



American Institute of CPAs  
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**WRITTEN STATEMENT**  
**OF**  
**THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**  
**FOR THE RECORD OF THE**  
**FEBRUARY 15, 2017**  
**HEARING OF**  
**THE UNITED STATES HOUSE OF REPRESENTATIVES**  
**COMMITTEE ON SMALL BUSINESS**  
**ON**  
**STARTUPS STALLING? THE TAX CODE AS A BARRIER TO**  
**ENTREPRENEURSHIP**

## INTRODUCTION

Chairman Chabot, Ranking Member Velazquez, and Members of the House Committee on Small Business, thank you for the opportunity to testify today at the hearing on "Startups Stalling? The Tax Code as a Barrier to Entrepreneurship." My name is Troy Lewis. I am an Associate Teaching Professor at Brigham Young University. I am also a sole tax practitioner and the Immediate Past Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). I am pleased to testify today on behalf of the AICPA.

The AICPA is the world's largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state, local 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.

We applaud the leadership taken by the Committee to consider ways to promote entrepreneurship by addressing potential barriers in the Internal Revenue Code (IRC or "Tax Code"). Small businesses are the foundation of the U.S. economy, employing over half of the private-sector workforce and creating nearly two-thirds of this nation's net new jobs over the past decade and a half.<sup>1</sup>

## GOOD TAX POLICY

First, we should consider the features of an ideal tax system for small businesses. The AICPA urges the Committee to consider comprehensive tax reform that focuses on simplification and other *Principles of Good Tax Policy*<sup>2</sup> as explained in a report we recently updated and issued. Our tax system must be administrable, stimulate economic growth, have minimal compliance costs, and allow taxpayers to understand their tax obligations.

We believe these features are achievable if the following twelve principles of good tax policy are considered in the design of the system:

- Equity and Fairness
- Convenience of Payment
- Certainty
- Effective Tax Administration

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<sup>1</sup> Small Business Administration Office of Advocacy, Frequently Asked Questions, September 2012; [https://www.sba.gov/sites/default/files/FAQ\\_Sept\\_2012.pdf](https://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf).

<sup>2</sup> AICPA, Guiding Principles for Good Tax Policy: A Framework for Evaluating Tax Proposals, 2017; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/tax-policy-concept-statement-no-1-global.pdf>.

- Information Security
- Neutrality
- Transparency and Visibility
- Accountability to Taxpayers
- Simplicity
- Economic Growth and Efficiency
- Minimum Tax Gap
- Appropriate Government Revenues

Our profession has long-advocated for a transparent tax system. For example, we urge Congress to use a consistent definition of taxable income without the use of any phase-outs. Provisions, such as phase-out rules, that limit or eliminate the use of certain deductions and exclusions for those taxpayers in higher tax brackets, perpetuate the flaws of the current system, cause tax consequences of business decisions to be nontransparent and hinder the ability for new entrepreneurs to grow their businesses. The use of phase-outs – in order to increase the effective tax rate – contributes to the complexity and lack of transparency of the present tax system. These rules also unfairly create marginal rates in excess of the statutory tax rate. We urge Congress to use tax reform as an opportunity to remove phase-outs and develop the best definition of taxable income or adjusted gross income by creating simple, transparent, tax rate schedules that are applied consistently across all rate brackets, eliminating additional hidden taxes.

We also urge you to make tax provisions permanent. For all businesses, and small businesses in particular, uncertainty in the Tax Code creates unnecessary confusion, anxiety, and financial burdens that impact cash flow, and, thus, a business's ability to hire and expand. Complexity can also result in taxpayers not taking full advantage of provisions intended to help them, resulting in higher taxes and greater compliance costs. While our Tax Code has always had a tendency to change, in recent years the rate of change has accelerated. New regulations, revenue procedures and notices come out daily, providing guidance on enacted laws. Extender bills pass annually only to expire, often within less than a month of enactment, leaving taxpayers unable to avail themselves of intended tax breaks and benefits. When a small business client asks a simple question such as "what is my tax rate," CPAs have to explain how it is not quite that simple to answer because there is the regular tax, the alternative minimum tax (AMT), the net investment income tax and the variety of phase-ins and phase-outs for numerous provisions that all impact an overall blended rate. America's entrepreneurs need a Tax Code that is simple, transparent, and certain.

