COMMITTEE ON WAYS AND MEANS
CHAIRMAN DAVE CAMP

Strengthening the Economy and Increasing Wages by Making the Tax Code Simpler and Fairer for America's Small Businesses

Overview

Whether operated as sole proprietorships, partnerships, or S corporations, small businesses continue to be the driving force for economic growth and job creation in the American economy and have generated 65 percent of net new jobs over the past 17 years according to the Small Business Administration.

Despite their significant contributions, however, small businesses and entrepreneurs face a daunting array of Federal tax rules and regulations that consume valuable time and resources. Consider the following small business facts:

- **Tax compliance costs are 65 percent higher** for small businesses than for big businesses, costing small business owners $18 billion to $19 billion per year.
- Nearly **nine out of every ten small businesses rely on outside tax preparers**, and according to data provided by the Internal Revenue Service, a business taxpayer spends an average of 23 hours on tax compliance.
- The current **patchwork of complex and often inconsistent rules** often leads to disparate results depending on the organizational structure of the business.

The combined impact of these tax costs and complexity means fewer resources to expand a business, hire new employees, and increase wages and benefits.

Tax reform done right should make the code simpler and fairer, while strengthening our economy. The discussion draft is the result of multiple public hearings and witness testimony. As part of a broader, comprehensive tax reform package that significantly lowers rates for individuals, small businesses, and corporations, **the draft reforms and simplifies a number of tax rules affecting small businesses and their workers**. The discussion draft **also offers two approaches to modernize the way the United States taxes pass-through businesses, such as partnerships and S corporations.**

In the interest of transparency, the Committee is soliciting feedback from a broad range of stakeholders, practitioners, economists, and members of the general public on how to improve this proposed set of reforms.

Small Business Draft:
Core Components

To help strengthen the economy by helping small businesses expand operations, hire new workers and increase wages and benefits, the discussion draft contains several commonsense reforms that simplify tax compliance for small businesses and provide certainty with respect to the ability of small businesses to recover certain costs immediately.

Spur Investment by Providing Permanent Expensing of Investments in Equipment and Property. The draft makes permanent section 179 expensing at pre-stimulus levels, allowing small businesses to deduct immediately investments in new equipment and property up to $250,000, with the deduction phased out for investments exceeding $800,000 (both amounts indexed for inflation). Without legislation, these levels will revert to $25,000 and $200,000, respectively, in 2014, which would be a tax increase for these employers. The draft also makes permanent the current-law provisions allowing computer software and certain investments in real property to qualify for section 179 expensing. This proposal is based on a provision of H.R. 886, introduced by Reps. Jim Gerlach (R-PA) and Ron Kind (D-WI). The proposal applies to tax years after December 31, 2013.

Simplify and Expand Use of Cash Accounting for Small Businesses. The draft replaces the current array of complicated tax-accounting rules that apply to small businesses and farms with a uniform rule under which all businesses with gross receipts of $10 million or less may use the cash method of accounting. The accounting rules for farming businesses would be coordinated with the new general rule, and sole proprietors would continue to be able to use the cash method regardless of the level of gross receipts. The discussion draft also coordinates the new cash-accounting rules with the uniform capitalization rules generally to exempt small businesses from the complex capitalization rules that require the allocation to their inventory of certain direct costs (e.g., materials and labor) associated with the production of the inventory as well as indirect costs (e.g., overhead and administrative expenses). This proposal is based on H.R. 947, introduced by Reps. Aaron Schock (R-IL) and Mike Thompson (D-CA). The proposal is effective for tax years after December 31, 2013.

Provide Relief by Establishing a Unified Deduction for Start-up and Organizational Expenses. For new businesses, the draft combines three existing provisions for start-up and organizational expenses into a single provision applicable to all businesses. Under a revised section 195, the draft increases the threshold for start-up expenses to $10,000 (up from $5,000), with a phase-out beginning at $60,000 of such expenses (up from $50,000) and expands the deduction to cover organizational expenses. The draft repeals the separate special rules relating to the organizational costs of corporations and partnerships. Expenses above the new limit continue to be deductible over the 15-year period following the start of the business. This proposal is based on a provision of H.R. 886, introduced by Reps. Jim Gerlach (R-PA) and Ron Kind (D-WI). The proposal is effective for expenses paid or incurred after December 31, 2013.

