the Senate should think about in the move to reform our Federal tax code.

We would also like to clarify a myth that the media often says, and it seems law students and lawyers like to repeat in law school journals, that S corporation ESOP companies are tax exempt. What Congress did in 1997 was permit a deferral of taxation of S corporation shareholders who were paid, via a distribution, from the ESOP on the value of S assets --- in other words, the ESOP participant pays taxes on her or his account

when it is distributed in cash to the employee owner who retires, leaves the company vested, or is sadly disabled, or dies while an employee.

Thus, the cost to the Treasury of the ESOP S regime is not the bulk of the so-called tax expenditures that encourage a policy that has tons, and yes, I say tons, of evidence from very reputable social and economic researchers that show employee-owned companies, in the vast majority of instances, are more productive, more profitable, and provide sustainable jobs that are locally-controlled here in the U.S.

The ESOP community respects the call by this Committee, by the leadership of both political parties, and the Administration for policies that will "create" jobs; we understand that differences arise over the precise policies that should be implemented to "create" jobs as well.

We, however, with all due respect to our national leaders, including those who sit on this Committee, note that unemployment rises to unacceptable levels when people lose their jobs, when they are laid off. Thus, it would seem that encouraging a policy that results in fewer lay offs, in sustaining employees in the jobs they have, is perhaps the best approaches to making sure those who want to work have jobs.

In that regard, we take note that 15 members of this Committee have introduced and co-sponsored H.R. 1244, the Promotion and Expansion of Private Employee Ownership Act of 2011. We, of course, express our strong support for this legislation, which is primarily focused on increasing employee stock ownership among S corporations by expanding the attractiveness of the ESOP to men and women who have reached a point in life when they have to 'exit' their ownership of an S corporation. The precise mechanism is a provision applied first in 1984 to C corporations that are not publicly traded by deferring the capital gains tax on the sale of privately held stock to an ESOP if the ESOP holds more than 30% of the sponsoring corporation's stock, and if the seller reinvests her/his proceeds in the securities of other U.S. corporations [IRC 1042]. In particular we tip our hats to Congressmen Reichert, Kind, Boustany, Blumenauer, Paulsen, and Pascrell, who introduced this legislation on March 29, 2011. Not only have nine colleagues of this Committee joined them, so have 49 other members of the House. Similar legislation, with support from both sides of the chamber, is pending in the U.S. Senate --- S. 1512.

We respectfully request that as the Committee works on reforming the Federal tax code, it works as it did in 1985, Congress needs to take steps to encourage greater ownership of productive assets in our nation by remaining firm in its support of employee stock ownership through the ESOP model.

And with that we close with a salute to the leadership of the Committee, in particular Chair Camp, who has made it clear that piecemeal reform of the tax code, by addressing only those provisions that impact businesses organized as C corporations, and the rates on which their taxes are calculated, is not in the best interests of American businesses, nor individual taxpayers. In this regard, a total, holistic approach to making

our tax code support jobs, our free enterprise system, with fairness, is the pathway this Committee is following. History proves that such an approach is the correct approach.

We appreciate your hearing on the potential impact of tax reform on pass through entities, and the openness with which you are conducting your review.

AMERICAN UNIVERSITY

WASHINGTON, DC

KOGOD TAX CENTER

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March 22, 2012

Committee on Ways and Means
U.S House of Representatives
Hearing on Treatment of Closely – Held Businesses in the Context of Tax Reform

Good Afternoon:
I am submitting a testimony in support of your efforts to reform the tax code for closely held businesses. To more efficiently administer the tax law and reduce the overall burden and cost of complying with the law, I propose a simplification of the cash method of accounting already generally used by most small businesses. The simplification calls for the recognition of income and deductions only when cash is received or expenses are actually paid. I believe the simplification will not reduce revenue to the government and will increase the level of compliance from small businesses and entrepreneurs.

Please do not hesitate to contact me if you have any questions.