## **AICPA PROPOSALS**

We appreciate the opportunity to provide input as Congress develops tax reform policy for small businesses and their owners. In the interest of good tax policy and effective tax administration, we will address the following issues:

1. Tax Rates for Pass-through Entities

2. Distinguishing Compensation Income
3. Cash Method of Accounting
4. Limitation on Interest Expense Deduction
5. Definition of "Compensation"
6. Net Operating Losses
7. Increase of Startup Expenditures
8. Alternative Minimum Tax Repeal
9. Border Adjustment Provisions
10. Mobile Workforce
11. Retirement Plans
12. Civil Tax Penalties
13. Tax Administration

### **1. Tax Rates for Pass-through Entities**

As Congress moves forward with tax reform, it is important to recognize that a rate reduction for only C corporations is inappropriate. The vast majority of businesses are structured as pass-through entities (such as, partnerships, S corporations, or limited liability companies).<sup>3</sup> In 2014, there were almost 25 million individual tax returns that included a non-farm sole proprietorship.<sup>4</sup>

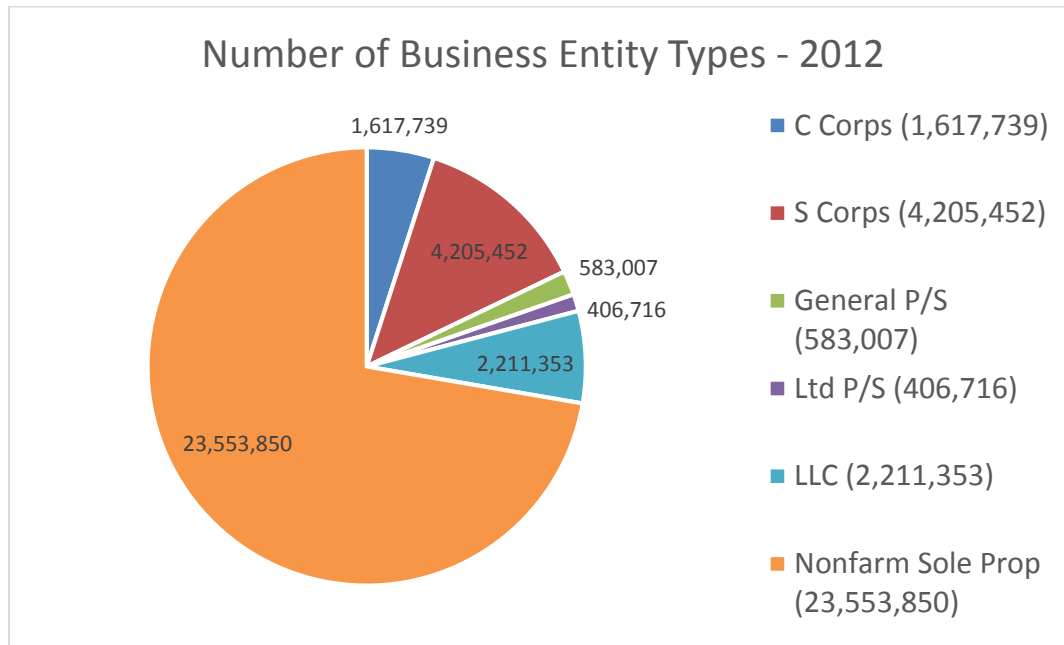
IRS data for 2012, the most recent data publicly available, indicates the following mix and numbers of business entity filings.<sup>5</sup>

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<sup>3</sup> Census Bureau, County Business Patterns, <http://www.census.gov/econ/cbp/>; Census Bureau, Nonemployer Statistics, <http://www.census.gov/econ/nonemployer/>.

<sup>4</sup> IRS, Sole Proprietorship Returns, Tax Year 2014; <https://www.irs.gov/pub/irs-soi/soi-a-inpr-id1614.pdf>.

