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Susan Marshall, Clerk
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515

Dear Ms. Marshall and Members of the U.S. House Committee on Small Business:

Thank you for the opportunity to provide commentary to the House on matters affecting small business at the full Committee hearing on Wednesday July 22, 2015.

Background

McGladrey is a leading provider of assurance, tax and consulting services focused on the middle market with nearly 8,000 professionals in 80 cities nationwide. The firm is one that is designed to meet the needs of local and middle market businesses.

We also operate a member network of independent firm's known as The McGladrey Alliance comprised of more than 90 independently owned accounting and business consulting firms in 42 states and Puerto Rico.

The size of our practice and the large concentration of small to medium sized clients in the middle market segment demonstrate our frequent exposure to the compliance challenges facing small businesses today.

Personal Background

My own practice concentration is the smaller end of the middle market that we refer to as the Local Markets Group (LMG). Our Boston LMG practice is made up of approximately 50 professionals. As a practitioner with 40 years of experience working in this sector, my day to day work consistently exposes me to the compliance requirements of my client base which is made up approximately for some 40 small businesses ranging in size from under $5 million to $100 million in revenue with workforces from less than 10 employees up to about 200. All of the clients are privately owned and many are family owned. My client base is representative of the others in my practice made up of a dozen partners and senior managers. We collaborate and share our experiences regularly including sharing of resources, training and researching together.

In that regard, a recent poll of members from the LMG group was conducted in order to obtain some of the more common challenges we face with the current tax code, compliance and reporting requirements. Following are a few of subjects that had recurring themes. On behalf of my firm and the many clients we serve we respectfully submit these subjects for your review and consideration.

Depreciation - TARS Legislation and the De Minimus rules

Depreciation has been around since the beginning of the tax code. In its simplest form it was designed to spread the deduction for a taxpayers acquisition of large capital items over a period of time and over the estimated useful life of the acquired property. Periodically Congress incented businesses to acquire more capital equipment by allowing more generous depreciation deductions. The result was simple, a small business owner would buy equipment and write all of it off immediately and the rest of it off over a reasonable period of time. The rules and reporting are no longer simple, despite that the intended result has not changed.

The de minimus safe harbor limits are provided in Treasury Reg. §1.263(a)-1(f)(1)(ii)(D) for taxpayers without an applicable financial statement (AFS) further prescribed in Rev. Proc. 2015-20. Because McGladrey is one of the largest CPA and advisory firms in the U.S., with offices all over the country we work with thousands of small businesses that DO NOT have an AFS.

In some cases, like the safe harbor rules, a taxpayer can take advantage of the rule by simply putting it into practice. In other cases, an election will need to be filed with a return. However, in order to be in full compliance with the regulations, most taxpayers will need to file a Form 3115 to adopt new accounting methods. Many experts believe that almost all taxpayers with fixed assets or repairs will be required to file at least one accounting method change to be in compliance with the new rules. If a Form 3115 is required, it will need to be filed by the due date (including extensions) of the current year return, assuming the taxpayer is a calendar-year taxpayer. At McGladrey, tax professionals have been advised to recommend preparation of the 3115 which is at great cost and consequence to the taxpayers.

Rather than requiring a Form 3115 to be filed with most returns, an alternative solution might have been to simply change the current Form 4562 to include a series of check boxes, elections and the additional information required by the standards to conform simplifying the entire process.

We also believe in reducing the burden of compliance with these rules by increasing the De Minimus Safe Harbor Amount for Taxpayers without an AFS. From discussions with our business clients that do not maintain an AFS (as defined in Treasury Reg. §1.263(a)-1(f)(4)), we have learned that many have capitalization policies in excess of $500. Historically, these clients rarely have been challenged under IRS examination of maintaining a policy that does not clearly reflect income. As such, a $500 safe harbor does not appear to be a practical solution for taxpayers without an AFS.