Your consideration of my testimony is greatly appreciated.

Sincerely,
David J. Kautter

Enclosure: Testimony

AMERICAN UNIVERSITY

WASHINGTON, DC

KOGOD TAX CENTER

Statement for the record of
Mr. David J. Kautter
Managing Director of Kogod Tax Center
American University Kogod School of Business
Washington, District of Columbia

Committee on Ways and Means
U.S. House of Representatives

Hearing on
Treatment of Closely-Held Businesses in the Context of Tax Reform
March 13, 2012

Chairman Camp, Ranking Member Levin and Members of the Committee, thank you for the opportunity to submit written comments on tax reform pertaining to the treatment of small businesses.

I have been a tax professional for over 35 years. For most of that time, I advised clients on tax matters as a partner with a Big Four accounting firm. I also served as tax counsel to former Senate Finance Committee member John Danforth, and I have remained closely involved in the tax policy process over the entire course of my career.

I am writing to you today to support your efforts to reform the tax code for closely held businesses in the hopes of growing and creating jobs. Reducing the complexity of the current

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tax law pertaining to small businesses would allow small business owners to spend more time creating jobs and less time filling out forms. As the United States continues to struggle with a persistently high unemployment rate, the need for small businesses to create new jobs is self-evident.

According to the Small Business Administration, over half of all employed Americans work for small businesses which account for 98 percent of all U.S. employers. Additionally, small businesses account for nearly 45 percent of the total private sector payroll. In 2010, small businesses accounted for 75 percent of all new jobs created in America.[1] Small businesses are a critical source of economic growth and new jobs which is why U.S. tax policies must encourage these businesses to reinvest their profits in a manner that will foster job growth.

One may question whether tax reform can create jobs, but it cannot be denied that the time and resources consumed by tax compliance foster neither economic growth in the small business community nor efficient tax administration. In fact, the Taxpayer Advocate has labeled the complexity of the Internal Revenue Code the 'most serious problem' taxpayers, including small businesses, encounter. Despite continual calls for simplification, there have been no fewer than 4,428 amendments to the Code over the last 10 years. The Taxpayer Advocate estimates that each year small businesses spend approximately 2.5 billion hours complying with tax filing requirements, the equivalent of 1,250,000 full-time jobs. In addition, over 70 percent

[1] Small Business Administration, "The Role of Small Business in Economic Development of the United States: From the End of the Korean War to the Present," 2010, at p. 6.

of all unincorporated businesses use paid tax preparers and spend over $16 billion for professional advice and compliance assistance from attorneys and accountants.[2] While this complexity has spawned full employment for tax professionals, our economy cannot prosper when businesses, especially small businesses, are diverting valuable time and resources to unproductive behavior that is an inevitable drag on the economy.

Any reform that reduces the time and cost of complying with tax filings will enable small businesses to use their resources in more productive ways. In addition, making tax compliance more understandable will serve to change the public's perception that the Code is unfair and replete with "loopholes" only understood by sophisticated tax professionals. In short, we believe that simplifying the tax code will increase taxpayer compliance, ease the burden of tax administration, raise government revenue and ultimately reduce the tax gap.

Our view is that one of the most effective ways to reduce the current tax compliance burden on small business is to dramatically simplify the manner in which they compute their income subject to tax. The rules governing the computation of taxable income are not only unduly complex, they are unnecessarily burdensome. Put simply, we propose an alternative method for small businesses to maintain their tax books and records and compute their taxable income: The Simplified Cash Method of Accounting ("SCM"). The SCM would enable small businesses to focus their efforts on growth rather than filling out tax forms. It would also

[2] See, Taxpayer Advocates Service 2010 Annual Report to Congress - Volume -1, pp. 3-5.

reduce time consuming and expensive administrative burdens upon the IRS and foster an overall economic climate that would unleash resources that can be devoted to more productive, job creating activities.