<sup>5</sup> IRS, SOI Tax Stats – Integrated Business Data, Table 1: Selected financial data on businesses; 1980-2012; <https://www.irs.gov/uac/soi-tax-stats-integrated-business-data>. Table created by the AICPA using IRS data. IRS data on nonfarm sole proprietorships indicates the number has grown to 23,631,831 for 2014, a 4.6% increase from 2012. See IRS, *Sole Proprietorship Returns, Tax Year 2014*, Figure L; <https://www.irs.gov/pub/irs-soi/soi-a-inpr-id1614.pdf>.



Congress should continue to encourage, or more accurately – not discourage, the formation of sole proprietorships and pass-through entities because these business structures provide the flexibility and control desired by many new business owners as opposed to corporations which are subject to more formalities. Entrepreneurs generally do not want to create entities that require extra unnecessary legal obligations (such as holding annual meetings of a board of directors) or offer limited liability. They prefer business structures that afford immediate tax advantages, such as the flow-through of early stage losses and a single layer of taxation. As a business grows, however, it may need to change its structure to raise additional equity funding or bring on more shareholders (including employee-shareholders).

If Congress decides to lower income tax rates for C corporations<sup>6</sup> (which are generally larger businesses), small businesses should also receive a rate reduction. Tax reform should not disadvantage sole proprietorships and pass-through entities at the expense of furthering larger C corporations.

## **2. Distinguishing Compensation Income**

We recognize that providing a reduced rate for active business income of sole proprietorships and pass-through entities will place additional pressure on the distinction

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<sup>6</sup> House Republican’s Tax Reform Task Force, *A Better Way: Our Vision for a Confident America - Tax*, June 24, 2016; <http://abetterway.speaker.gov/assets/pdf/ABetterWay-Tax-PolicyPaper.pdf>.

between the profits of the business and the compensation of owner-operators. We recommend determining compensation income by using traditional definitions of "reasonable compensation" supplemented, if necessary, by additional guidance from the Secretary of the Treasury. Changes to existing payroll tax rules, such as a requirement for partnerships and proprietorships to charge reasonable compensation for owners' services and to withhold and pay the related income and other taxes, will also facilitate compliance for small businesses.

We encourage Congress to consider the existing judicial guidance on reasonable compensation that reflects the type of business (for example, labor versus capital intensive), the time spent by owners in operating the business, owner expertise and experience, and the existence of income-generating assets in the business (such as other employees and owners, capital and intangibles). There is existing law developed by judicial decisions relating to reasonable compensation.

We acknowledge that reasonable compensation has been the subject of controversy and litigation (hence, the numerous court decisions helping to define it). Therefore, we suggest that the Internal Revenue Service (IRS) take additional steps to improve compliance and administration in this area. For example, the creation of a new tax form (or preferably, modification of an existing form, such as Form 1125-E, Compensation of Officers) or a worksheet maintained with the taxpayer's tax records, would allow businesses to indicate the factors considered in determining compensation in a consistent manner. These potential factors include:

- a. Approximate average hours per week worked by all owners;
- b. Approximate average hours worked per week by non-owner employees;
- c. The owner's years of experience;
- d. Guidance used to help determine reasonable compensation for the geographic area and years of experience (such as, wage data guides provided by the U.S. Bureau of Labor Statistics); and
- e. Book value and estimated fair market value of assets that generate income for the business.

Changes are also necessary for existing payroll tax rules to require partnerships and proprietorships to charge reasonable compensation for owners' services and to withhold and pay the related income and other taxes. These types of changes to existing payroll tax rules will facilitate small business compliance. The partners and proprietors are not treated as "employees," but rather owners subject to withholding – a new category of taxpayer – similar to a partner with a guaranteed payment for services. Similar rules requiring reasonable compensation currently exist in connection with S corporations and such owners are considered employees of the S corporation. The broader inclusion of partners

and proprietors in more well defined compensation rules, should facilitate and enhance the development of appropriate regulations and enforcement in this area.