To distinguish, one should compare a taxpayer with an AFS to those without. The current rule does not take into consideration the complexity or size or sophistication of the taxpayer and their accounting department. A large closely held business that does not have a financial statement audit could have an accounting department just as sophisticated as that of an SEC company.

However, this similarly situated taxpayer is limited to a capitalization threshold of $500 under the de minimus threshold, rather than the more generous $5,000 amount provided to taxpayers with an AFS.

Granted, a taxpayer without an AFS is not handcuffed by the $500 threshold so long as they can prove under examination that deducting items in excess of $500 is a clear reflection of income. Unfortunately, due to the subjective nature of the “clear reflection of income” determination, taxpayers fear that an IRS examining agent may have a different opinion as to whether or not the expenditures are a clear reflection of income, which could lead to lengthy and costly disputes at the examination and appeal level—or even litigation—over an item that is nothing more than a timing difference. Increasing the safe harbor amount for taxpayers without an AFS would reduce taxpayer anxiety and potential future conflicts under examination.

We suggest increasing the de minimus safe harbor threshold for taxpayers without an AFS. Potential alternatives include a general increase in the amount across all business types, different thresholds based upon industries or a threshold based upon a certain percentage of average gross receipts for the three preceding tax years. Regardless of the method selected to increase the de minimus safe harbor, the threshold for taxpayers with and without an AFS should be indexed for inflation.

Reviewed Financial Statements Included as an AFS

In the preamble of Treasury Decision (T.D.) 9636, Treasury states that it does not believe reviewed financial statements as defined in the AICPA’s Statement of Standards for Accounting and Review Services “provide sufficient assurance to the IRS that such policies are being followed and, accordingly, that the taxpayer is using a reasonable, consistent methodology that clearly reflects income” and should not qualify as an AFS.

A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management. While a review is less in scope than an audit, the certified public accountant is performing analytical procedures to provide some assurance, even though it is limited, that they are not aware of any material modifications that should be made to the financial statements. Arguably, such assurance of no material modification supports the position that reviewed financials meet the AFS expectation that a taxpayer is using a reasonable, consistent methodology that clearly reflects income.

We respectfully suggest a review of the current Treasury and IRS provisions and reconsider their position and include reviewed financial statements as an AFS under Treasury Reg. §1.263(a)-1(f)(4) for purposes of the de minimus safe harbor election.

Taxpayer Privacy - Breached IRS Authorization System

The cost and consequence of data breaches today is substantial. Recent data breaches to the IRS system, affecting thousands of taxpayers has magnified the effect of the breaches. Within our own small service line of 50 professionals we recently conducted a poll that indicates we are currently assisting clients with more than 20 cases of breach and compromise. Though we are not professing or prescribing a fix to the data security problem, what is clear is that substantially more resources are needed to stem the tide of this problem in addition to developing a streamlined and comprehensive solution to the problem. We have clients who have been waiting for months to obtain their refunds, while in the meantime the hackers have already taken the money and run.

The current remediation plan is not effective or comprehensive enough. The current program includes notification by the IRS to the taxpayer recommending they obtain Publication 4535, Identity Theft Prevention and Victim Assistance. If the taxpayer has there is a refund pending, there is no mention in the correspondence as to the status of that refund or the likelihood of when the refund will be issued. In the correspondence the IRS attempts to provide comfort to the taxpayer by indicating that their tax return and future returns have been "flagged" to monitor future activity.

The IRS correspondence goes on to inform the taxpayer they are provided the "option" to obtain and "IP Pin #." The taxpayer is further instructed to file a complaint with the Federal Trade Commission (FTC) and to contact the Social Security Administration (SSA) to validate earnings with the Administration. Finally a toll free hotline is also provided to the taxpayer. That is simply not enough.

