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WRITTEN TESTIMONY OF JEFFREY A. PORTER

ON BEHALF OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

PUBLIC HEARING ON

ADDING TO UNCERTAINTY: SMALL BUSINESSES' PERSPECTIVES ON THE TAX CLIFF

SEPTEMBER 13, 2012

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Good morning Chairman Walsh, Ranking Member Schrader and Members of the Subcommittee. I am Jeffrey A. Porter, Vice Chair of the American Institute of Certified Public Accountants' (AICPA) Tax Executive Committee. I am a sole practitioner at Porter & Associates, CPAs, a local firm in Huntington, West Virginia, which concentrates in providing tax planning and business advisory services for small to medium sized businesses and high net worth individuals. On behalf of the AICPA, I am pleased to have the opportunity to testify today on the topic of small businesses' perspectives on the "Tax Cliff."

The AICPA is the world's largest member association representing the accounting profession, with nearly 386,000 members in 128 countries and a 125 year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

Our members are well aware of the great uncertainty facing small businesses today in regards to income taxes rates, estate taxes rules, and the re-occurring, so called "tax extenders." Our members are receiving inquiries from their clients, sometimes on a daily basis, on whether the "Bush Tax Cuts" will be extended, what will happen with estate taxes, how the "Tax Cliff" will affect their businesses, and whether a particular tax incentive will be extended another year. This year has become an extraordinary year for uncertainty in taxes as well as the macro economy, making it extremely difficult for small businesses and their owners to make informed business and financial decisions.

EXPIRATION OF THE 2001 AND 2003 TAX CUTS

The Economic Growth and Tax Relief Reconciliation Tax Act (EGTRRA) of 2001 made substantial changes to the individual income tax law including to the ordinary income tax rates, the capital gains rate, and the tax rate on qualified dividends. EGTRRA also made substantial changes regarding the elimination of phase-outs of itemized deductions and

personal exemptions, eliminated the marriage penalty on the standard deduction and the lower income tax bracket, as well as changes to the amount of and requirements to qualify for many other incentives (e.g., child tax credit, adoption expense credit and dependent care credit). These income tax changes were initially scheduled to expire after 2010, but were generally extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA).

EGTRRA also made major revisions to the estate, gift, and generation-skipping transfer (GST) tax regimes. In December 2010, TRUIRJCA modified and extended temporarily the estate, gift, and GST tax provisions of EGTTRA and also created some new provisions.

All of the provisions of EGTTRA, as well as the provisions of TRUIRJCA, are scheduled to expire on December 31, 2012, and the income, estate, gift, and GST tax laws in effect prior to 2001 are scheduled to return.

Income Taxes

Small businesses, formed as corporations, pass-through entities, or sole proprietorships, are currently facing considerable uncertainty with regard to income taxes. This uncertainty is not limited to one or two tax provisions, but instead affects many areas of the Internal Revenue Code (Code), including income tax rates, long-term capital gains rates, the rate for qualified dividends, and whether, and to what extent, certain deductions, credits and exemptions will be available.

The uncertainty becomes more unsettling when you look at the potential changes in tax treatment for some items of income and deduction. For example, qualified dividends are currently taxed at a maximum income tax rate of 15%. However, these same dividends might be subject to a maximum rate of 39.6% beginning in 2013. This tax hike is a 164% increase. If you take into consideration the 3.8% Medicare tax on passive investments, the tax rate on dividends could reach 43.4% or nearly a 190% increase.

There is also a significant change scheduled to take effect in 2013 for many deductions and exemptions. For example, the phase-out of itemized deductions for high income individuals is scheduled to return. This means that a taxpayer, who received a $10,000 deduction for a $10,000 charitable contribution this year, may only receive a $2,000 deduction for the same charitable contribution next year. Assuming there is no change in income tax rates, a return of the phase-out rules could reduce the benefit of a taxpayer's charitable contribution by up to 80%.[1]

[1] The phaseout and terminination provisions of the overall limitation on itemized deductions sunset on December 31, 2012, at which time an individual whose adjusted gross income exceeds the applicable amount, will have itemized deductions otherwise allowable reduced by the lesser of (1) 3% of the excess of the adjusted gross income over the amount, or (2) 80% of the amount of the itemized deductions otherwise allowable. *See* I.R.C. section 68(a).