Under the "simplified cash method" of accounting ("SCM") computation of taxable income would be reduced to the following formula:

Cash Receipts

Less: Cash Expenses including:

- Inventory
- Prepayments
- Materials/Supplies
- Depreciable Property

Taxable Income

In short, derivation of taxable income would be based solely on amounts actually received or paid during the tax year by means of examining the taxpayer's checkbook for when checks were written and deposits made.

With respect to gross income, under SCM gross income would consist only of cash, property or services received during the taxable year without regard to imputed income under the constructive receipt, cash equivalence or economic benefit doctrines Although determining and valuing the receipt of in-kind goods and services will continue to be an issue, small

businesses will otherwise be able to calculate income by adding up their bank deposits for the year. Any timing advantage afforded to taxpayers from not being subject to the judicial doctrines mentioned above will be minimal given that small businesses cannot, as a practical matter, defer recognition of cash by more than a few months without creating severe cash flow problems with regard to the payment of their own bills. The complexity of the judicial doctrines mentioned above does not warrant their application to small businesses.

With respect to tax expenses, there are four areas that create most of the complexity for small businesses: Inventory, prepayments, material/supplies, and depreciable property. We would propose that all expenditures for inventory, prepayments, materials/supplies and depreciable property be deductible when paid. All current expenditures, including those for the acquisition and/or construction of inventory, would be deducted when paid. While a technical violation of the matching principle of accounting, allowing for the immediate deduction of the cost of inventory simplifies a small business recordkeeping at relatively little cost to the government. For a small business to stay in business inventory paid for and deducted in one year will likely be sold no later than the next year to ensure sufficient cash flow for the business to continue in operation. The same holds true for prepayments. The vast majority of small businesses do not have the financial wherewithal to prepay expenses at all, let alone make substantial prepayments.

Permitting the immediate expensing of depreciable property simply continues 100% bonus depreciation for property acquired in 2011 and expands upon the §179 expense allowance currently available for small businesses. It may be appropriate to put some sort of

limitation on the ability of small businesses to immediately deduct otherwise depreciable property, such as certain very long lived property. But, as a general principle, we would advocate allowing small businesses to immediately deduct amounts they spend for otherwise depreciable property. Finally, exempting small businesses from the extensive proposed rules relating to whether an expense should be capitalized or deducted naturally follows if small businesses are allowed to immediately expense depreciable property. As discussed below, thresholds or limitations should be established to limit SCM to only small businesses similar to those currently described in §448 or §179.

Thresholds or limitations should be established to limit SCM to only small businesses similar to those currently described in §448 or §179. Under current law, only sole proprietorships, S corporations, qualified personal service corporations, C corporations with gross receipts of not more than $5 million and partnerships with no partner being a C corporation with gross receipts over $5 million may currently use the cash method. We would propose applying these same limitations for the SCM. If these limitations were used, approximately 99 percent of all business taxpayers accounting for over 12 percent of all business gross receipts will qualify for the proposed SCM accounting method. Alternatively, if the gross receipt dollar limits for SCM's adoption were set at $5,000,000 or $10,000,000 for all taxpayers almost the same 99 percent level of qualification would be reached. The small decrease (.4 %) would be primarily attributable to sole proprietorships, S corporations and qualified personal service corporations whose gross receipts exceed the $5,000,000 or $10,000,000 threshold. Regardless of whether a $5,000,000 or $10,000,000 gross receipt

dollar limitation is utilized, the percentage of business gross receipts subject to SCM would increase to around 16 percent.

Because most businesses will qualify for SCM and its reduced tax compliance burdens, taxpayers will be more able to maintain their own accounting records and prepare their own returns reducing the need for costly tax professionals who currently prepare over 70 percent of all business returns. Such a reduction in the reliance on tax accountants and lawyers will foster a better appreciation by average Americans that the tax law is not benefitting only special interests but is, in fact, attempting to measure each taxpayer's true economic income. In short, SCM will offer better compliance at lower cost to both taxpayers and the government with minimal, if any, loss of tax revenue.