Ease Tax Compliance by Changing the Due Dates for Business Tax Returns. To assist taxpayers and tax professionals in filing tax returns accurately and on time, the discussion draft makes several changes to the current schedule for filing tax returns by the various types of small businesses. These changes address problems currently facing taxpayers and tax professionals who often have insufficient time to prepare accurate returns, because required information from a business is not available under the current due-date schedule, which often requires them to seek extensions to accommodate these deadlines. Under the discussion draft:

- Partnerships must file by March 15 (or two and a half months after the close of their tax year).
- S corporations must file by March 31 (or three months after the close of their tax year).
- C corporations must file by April 15 (or three and a half months after the close of their tax year).
- Individuals, including sole proprietorships, continue to file by April 15.

All taxpayers are eligible for a six-month extension. This provision is based on H.R. 901, introduced by Rep. Lynn Jenkins (R-KS). The proposal generally is effective for tax returns filed for tax years beginning after December 31, 2013.

Small Business Draft:
Two Options for Reforming the Rules for Small Businesses Organized as Partnerships and S Corporations

Despite their similarities, partnerships and S corporations are subject to two distinct sets of rules for Federal tax purposes. These rules result in significant tax-driven differences between different entity forms, including: capital structures, the allocation of income and deductions among owners, the treatment of contributions and distributions of property, and the treatment of debt incurred by the business. The draft provides two options for reform of the Federal tax rules applicable to pass-through businesses.

Option 1 – Revisions to Subchapter S and Subchapter K

To reduce the double taxation of business income, Option 1 incorporates a number of provisions from the S Corporation Modernization Act (H.R. 892, introduced by Reps. Dave Reichert (R-WA) and Ron Kind (D-WI)) intended to encourage C corporations to elect S status and provide greater flexibility to current S corporations in their day-to-day operations. With respect to partnerships, Option 1 establishes additional limits on the use of partnerships as tax avoidance structures without interfering with the legitimate business operations of partnerships, clarifies confusing areas of partnership law, and corrects a technical flaw with partnership rules to align them with S corporation rules. The specific revisions:

S Corporations

- Permanently reduce to five years (from ten years) the period following a conversion from C corporation status to S corporation status during which an S corporation must pay the highest corporate tax rate on certain built-in capital gains. In addition, the proposal makes permanent the rule that installment sales are governed by the provision applicable in the tax year when the sale was made.
- Increase to 60 percent (from 25 percent) the portion of an S corporation's income that may be passive without incurring an entity-level tax, and eliminate the current rule that terminates an S corporation's pass-through status if it has excess passive income for three consecutive years.
- Permit non-resident aliens to be S corporation shareholders through a U.S. electing small business trust ("ESBT" – a type of trust that is permitted to own stock of an S corporation), which better aligns the S corporation rules with the partnership rules. Accordingly, the trust must withhold tax on income earned from the S corporation, thus ensuring that non-resident aliens are subject to U.S. tax on their shares of S corporation income.
- Allow an ESBT to deduct charitable contributions made by the S corporation subject to the contribution limits and carryover rules applicable to individual donors.
- Modify the shareholder basis adjustment rules for S corporations making charitable contributions. This provision conforms the S corporation rules to partnership rules and provides a fair market value deduction for a charitable contribution, but limits the decrease in the shareholder's stock basis to the adjusted basis of the contributed property.
- Simplify the procedure and extend the time for making an S corporation election, permitting a corporation to make the election on its first tax return.

Partnerships

- Repeal the rules relating to guaranteed payments to partners, treating payments received by partners as either payments in their capacity as partners (i.e., part of their distributive shares of partnership income or loss) or in their capacity as non-partners. In addition, the draft repeals the special rule for deceased or retiring partners that treats certain payments in liquidation as guaranteed payments, subjecting such payments to the general rules.
- Require mandatory adjustment of a partnership's basis in partnership property when a partnership distributes property to a partner or a partner transfers his interest in a partnership, with corresponding adjustments in cases involving tiered partnerships. These provisions are designed to prevent abuses that result when: (1) property distributions shift the character of gains or losses among partners and (2) acquisitions result in the duplication of gains or losses.
- Adjust the limitation on a partner's share of losses to take into account charitable contributions and foreign taxes, conforming the partnership rules to the S corporation rules and thus preventing a partner from deducting losses in excess of basis.
- Clarify that all distributions of inventory items are treated as a sale or exchange between the partner and the partnership, eliminating the requirement that inventory be substantially appreciated in value to trigger gain recognition. This aligns the rule for distributions with acquisitions, assuring that the character of gain from ordinary items may not be converted to capital gain.
- Require that partners contributing property with built-in gains or losses be subject to tax on the pre-contribution gain or loss when the partnership distributes such property without the current limitation of seven years for recognition of such pre-contribution gains or losses.