Regardless of whether you support or oppose an increase in income taxes, it is important to understand the significance of what is at stake. For example, it is nearly impossible to estimate the true cost of a purchase of new equipment when income tax rates are uncertain. Although income taxes are not the only factor in making business decisions, prudent business owners want to understand the tax consequences of a transaction.

Multi-year planning and the ability to predict (or at least estimate) business profits and taxes are critical in operating a business. It is also essential to know future income tax rates in structuring major business transactions such as in the sale of a business or its assets. In order to determine a sales price that is acceptable to both the buyer and seller, both parties need to understand their potential tax liability for the current year as well as any future year. Tax considerations are even more substantial if the sale is structured as an installment sale. Since banks are hesitant to lend money in many of these types of transactions, the seller frequently finances the transaction for the purchaser over a number of years. In order to determine an agreeable sales price and appropriate interest rate, both parties need to calculate (or reasonably estimate) the ordinary income taxes and capital gains taxes due on the transaction for the current and subsequent years. Without this information, it is extremely difficult for either party to make an informed decision.

A number of individuals are also modifying their business plans solely to take into consideration income taxes. For example, I am aware of one small business owner who is eager to have certainty with regards to the taxation of dividends. The business owner is considering whether to pay a significant dividend, or perhaps two dividends, at the end of the year while the 15% rate is still available. If it were not for the possibility that dividends may be taxed at ordinary income tax rates in 2013, the owner absolutely would not consider paying a dividend this year.

Estate, Gift and Generation-Skipping Transfer Taxes

The AICPA urges Congress to take prompt action to enact permanent estate, gift, and GST tax provisions and thus provide needed certainty to taxpayers in planning their affairs. The uncertainty of these laws impedes proper estate planning for small business owners, and the necessity to revise estate planning documents multiple times places an undue burden on individuals.

Many small business owners are considering substantial gifts to fully utilize this year's lifetime exemption. For example, I am aware of one retailer who is planning to gift approximately $5,000,000 in his company's stock to his daughter even though it causes some issues with his overall business succession plan. According to the owner, the gift is not necessarily in the best interest of the business, but he does not want to forgo this "once-in-a-lifetime opportunity" to make a transfer of this size. Generally, a business succession plan takes several years to execute, however some small business owners feel pressure to accelerate or modify their plan given the uncertainty in transfer taxes.

The AICPA strongly recommends that Congress take into consideration some important tax administration issues when enacting permanent estate, gift, and GST tax provisions. Our suggestions, which have been submitted previously, are based on various studies and reports over the past decade. In developing these suggestions, we focused on the complexity of the current system, taxpayer planning and compliance burdens, ease of administration and revenue constraints. Our suggestions, in priority order, are:

1. GST Technical Modifications – Make permanent the technical modifications to the GST tax rules enacted in EGTRRA and extended temporarily by the TRUIRJCA, which provide relief from several GST tax "traps" that existed under previous law. (See AICPA's letter dated November 18, 2011 for more details on this important, non-controversial technical provision.)

2. Estate and Gift Tax Exemption – Maintain from the TRUIRJCA an applicable exclusion (exemption) amount indexed for inflation for gift and estate taxes that eliminates planning, filing, and estate tax payment burdens for all but the largest estates. If the gift and estate tax exemption amount is reduced below the current $5.12 million level, it is important that those taxpayers, who made taxable gifts in 2011 and 2012 in order to utilize all or a part of the current exemption, not be subject to gift or estate tax in the future on the amount that was excluded by the exemption in those (2011 and 2012) years. In other words, any statutory provision should make clear that the amount of taxable gifts covered by the exemption amount in 2011 and 2012 is not again included in the amount subject to gift or estate tax.

3. Uniform Exemption Amount – Maintain from the TRUIRJCA a uniform exemption amount for estate, gift, and GST tax purposes. This uniform exemption amount considerably simplifies planning for individuals.

4. Portability – Maintain the portability rules which allow a surviving spouse to utilize any unused portion of the first spouse to die's estate tax exemption. This provision, which was enacted as part of the TRUIRJCA, would significantly simplify estate planning and estate administration for married couples if they could rely on it. However, the portability provision is currently not very useful from a planning perspective since the provision is scheduled to expire on December 31, 2012. Married couples still need to obtain professional advice to assist them with attempting to equalize their estates by dividing up jointly owned property and establishing marital trusts. We also recommend that this Subcommittee consider making the GST exemption portable.