Background on the Kogod Tax Center

The Kogod Tax Center is a tax research institute located at American University's Kogod School of Business. The Center promotes balanced, nonpartisan research on tax law, the challenges of tax compliance and planning, and the implications of tax reform.

Our efforts focus principally on tax issues affecting small businesses, entrepreneurs, and middle-income taxpayers. We develop and analyze potential solutions to selected tax-related

problems faced by these three sectors of the economy promote public dialogue to inform taxpayers, policymakers, academics, the press, and tax practitioners about critical tax issues.

We appreciate your taking our concerns on behalf of small businesses into account. Please do not hesitate to contact me if you have any questions.

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Statement on behalf of the National Association of Home Builders

Committee on Ways and Means

Hearing on

The Treatment of Closely-Held Businesses in the Context of Tax Reform

March 7, 2012

The National Association of Home Builders (NAHB) appreciates the opportunity to submit this statement on the "Treatment of Closely-Held Businesses in the Context of Tax Reform."

Founded in 1942, NAHB is a federation of more than 800 affiliated state and local building industry associations. It is the voice of the housing industry in the United States. NAHB represents more than 140,000 builder and associate members throughout the country, including individuals and firms that construct and supply single-family homes, as well as apartment, condominium, multifamily, commercial and industrial builders, land developers and remodelers.

Residential Construction is Small Business Dominated

The residential construction sector, which includes single-family and multifamily home builders, remodelers and other businesses connected to the housing sector, is dominated by small businesses. The median NAHB home builder member has 4 employees, constructs 3 homes per year, and reports less than $1 million in gross receipts. Approximately 80% of NAHB's membership consists of businesses organized as non C-Corporation entities (sole proprietorships, partnerships, LLCs and S Corporations). Of the 20% of members organized as C Corporations, very few are publicly-traded corporations.

Because housing plays such a central role in the economy, tax changes that impact pass-thru entities could have a broad impact—both positive and negative—on the economy as a whole. Housing contributes to gross domestic product (GDP) in two basic ways: through private residential investment and consumption spending on housing services. Historically, residential investment has averaged roughly 5 percent of GDP while housing services have averaged between 12 and 13 percent, for a combined 17 to 18 percent of GDP. These shares tend to vary over the business cycle. Residential investment includes construction of new single family and multifamily structures, residential remodeling, production of manufactured homes, and brokers' fees. Consumption spending on housing services includes gross rents (which include utilities) paid by renters, and owners' imputed rent (an estimate of how much it would cost to rent owner-occupied units), and utility payments.

Currently, because of the impacts of the Great Recession, housing's total contribution to GDP stands at 14.9 percent. Housing starts are down by more than 75% since their peak at the beginning of 2006, with more than 1.45 million jobs lost in the residential construction sector. Home prices are down approximately one-third from 2006 levels, wiping out trillions of dollars of wealth of the nation's 75 million homeowners.

The ongoing depression in the residential construction industry also translates into lower federal tax revenue as builders and the housing service sector struggle. Residential construction provides a sizeable revenue source for local, state and federal governments. NAHB strongly believes there is great potential for increased revenue if tax reforms are implemented that both promote economic growth and recognize the importance of housing to the economy.

NAHB estimates the following economic impacts from home building and remodeling.[1] Construction of an average single-family home creates 3.05 jobs and generates $89,216 in federal, state, and local tax revenue. Construction of an average multifamily unit creates 1.16 jobs and generates $33,494 in federal, state and local tax revenue. Expenditures of $100,000 of remodeling improvements create 1.11 jobs and generates $30,217 in federal, state and local tax revenue.

Until the nation's housing markets recover, there can be no robust economic recovery for the economy at large. Housing is linked to household wealth, consumer confidence, a healthy labor market (by enabling people to locate from city to city), and the direct jobs impact connected to the housing industry.