Option 2 – New Simple, Unified Pass-through Rules

This option addresses long-standing concerns about the separate Federal tax rules applicable to partnership and S corporations and the different tax treatment that may result from the same transaction due solely to the business structure an entrepreneur selects at the state level (e.g., partnership, LLC, corporation). This option repeals current law Subchapter K and Subchapter S and provides a simple, uniform set of rules that apply to non-publicly traded businesses for Federal tax purposes regardless of how the business is organized at the state level. This unified regime provides a more efficient tax system for small businesses and pass-through entities. Specifically, the new rules:

- Encourage the formation of new businesses by allowing contributions of property and money on a tax-free basis.
- Avoid disruption of long-standing economic principles by maintaining the pass-through of items of income, gains, losses and credits, so that such items have the same character in the hands of the owners that they have in the hands of the entity.
- Reduce the use of complex structures to engage in tax avoidance by permitting only net ordinary income or loss, net capital gain or loss, and tax credits to be specifically allocated to owners.

- Close the tax gap while also simplifying the owner's current quarterly estimated tax responsibility by requiring entity-level withholding on the pass-through entity's income and gain with a corresponding credit for the owner's tax reporting.
- Prevent owners from gaming the tax system by using losses to reduce tax liability by limiting deductions for losses to an owner's basis in his pass-through interest, but allowing excess losses to be carried forward indefinitely.
- Ensure that taxes are paid on real, economic gains (but not on returns of capital) by limiting tax-free distributions to the owner's basis in the business.
- Prevent the use of pass-through entities to shift gains and losses amongst owners with different tax profiles by (1) requiring pass-through businesses to recognize gain on all distributions of appreciated property and (2) preserving losses in distributed property by requiring owners to take carryover basis in the distributed property.
- Conform to the basis rules that currently apply to partnerships by allowing owners basis in their ownership interests for entity-level debt (both recourse and non-recourse).
- Provide certainty with respect to owners who actively participate in the business by allowing owners to be treated as employees of the business.

Small Business Draft:
Unaddressed Issues and Questions

Unaddressed Issues. The Committee recognizes that the discussion draft does not address certain technical and policy issues that may need to be resolved in final legislation. The Committee invites comments on how to address such issues, especially those related to:

- Employment and self-employment taxes of partners and shareholders, both under Option 1 (which preserves Subchapters K and S) and under Option 2 (which requires new rules for the employment and self-employment taxes of owners).
- The effect of the proposed threshold for cash accounting on other provisions of the tax code not directly related to accounting methods.
- Transition rules necessary to facilitate the adoption of new provisions by existing small businesses and pass-through entities, with a goal of minimizing disruption.
- The proper treatment of and potential problems faced by foreign partners in U.S. partnerships and U.S. partners in foreign partnerships in the context of a unified pass-through regime (Option 2). (Note that the draft does provide that current section 1446 overrides the proposed withholding requirement in the draft in cases where both apply.)
- Mergers, divisions, and reorganizations, with respect to Option 2.
- Conforming changes in Option 2 to integrate the new unified regime into the related tax rules.
- Other areas of small business taxation that are not addressed in the discussion draft.

Questions. While the Committee invites input on all aspects of the discussion draft, there are issues on which the Committee is especially interested in receiving constructive feedback concerning the options for reforming the tax rules governing pass-through businesses.

- Under current law, partners and S corporation shareholders are also subject to different requirements in other respects, including: treatment of different types of debt; allocations of income, loss, and deduction; and property distributions. How can these rules be coordinated and modernized to minimize the disparate treatment between partners and S corporation shareholders, in particular for owners under Option 2 in the discussion draft?
- Under Option 2 of the discussion draft, special allocations of tax items are not permitted to the same extent as current law. Instead, owners may allocate net ordinary income/loss, net capital gain/loss, and credits, with each owner allocated items equal to his or her proportionate share of each category. What effect do the allocation rules have on current partnership transactions where businesses (or assets) have been combined and each owner receives income from a separate business (or particular assets)?
- In light of the entity-level withholding proposed in Option 2, should the Internal Revenue Service be permitted to audit and assess tax liability at the entity level?
- How should tax-indifferent owners, such as pension funds and other tax-exempt organizations, be incorporated into the withholding proposal under Option 2?
- How can transition rules be designed to minimize the burdens on existing businesses currently treated as partnerships and S corporations with respect to adopting the modifications in Option 1 or Option 2?