The AICPA believes there are advantages of this reasonable compensation approach for owners of all business types. These advantages include:

- a. Fairness that respects the differences among business types;
- b. A reduced reliance by both taxpayers and the IRS on quarterly estimated tax payments for timely matching of the earning process and tax collection;
- c. Diminished reliance on the self-employment tax system (since businesses would include payroll taxes withheld from owners and paid for owners along with their employees); and
- d. Simplification from uniformity of collection of employment tax from business entities, and an ability to rely on a deep foundation of case law (in the S corporation and personal service corporation areas) to provide regulatory and judicial guidance.

In former Ways & Means Chairman Dave Camp's 2014 discussion draft,<sup>7</sup> a proposal was included to treat 70 percent of pass-through income of an owner-employee as employment income. While this proposal presents a simple method of determining the compensation component, it would result in an inaccurate and inequitable result in too many situations. If Congress moves forward with a 70/30 rule, or other percentage split, we recommend making the proposal a safe harbor option. Small businesses need simplicity and clarity in the rules. For example, the proposal must make clear that the existence and the amount of the safe harbor is not a maximum amount permitted but that the reasonable compensation standard utilized for corporations will remain available to sole proprietorships and pass-through entities. These rules will provide a uniform treatment among closely-held business entity types.

### **3. Cash Method of Accounting**

The AICPA supports the expansion of the number of taxpayers who may use the cash method of accounting. The cash method of accounting is simpler in application than the accrual method, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the income. Therefore, entrepreneurs often choose this method for small businesses. We are concerned with, and oppose, any new limitations on the use of the cash method for service businesses, including those businesses whose income is taxed directly on their owners' individual returns, such as partnerships and S corporations. Requiring businesses to switch to the accrual method upon reaching a gross receipts threshold unnecessarily creates a barrier to growth. A required switch to the accrual method affects

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<sup>7</sup> H.R. 1, "The Tax Reform Act of 2014,"  
[https://waysandmeans.house.gov/UploadedFiles/HR\\_1\\_FINAL.pdf](https://waysandmeans.house.gov/UploadedFiles/HR_1_FINAL.pdf).

many small businesses in certain industries including accounting firms, law firms, medical and dental offices, engineering firms, and farming and ranching businesses.

The AICPA believes that limiting the use of the cash method of accounting for service businesses would:

- 1) Discourage natural small business growth;
- 2) Impose an undue financial burden on their individual owners;
- 3) Increase the likelihood of borrowing;
- 4) Impose complexities and increase their compliance burden; and
- 5) Treat similarly situated taxpayers differently (because income is taxed directly on their owners' individual returns).

As the AICPA has previously stated,<sup>8</sup> we believe that Congress should not further restrict the use of the long-standing cash method of accounting for the millions of U.S. businesses (e.g., sole proprietors, personal service corporations, and pass-through entities) currently utilizing this method. We believe that forcing more businesses to use the accrual method of accounting for tax purposes increases their administrative burden, discourages business growth in the U.S. economy, and unnecessarily imposes financial hardship on cash-strapped businesses.

#### **4. Limitation on Interest Expense Deduction**

Another important issue for small businesses is the ability to deduct their interest expense. New business owners have interest from small business loans they incur to fund operations prior to revenue generation, working capital needs, equipment acquisition and expansion, and even to build credit for larger future loans. These businesses rely on financing to survive. Equity financing for many start-up businesses is simply not available. A limitation in the deduction for interest expense (to the extent of interest income) would effectively eliminate the benefit of a valid business expense for many small businesses, as well as many professional service firms. If a limit on the interest expense deduction is