5. State Tax Credit – Reinstate the full state estate or death tax credit, or provide another mechanism (such as a surtax), that would allow states to uniformly

"piggyback" on the federal estate tax. To avoid diminishing tax revenues, many states have decoupled from the federal estate tax and enacted their own estate tax regimes, resulting in unnecessary complexity and uncertainty in both planning and administration.

6. Relief Provisions – Provide broad-based liquidity relief, rather than targeted relief provisions. Broad provisions that would apply to all illiquid estates would be both simpler and fairer to all taxpayers. At a minimum, the section[2] 6166 installment payment rules and its holding company provision should be modernized to allow eligibility for all types of business forms, including pass-through entities (i.e., partnerships, limited liability companies, etc.) in addition to currently-allowed corporations.

7. Number of Tax Brackets – Provide many tax brackets to avoid cliff taxation. We note that there have been some proposals in the past that have included a rate structure with a very limited number of tax brackets and a large gap between brackets. For example, such a system might provide for only two brackets, such as 15% and 30%, with estates over a certain size paying the higher bracket (30% in this example), and estates below that number paying the lower bracket (15%). In such a proposal, there would be significant uncertainty in the planning process for married couples with sizeable estates. For example, taxpayers may have to consider if estate tax should be paid at the death of the first spouse at a 15% rate compared to an alternative of paying the tax in the future but at a higher rate. In addition, this type of "cliff" taxation allows too much disparity among similarly situated taxpayers, where one receives estate planning advice and pays significantly less tax when compared to the individual who does not receive such advice.

We note that the Administration's budget proposals for fiscal year 2013 would make permanent the portability provisions enacted in TRUIRJCA. In addition, the Administration's budget proposals would make permanent at the 2009 law levels the provisions enacted in 2001. As a result, the GST tax technical provisions would be made permanent as part of the broader effort to accomplish estate tax reform by making permanent certain estate, gift and GST tax provisions enacted in 2001. We applaud this effort to permanently extend these expiring provisions. Furthermore, the AICPA advocates that the GST tax technical provisions in EGTRRA, as extended by TRUIRJCA, should be made permanent, without any interruption in their applicability, due to undue burdens upon taxpayers who relied on these provisions in managing their affairs since 2001 and the need for the simplicity provided by these provisions going forward.

[2] All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder, unless otherwise specified.

TAX EXTENDERS

The AICPA appreciates your efforts in examining small businesses' perspectives on tax extenders, which in the last several years have repeatedly created uncertainty and confusion. While some measures, such as those designed for economic stimulus, are appropriate for temporary and sporadic use, longstanding, continually renewed, temporary tax provisions, including many incentive provisions, have become far too common. In its January 2012 report[3] on expiring tax provisions (affecting individuals and other taxpayers), the Joint Committee on Taxation notes more than 60 different tax provisions expired on December 31, 2011, and more than 42 tax provisions will expire on December 31, 2012.

These ever-changing, often expiring, short-term changes to the tax laws make it increasingly difficult for small businesses and their owners to do any long-term tax, cash-flow or financial planning. These planning challenges are further compounded when tax laws are changed after the year has already begun but are slated to take effect that same tax year. When tax laws are issued late in the year or at the last minute, individuals try their best to comply with no ability to plan for such last-minute provisions, no matter how well-intentioned.

Uncertainty also breeds complexity. The need to extend expiring provisions (e.g., the research and experimentation credit) adds confusion and, in many cases, undermines the policy reasons behind these incentives. The on-again-off-again nature of these provisions, coupled with retroactive tax law changes, make long-term planning difficult, result in the filing of amended returns, and significantly increase the overall complexity.

Future tax changes should be enacted with a presumption of permanency, except in rare situations in which there is an overriding and explicit policy reason for making provisions temporary, such as short-term stimulus provisions or when a new provision requires evaluation after a trial period.