Business Tax Policy and Home Building

Given that most home builders and remodelers are organized as pass-thru entities for tax purposes, the individual income tax rate system functions as the de facto business tax rate. For this reason, the nation's home builders support extending the 2001/2003 individual income tax rate reductions.

Furthermore, as small firms, there are certain tax rules that help reduce the administrative burden that complicated tax rules can impose on businesses that do not have in-house tax expertise. Good examples of the simplifying rules include the section 179 small business expensing provisions and the cash tax accounting rules. Both of these provisions significantly reduce the compliance costs of the existing tax code. Moreover, cash accounting is critical for small firms because it helps prevent a timing mismatch between taxes paid and actual revenue received. Under an accrual basis, it is possible for small firms to owe taxes before revenue is in hand, thereby creating cash flow challenges. Such taxation would constitute tax of "phantom income," as it requires paying taxes on money not yet received by the business.

[1] The Direct Impact of Home Building and Remodeling on the U.S. Economy. NAHB Economics Group. (http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=103543&channelID=311)

Another important rule for home builders that helps prevent taxation on phantom income is the section 460(e) home construction contract exception to the long-term tax accounting rules. In general, the tax code requires businesses operating under contracts that require more than one tax year to complete (long-term contracts) to pay taxes on the expected revenue (a form of phantom income) proportionally for each year of the contract. This is in contrast to the completed contract method.

These rules were established by the Tax Reform Act of 1986 to ensure large businesses operating under contracts lasting many years did not defer tax liability for long periods of time. This would occur in absence of the long-term contract rules because such taxpayers could defer income tax payment until the contract was completed.

Section 460(e) provides an important exception to these long-term contracts for certain home building contracts. This change was made after the 1986 reform effort because it was recognized that home building was an example of a small business under which construction could take slightly more than a year (or span two tax years). The home construction contract exception allows home builders to use the completed contract method of tax accounting, thereby preventing home builders from having to finance half of the expected income tax payment associated with the construction and sale of a home, as would be required under the long-term tax accounting rules. Under the tax code, a qualified home construction contract is a construction contract for which at least 80 percent of the estimated total costs are reasonably expected to be attributable to construction or development of the dwelling units contained in buildings with 4 or fewer units and improvements to real property located on the site of such units.

Finally, due to the Great Recession and its economic impacts, another form of phantom income taxes is taking a toll on many home builders across the nation. Section 108 of the tax code requires cancelled debt to be treated as taxable income. As part of the consequences of the housing market crisis, many builders own land that was purchased with acquisition, development and construction (AD&C) loans from both national and community banks. As land prices fell, some of these loans became distressed. Efforts were and continue to be made to mitigate troubled loans. Some of these market-based efforts involve limited principal reduction, interest rate decreases, term extensions, or other actions that would constitute cancellation of debt.

Unfortunately, such actions also give rise to income tax liability for small firms already facing the worst market environment since the Great Depression. As a result, the only option for many of these firms is declare bankruptcy or become insolvent. Unlike large firms, bankruptcy for many, small family-owned firms can mean the end of generations-old family enterprises.

As part of the American Recovery and Reinvestment Act of 2009, Congress provided an up to 10-year tax deferral for such income tax liability for debt forgiven in 2009 and 2010. However, for builders operating in states where debt issues became a factor in 2011, this deferral offered no benefit. And the deferral itself was of limited benefit for small businesses without the access

to lending and capital that large businesses possess and without which it is difficult to maintain operations.

For this reason, NAHB supports providing a tax exclusion for business debt forgiveness for debt mitigation efforts in 2011 and for a number of years thereafter, until the business economic environment substantially improves. Such a tax policy change would enable small, family owned firms to avoid bankruptcy and contribute to the economy recovery as individual local markets improve.