Given the severity of data breaches today and the amount of compromised information, we believe the IRS should be providing greater guidance around security and prevention measures. We believe that social security numbers now create such a worldwide target that an accelerated plan to cease using them may be in order in an effort to create a more secure alternative. Obtaining an IP Pin should be considered mandatory, not optional. We also suggest the Service consider providing additional instructions to the taxpayers on the additional measures they can take to protect their privacy with things like their bank and investment accounts, credit cards, and related credit and investment arrangements. Those steps require a sense of urgency and should be undertaken immediately. For example the Service should consider advising taxpayers to implement a credit "freeze."

Do what the Hackers do

Our practice recently obtained the services of an expert to speak to our team on the subject. He provided recommendations worth sharing. In summary he suggested that because the system is broken, any individual can access a free annual credit report from a public site, annualcreditreport.com, from each of the 3 most common credit bureaus. Therefore, once a year a taxpayer needs to take 15 minutes and pull their own credit report from the bureaus. In doing so the taxpayer has the opportunity to thwart the hacker from obtaining your credit history thru these free credit reporting sites. If the taxpayer senses foul play, they would be equipped with the information required to prevent further compromise.

Even if the taxpayers credit is "frozen" they still need to take steps like this because existing lines of credit can be taken over by simply calling the issuer and requesting a new card, changing an address, or even adding stolen payment card to a digital technology like ApplePay by leveraging "knowledge based authentication" questions that can only be found in the credit report.

Below is more information on security freezes. Reducing the chances of becoming a victim takes about 15 minutes of effort. We believe the Service would be serving the taxpayers well by recommending measures such as these.

The websites to freeze files are:

https://www.experian.com/freeze/center.html
https://www.freeze.equifax.com/Freeze/jsp/SFF_PersonalIDInfo.jsp
http://www.transunion.com/securityfreeze

Freezing your credit files won't protect you from having your Personal Identity Info used for tax return fraud, thus the reason why obtaining a Tax Pin should be mandatory and done in tandem with credit freezing.

Our firm is spending hundreds or hours of time at taxpayer expense to help them manage the maze to assist them in obtaining refunds and protect them from further fraudulent activity. This problem is severe and therefore requires an equal or greater effort and resources to manage the problem. The toll free number does little to resolve taxpayer fears and resolve status. One often stays on hold for hours before obtaining a live contact. There is no shortcut to this solution, it requires a dedicated team with dedicated resources empowered to help the taxpayer, or their designee), to obtain what is rightfully theirs.

S Corp Loans and Basis – All Loans are Not Created Equal

A burden and a significant risk for many small business owners, specifically the shareholders of S Corporations, is the necessity to invest Capital into the business, often including the need to pledge their personal assets in order to borrow and more often than not, guaranty money borrowed from 3rd parties. Typically a business owner starts a business and continues to fund the business with their own money or borrowed money, which they are "on the hook" for.

This is not a case against the need to track basis, but to simplify the tracking of basis and have the IRS acknowledge and recognize the true economics of a business loan on the same platform as between the 3rd party lender and the business owner. In short, if the shareholder borrows money and puts it into his company, he gets basis. If on the other hand he arranges to borrow money for the business and guarantees the debt including placing his personal assets as collateral, such as a mortgage on his house or property, then the taxpayer does not get basis, despite that he and his corporation still owes the bank.

The Simple Case for Simplification

This is simply a case for simplification. Loans that meet the appropriate criteria can and should be considered basis. This would streamline and simplify the process, reduce audits and eliminate the costs of tax court cases.

Simplifying Calculations

A common burden for small business owners and their tax advisors is computing and carrying forward complex "basis schedules." The basis schedules are designed to track the basis. Basis is typically used to provide the amount by which a shareholder would include in a gain or loss calculation for the sale of their shares of the stock. However, the basis is also used and can limit the losses that a shareholder can take when his business has a loss. Further, the repayment of the shareholders loan can cause unintended income tax consequences when the company pays back the personal loan if the loan lacks basis.