Alternative Minimum Tax

Small businesses, including those operating as pass-through entities, are at risk of being subject to the alternative minimum tax (AMT). Originally adopted as a way to ensure that all taxpayers pay a minimum amount of tax on their economic income, the AMT has evolved into one of the tax law's most complex components. In fact, the AMT is a separate and distinct tax regime from the "regular" income tax, which requires taxpayers to make a second, separate computation of their income, expenses, allowable deductions

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[3] Joint Committee on Taxation, *List of Expiring Federal Tax Provisions, 2011-2012* (JCX 1-12), January 6, 2012.

and credits. This separate calculation must be performed on all components of income including business income for sole proprietors, partners in partnerships and shareholders in S corporations.

As complex as the calculations for the AMT are, Congress also chose not to index the AMT tax rates or the exemption levels for inflation unlike the normal tax rates schedules. As a result, the AMT exemption has become an annual battle for Congress and the inflation factor is typically implemented retroactively. As of today, Congress has allowed the inflation indexing to expire for 2012. As a result, estimated tax planning for small businesses has to take into account the lower AMT exemption amount.

For example, when the "AMT patch" is not in place at the start of a tax year, many individuals must factor AMT in their quarterly estimated tax payments. This means that a small business owner, who possibly is strapped for cash, may have to pay a substantial amount in estimated taxes during the year. If the AMT patch is eventually passed, the Internal Revenue Service (IRS) will issue a refund for any overpayment of taxes once the small business owner files a return. However, the small business owner essentially provides the IRS with an interest-free loan or risks paying an underpayment penalty if the AMT patch is not passed. It is a no-win situation for these taxpayers.

The AICPA has a long-standing position of supporting repeal of the AMT for both individual and corporate taxpayers. However, we recognize there is a significant revenue cost associated with this simplification reform. Alternatively, we strongly urge Congress, at a minimum, to permanently index the AMT for inflation – which would eliminate a significant amount of uncertainty in tax planning.

Section 179 Expensing and Bonus Depreciation

One of the most important tax incentives for small businesses to invest in machinery and equipment is to allow for faster cost recovery of the business property. Generally, businesses are allowed to deduct the cost of capital expenditures over time according to depreciation schedules. However, Congress has passed certain exceptions to the rule over the years, the most significant of which are scheduled to change at the end of 2012.[4]

First, to help small businesses quickly recover the cost of capital outlays for qualifying personal property, small businesses can elect to write off these expenditures in the year of acquisition instead of recovering the costs over time through depreciation. This expense election is commonly referred to as the "Section 179 election."

For 2010 and 2011, small businesses were allowed to expense up to $500,000 of capital expenditures. In order to ensure the incentive was only available to small businesses, the maximum expense amount was gradually reduced once qualifying property placed in

[4] *See* I.R.C. sections 179(b) and 168(k)(5).

service during the year exceeded $2,000,000.[5] For 2012, the maximum write off amount is $139,000 and subject to reduction once a taxpayer's aggregate expenditures exceed $500,000.[6] For 2013, the maximum expensing amount and phase-out threshold are scheduled to drop to $25,000 and $200,000, respectively.[7]

The other incentive which is in doubt is commonly referred to as "bonus depreciation." In previous legislation, Congress allowed businesses to more rapidly deduct capital expenditures by permitting an additional first-year write-off of 50% of the cost.[8] For investments placed in service after September 8, 2010 and before December 31, 2011 (through December 31, 2012 for certain property), the law provided for 100% first-year depreciation.[9] In other words, the entire cost of qualifying property placed in service during that time frame can be written off, with no limitation. For the 2012 tax year, however, the law reverted back to allowing 50% additional first-year depreciation. The bonus depreciation rules are scheduled to expire on December 31, 2012. Thereafter, small businesses can only recover the cost of property over the life of the asset (unless section 179 applies).

Unfortunately, the uncertainty surrounding the ability to use accelerated recovery methods has resulted in unease for many small business owners and has been outright crippling for other business owners. For example, one small manufacturer, for which I am personally familiar, is currently evaluating whether to purchase a new printing press. The cost of the press is approximately $2,000,000, which is a *significant* expenditure for this company. If the owner orders the needed new press, he will receive and pay for the press in approximately six to eight months. However, the owner has decided to temporarily postpone the purchase during this time of uncertainty. Without the ability to determine his after-tax cost of the equipment, he is unwilling to make such a significant investment.