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Statement Submitted
By
National Beer Wholesalers Association

Committee on Ways and Means

Hearing on the Treatment of Closely-Held Businesses in
the Context of Tax Reform

March 7, 2012

Chairman Camp, Ranking Member Levin, Members of the Ways and Means Committee, the National Beer Wholesalers Association (NBWA) appreciates the opportunity to comment on the treatment of closely-held businesses in tax reform. The NBWA is a trade association that represents the interests of the 3,300 licensed, independent beer distributors - with operations located in every state and congressional district across the United States. NBWA members directly employ approximately 98,000 hardworking Americans who earn good wages and receive employer-provided benefits.

NBWA member companies are closely-held businesses. For them, tax reform represents a potential opportunity to improve the tax laws by reducing unnecessarily high tax rates while simplifying the rules by eliminating narrow, special benefits that apply to a limited number of taxpayers. However, like other closely-held businesses, NBWA members are anxious about tax reform. Based on some of the incomplete tax reform proposals that have been discussed to date, distributors are worried that tax reform could result in significantly higher taxes on their business income.

As is common for closely-held businesses, NBWA member companies are generally organized as partnerships, limited liability companies, or S corporations. Along with sole proprietorships, these business types are treated as "flow-through entities" under the tax law – the business owners pay tax directly on the income of the business. As a recent Ernst & Young study revealed, businesses organized in "flow-through" form account for more than half of all jobs in the United States. **Any tax reform that results in a higher tax burden for these flow-through businesses would harm their ability to continue to serve as the main producers of jobs in the U.S. economy.**

As the Ways and Means Committee continues to consider tax reform, we believe it should keep in mind a few basic principles to avoid an adverse impact on closely-held businesses.

First, tax reform should be comprehensive, encompassing both businesses and individuals. Tax reform that is limited to reducing corporate tax rates and that is paid for by eliminating business tax deductions and credits across-the-board could result in significantly higher taxes on the income of the 95% of U.S. business entities organized in flow-through form.

A corollary is that tax reform must set the tax rates of corporations and individuals at the same, lower rates. The top tax rates on flow-through business income are already set to increase from 35% in 2012 to nearly 45% in 2013. And some in Congress have suggested increasing the top individual tax rates paid on flow-through business income even higher. The tax rates on closely-held business income should be reduced, not increased.

Congress should also continue to seek ways to eliminate the economic distortions caused by the double taxation of corporate income. The Administration has proposed to nearly triple the top individual tax rate on dividends. As Chairman Camp pointed out during a hearing last month, "because dividends are paid out of income that has already been taxed at the corporate level and then are taxed again in the shareholder's hands, this proposal would push the total federal tax rate on dividends to 64%." Flow-through business entities are not subject to this punitive

double-taxation, but this comes at a significant price; in order to retain their flow-through status, they are denied access to public capital markets.

As Chairman Camp noted in the announcement for this hearing, some have suggested the idea of subjecting existing flow-through entities to double taxation as C corporations. Obviously such an idea would harm affected closely-held businesses and would cost them in their ability to invest and provide jobs. The double-taxation of corporate income is almost universally recognized to be undesirable, so subjecting thousands or millions of additional businesses to a double-tax regime cannot be viewed as a "reform." Expanded double-taxation certainly would not result in the type of pro-growth tax system that should be the Committee's goal.

With regard to the accounting concerns that are also a subject of this hearing, NBWA would urge the Committee to avoid in tax reform accounting changes that have retrospective impact or that will result in an acceleration of taxes paid by closely-held businesses. An example of such an accounting change is the Administration proposal to repeal the last-in-first-out (LIFO) method of inventory accounting. Repeal of LIFO would have an immediate adverse impact on the cash flow of NBWA members and others maintaining LIFO inventories. As a result of LIFO repeal, these businesses would owe significantly more in current taxes without having any additional business receipts out of which to pay those taxes. Any such impact on business cash flows would jeopardize the ability of affected businesses to continue to provide jobs.