A shareholder's basis in stock owned in, and loans made to, an S corporation must be calculated for various purposes. First, as in the case of a C corporation shareholder, an S corporation shareholder's basis in stock in the corporation is one of the components for calculating the amount of gain or loss to the shareholder on the sale or other disposition of the stock. Second, stock basis must be known to determine whether distributions to the shareholder are taxable. Third, a shareholder's basis in loans to the corporation is used to determine whether gain or loss results on repayment of the loan. Finally, a shareholder's basis must be tracked over time because a shareholder may only deduct losses and other amounts passed through from an S corporation to the extent of basis in the corporation's stock or debt held by the shareholder.

The Code provides that a shareholder's stock basis in an S corporation is used to calculate the amount of gain or loss the shareholder realizes on the sale or disposition of the stock, and to determine the taxation of distributions by the corporation with respect to the stock.

The shareholder's basis in loans made to the corporation is used in determining the amount of gain or loss recognized by the shareholder on repayment of the loans. To this extent, the shareholder's basis in stock of and loans to an S corporation serves the same purposes as a shareholder's basis in stock of and loans to a C corporation. However, an S corporation shareholder's combined basis in stock of and loans to the S corporation also sets the limit on the amount of losses passed through from the corporation that may be deducted by the shareholder. Losses passed through from an S corporation that exceed the shareholder's combined stock and debt basis may not be deducted by the shareholder. Instead, these "suspended losses" carry over indefinitely, and generally may be deducted by the shareholder to the extent the shareholder's basis in stock or debt is increased in a subsequent year.

A shareholder's initial basis in stock of and loans to an S corporation is computed in the same manner as a shareholder's basis in stock of or loans to a C corporation. Each year, however, an S corporation shareholder's basis is adjusted for income, gain, loss, deduction, and other items passed through from the corporation to the shareholder. Distributions with respect to the shareholder's stock and repayments on debt are also reflected in the shareholder's basis.

Only loans that create indebtedness of the S corporation to the shareholder provide the shareholder with basis for deducting losses passed through from an S corporation.

Thus, while direct loans of money by a shareholder to an S corporation result in a basis increase to the shareholder-lender, indirect loans (such as the shareholder's guarantee of the corporation's debt to a third party) generally do not result in an increase in the shareholder's basis.

Once the shareholder's initial basis is determined, it is adjusted each year for additional capital contributions and distributions and for income, gains, losses, deductions and other items passed through to the shareholder from the S corporation.

In addition to stock basis, S corporation shareholders must monitor their bases in loans to the corporation. A shareholder's loan basis is important because items of loss and deduction passed through from the corporation to the shareholder may be deducted only to the extent of the shareholder's stock basis and loans made by the shareholder to the corporation. In addition, a shareholder's basis in loans made to the corporation determines whether any subsequent loan repayments are taxable to the shareholder.

Not all transactions involving the lending of funds from a shareholder to an S corporation result in a basis increase for the shareholder. The critical questions are whether the purported loan involves indebtedness of the corporation to the shareholder, and whether the indebtedness is bona fide under general federal tax principles taking into account all facts and circumstances. If the loan is not actually between the corporation and the shareholder, the shareholder receives no increase in basis despite that he is still clearly on the hook with the bank.

In the situations discussed below, a shareholder's loan to an S corporation should give rise to an increase in the shareholder's basis.

Direct Shareholder Loans to Corporation

A shareholder's direct loan of money to an S corporation creates indebtedness of the corporation to the shareholder and thus creates basis in the indebtedness. However, the "creation" of a loan through a mere bookkeeping entry on the corporation's books, or the agreement by a shareholder to lend additional funds on demand by the corporation, does not necessarily result in a basis increase to the shareholder. In these cases whether indebtedness is bona fide depends on all facts and circumstances under general federal tax principles.