In summary, depreciation is an area of the tax law where uncertainty has a significant impact on business decisions. The ability to entirely write off a capital expenditure can influence small business owners' decisions. Likewise, the difference in 50% bonus depreciation, 100% bonus depreciation and no bonus depreciation is substantial for small businesses and undoubtedly impacts their decisions. The difference in taxes may determine whether a business owner purchases an asset this year, next year or perhaps not at all.

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[5] I.R.C. section 179(b)(1).
[6] *Ibid.*
[7] *Ibid.*
[8] I.R.C. section 168(k).
[9] I.R.C. section 168(k)(5).

Other Tax Extenders

Our members frequently receive inquiries and address concerns on a wide variety of other temporary tax incentives depending on the nature of their practice. For some small businesses, the research and experimentation credit is critical since a significant amount of the owners' time is spent developing new or improved products or processes, which may qualify for the credit. Other businesses are more concerned about the expiration of the work opportunity credit or new markets tax credit.

TAX REFORM

While this Subcommittee is examining the impact of the "Tax Cliff," we also urge you to consider how small businesses could greatly benefit from tax reform. Small businesses and their owners face challenges in making long-term decisions as well as compliance burdens when confronted with confusing, overlapping and inconsistent tax provisions.

The AICPA strongly supports Congress undertaking a comprehensive consideration of tax reform in the upcoming year. We are available to assist you in this process, and believe there are a number of issues affecting small businesses which should be addressed in any comprehensive tax reform. Specifically, we suggest you consider how to improve the administration of the Code by examining the following important issues:

1. Phase-Outs – The Code includes many exclusions, exemptions, deductions, and credits which are phased-out for taxpayers whose incomes exceed certain levels. There should be greater consistency across phase-outs in how income thresholds are determined, the income range over which the phase-out applies, and the method of applying the phase-outs.

2. Different Definitions of the Same Term – There are several terms which have multiple and inconsistent definitions in the Code, such as, "modified adjusted gross income," and this leads to confusion. Definitions should be consistent where the same term is used.

3. Retirement Plan Options – The Code provides for more than a dozen tax-favored employer-sponsored retirement planning vehicles, each subject to different rules pertaining to plan documents, eligibility, contribution limits, tax treatment of contributions and distributions, the availability of loans, portability, nondiscrimination, reporting and disclosure. These provisions should be simplified and the number of available plans should be reduced.

4. Inflation Adjustments – Inflation eventually erodes the equity of certain tax provisions. Although many items are now adjusted on an annual basis for inflation, some are not. Examples of items not adjusted for inflation include the business gift deduction, the capital loss limitation, and the definition of a

small business under section 1244. In these cases, the Code should allow for annual inflation adjustments.

We also suggest that you review the AICPA's Tax Policy Concept Statement #1: Guiding Principles for Good Tax Policy to assist you in identifying problems in the Code as well as to test any new proposals against the principles of good tax policy.

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It is important for Congress to reach an agreement with regards to the expiring tax provisions as soon as possible. The uncertainty of the tax law unnecessarily impedes long-term tax and cash-flow planning for businesses, and prevents owners from making informed decisions. Any further delay will magnify the frustration of many small business owners.

On behalf of our members and their small business clients, I also strongly urge you to not underestimate the effect that the Tax Cliff has on tax administration itself. If Congress waits until late in the year or even into next year to enact tax law changes, the IRS and commercial software vendors must scramble to revise or issue new tax forms and update software. As we experienced just a couple of years ago, this process would likely delay the initial date of when many taxpayers, including small business owners, can file their income tax returns. As a result, affected taxpayers would receive their refund checks days or perhaps weeks later than usual, which is particularly concerning for businesses operating under a tight cash flow.

Last-minute changes to the tax laws are also extremely problematic for CPAs. Our members, a vast majority of whom are small businesses, will face an increasingly compressed and perhaps hectic busy season in order to educate clients on the changes in the rules, advise owners on the after-tax consequences of business transactions, assist small businesses and individuals with tax and cash-flow planning and prepare income tax returns.

The AICPA appreciates this opportunity to comment today and we urge this Subcommittee to consider our suggestions as Congress decides how to address the expiration of the 2001 and 2003 tax cuts, the estate tax provisions, and the tax extenders.