Beer distributors continue to provide tremendous employment opportunities to hard-working men and women across the nation. We look forward to the opportunity to work with you and your Committee during the tax reform process and will do all that we can to ensure that America's small businesses will not be negatively impacted by tax reform.

Thank you for your consideration of NBWA's views.

Craig A. Purser
NBWA President and CEO

RATE
Reforming America's Taxes Equitably

March 6, 2012

The Honorable Dave Camp
Chairman
House Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
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The Honorable Max Baucus
Chairman
Senate Committee on Finance
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The Honorable Sandy Levin
Ranking Member
House Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Orrin Hatch
Ranking Member
Senate Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairmen Camp and Baucus and Ranking Members Levin and Hatch:

There is an overwhelming consensus among taxpayers, Congress, academics and nearly all other stakeholders that the federal tax system must be reformed and simplified in order for U.S. businesses to compete globally, promote economic growth and create U.S. jobs.

We believe the cornerstone of reform must be a significant reduction in the current 35% statutory corporate tax rate, which is why we have come together as the RATE Coalition (Reforming America's Taxes Equitably). The RATE Coalition is made up of like-minded businesses and associations with the purpose of advocating for sound and equitable reforms to the federal tax code that would reduce the corporate tax rate in order to improve the competitiveness of American business. Importantly, in our current deficit environment, we understand that base-broadeners may be required to achieve a meaningful corporate rate reduction.

Coalition member companies employ millions of Americans and provide benefits for retirees right here in the U.S.; yet higher tax rates and a complicated tax code put our companies at a distinct competitive disadvantage compared to our foreign competitors. In a global economy where capital is highly mobile, it's simply harder to compete from America. Research has found

that the corporate income tax rate can have a large impact on where companies choose to place production facilities and on the size of investments. We need to ensure that America is the place to invest now and in the future.

It has been 25 years since the last comprehensive tax reform was accomplished. Since then, other countries' tax systems have changed dramatically, and not to our benefit. Our competitors in the OECD have lowered their statutory tax rates while the U.S. rate has remained relatively constant. This has resulted in an uncompetitive tax environment that discourages investment and job creation here at home.

A lower U.S. corporate tax rate offers critical benefits to the U.S. economy and to all Americans. Most importantly, a lower corporate rate will boost investment in the U.S., bringing more American jobs, innovation and growth.

We urge you to move forward now to enact a lower corporate tax rate and restore America's competitive edge.

Respectfully,

Michael E. Szymanczyk
Chairman and
Chief Executive Officer
Altria Group, Inc.

Randall Stephenson
Chairman and
Chief Executive Officer
AT&T Inc.

Larry J. Merlo
President and
Chief Executive Officer
CVS Caremark

Alan Roger Mulally
President and
Chief Executive Officer
Ford Motor Company

Robert J. Stevens
Chairman and
Chief Executive Officer
Lockheed Martin Corporation

Edward R. Hamberger
President and
Chief Executive Officer
Association of American Railroads

Jim McNerney
Chairman, President and
Chief Executive Officer
The Boeing Company

Frederick W. Smith
Chairman of the Board and
Chief Executive Officer
FedEx Corporation

Gregory B. Maffei
President and
Chief Executive Officer
Liberty Media

Terry J. Lundgren
Chief Executive Officer, Chairman of the
Board, President, and Director
Macy's, Inc.

Matthew Shay
President and
Chief Executive Officer
National Retail Federation

Philipp Humm
Chief Executive Officer and
President
T-Mobile

Scott Davis
Chief Executive Officer
United Parcel Service

Robert A. Iger
President and
Chief Executive Officer
The Walt Disney Company

William H. Swanson
Chairman and
Chief Executive Officer
Raytheon Company

Glenn Britt
Chairman and
Chief Executive Officer
Time Warner Cable

Lowell McAdam
President and
Chief Executive Officer
Verizon Communications Inc.

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