As discussed below, the mere guarantee of an S corporation's debt by a shareholder does not create indebtedness of the corporation to the shareholder. However the shareholders guarantee to his bank or the 3rd party is absolute and enforceable and keeps many business owners awake at night. Indebtedness of the corporation to the shareholder is created, however, when a shareholder who has guaranteed debts of the corporation repays a loan made by a third party to the corporation. When the shareholder pays under the guarantee, he succeeds to the rights of the third-party lender and the indebtedness of the corporation to the lender becomes indebtedness owed to the shareholder. The corporation becomes indebted to the shareholder in the year the shareholder-guarantor pays the indebtedness of the corporation pursuant to the guarantee, and the shareholder receives a corresponding increase in basis at that time.

Direct Shareholder Loans to Corporation with Borrowed Funds

A loan of money by a shareholder to an S corporation of funds that are borrowed by the shareholder from a bank or other lender creates basis for the shareholder. Such a "back-to-back" loan should result in basis to the corporation's shareholders even if the corporation uses the funds to pay off a pre-existing bank loan, and even if the shareholders borrow the funds from the same bank that the S corporation repays. The important fact is that the shareholder has an actual liability to an outside bank and, as a result of that liability, is considered "poorer in a material sense."

If the shareholder borrows and then lends the funds in a circular transaction, the shareholder's basis in debt depends on the bona fide character of the debt. The shareholder's loan in such a situation is not an arm's-length loan, according to some courts. Furthermore, the shareholder is protected against loss and, therefore, has not made an actual economic outlay. These circular transactions are situations in which the shareholder has a liability to a related entity and a receivable from the S corporation, controls both entities.

Substitution of Shareholder Debt for Corporate Payment

Unlike a partnership, an S corporation shareholder does not receive basis for debts that the corporation owes to a third party. If an S corporation has incurred indebtedness to a third party, on the other hand, the shareholder can convert that debt into basis by substituting the shareholder's note for the S corporation's note to the third party. The technique may not succeed, however, if the corporation remains a party on the new note.

§752(a), which increases a partner's basis for his or her share of all liabilities of the partnership but in contrast, §1366(d)(1)(B) includes in an S corporation shareholder's basis only indebtedness of the corporation to the shareholder.

To avoid challenge by the IRS, shareholders who seek to obtain basis by restructuring bank-to-S-corporation loans should refrain from performing a simple substitution. Instead, shareholders should borrow from the bank, lend the proceeds to the S corporation, and have the corporation pay off its loan with the bank. If a simple substitution is made, the shareholders should adhere strictly to the form of the transaction. For example, the corporation should discontinue making payments to the bank on what is

now shareholder debt. In addition, the shareholders should be personally liable to the creditor to establish real economic risk to the shareholders from the substitution.

The fact that some shareholders' assets that are initially pledged as collateral on an existing loan between a bank and an S corporation will continue to be pledged as collateral on a loan between the bank and the shareholders does not protect the other shareholders against risk of loss. Therefore, the shareholders will be at risk for purposes of the at-risk rules.

Anecdotal Information
The Case for Simplification and Reducing the Backlog

As of this writing our firm is currently representing a small restaurant client ($2.5M per year Revenue) on IRS Audit where we have tracked basis and have limited the loss passthrough to the shareholders because the Corp. suffered a series of prior losses thus limiting the ability for the shareholders to take the 2013 loss (and 2014). The owners recently shuttered the operation and closed the business in 2015.

The business was audited because of the large loss reflected on the tax return. Despite that we limited the losses and announced that fact to the auditor, at great time an expense to our client, the auditor proceeded with the audit anyway. The auditor to date has spent 3 days on the audit. We have provided all of taxpayer's records as requested, despite repeated attempts to explain that any change will result in no change.

The taxpayers in this case are on the hook with a bank and with creditors. They understood the rules and borrowed the money personally. They used their capital and personal borrowings as basis, and that still was not enough to save the business, but they are left with the burden of an audit.

Thank you once again for the opportunity to present these examples that challenge taxpayers and their tax professionals.

Sincerely,

Leslie P. Vitale, CPA, MST
Partner Local Markets Group