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<sup>8</sup> AICPA comment letter on the "Continued Availability of Cash Method of Accounting," August 15, 2013; [http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/2013.08.15\\_Comments\\_on\\_Continued\\_Availability\\_of\\_Cash\\_Method\\_of\\_Accounting.pdf](http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/2013.08.15_Comments_on_Continued_Availability_of_Cash_Method_of_Accounting.pdf), AICPA written statement before the House Committee on Ways And Means, dated May 15, 2013, Small Business and Pass-through Entity Tax Reform Discussion Draft; <http://www.aicpa.org/Advocacy/Tax/Partnerships/DownloadableDocuments/AICPA-WRITTEN-STATEMENT-May-15-2013-hwmc-srsubcomte-camp-small-bus-submit.pdf>, and AICPA written statement before the House Committee on Small Business, Subcommittee on Economic Growth, Tax and Capital Access, dated July 10, 2014, Hearing on "Cash Accounting: A Simpler Method for Small Firms?"; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA%20WRITTEN%20STATEMENT%20July%2010%202014%20to%20House%20Subcte%20on%20Economic%20Growth%20Tax%20and%20Capital%20Access.pdf>.



paired with a proposal to allow for an immediate write-off of acquired depreciable property, it is important to recognize that this combination adversely affects service providers and small businesses while offering much larger manufacturers, retailers, and other asset-intensive businesses a greater tax benefit.

Currently, small businesses can expense up to \$500,000 of acquisitions per year under section 179 (\$510,000 for 2017) and deduct all associated interest expense. One tax reform proposal<sup>9</sup> under consideration would eliminate the benefit of interest expense while allowing immediate expensing of the full cost of new equipment in the first year. However, since small businesses do not generally purchase large amounts of new assets, this proposal would not provide any new benefit for smaller businesses (relative to what is currently available via the section 179 expensing rule). Instead, it only takes away an important deduction for many small businesses who are forced to rely on debt financing to cover their operating and expansion costs.

#### **5. Definition of "Compensation"**

Tax reform discussions have recently considered whether the tax system should use the same definition for taxable compensation of employees as it does for the compensation that employers may deduct. In other words, should businesses lose some of their current payroll-type deductions if employees are not required to report those same compensation amounts as income?

We are concerned, particularly from a small business perspective, about any decrease of an employer's ability to deduct compensation they have paid to employees, whether in the form of wages or fringe benefits (health and life insurance, disability benefits, deferred compensation, etc.). We are similarly concerned about expansion of the definition of taxable income for the employees, or removal of the exclusion for fringe benefits. Such changes in the Tax Code would substantially impact the small and labor-intensive businesses' ability to build and retain a competitive workforce.

#### **6. Net Operating Losses**

Congress should also provide tax relief to small businesses in the calculation of benefits related to net operating losses (NOLs). An NOL is generally the amount by which a taxpayer's business deductions exceed its gross income. Corporations currently operating at a loss can benefit from carrying these NOLs back or forward to offset taxable income in prior or future years. According to the current rules, these losses are not deducted in the

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<sup>9</sup> House Republican's Tax Reform Task Force, A Better Way: Our Vision for a Confident America, June 24, 2016; <http://abetterway.speaker.gov/assets/pdf/ABetterWay-Tax-PolicyPaper.pdf>.

year generated, but carried back two years and carried forward 20 years to offset taxable income in such years.

One of the purposes of the NOL carryback and carryover rules is to allow a corporation to better reflect its economic position over a longer period of time than generally is allowed under the restraint of the annual reporting period. Since 1987, our experience with the 90 percent AMT limitation on the use of NOLs shows that this limitation often imposes a tax on corporations, especially small businesses in their early growth years, when such businesses are still struggling economically. Therefore, a proposal<sup>10</sup> for a 90 percent limitation on NOLs imposes an artificial restriction on a company's use of business losses and discriminates against companies with volatile income which could potentially pay more tax than companies with an equal amount of steady income over the same period.

For sole proprietors, the calculation of the NOL is overly complicated. Congress should simplify the calculation while retaining the carryback option for small businesses. Most startup businesses are formed as pass-through entities<sup>11</sup> and the initial startup losses incurred are "passed down" and reported on the owners' tax returns. Because individual taxpayers report both business and nonbusiness income and deductions on their returns, the required calculations to separate allowed business losses from disallowed personal activities is complex.<sup>12</sup> Individual business owners would benefit from more specific guidance on NOL computations.

## **7. Increase of Startup Expenditures**

In the interest of economic growth, we encourage Congress to consider increasing the expensing amount for startup expenditures. Section 195 allows immediate expensing of up to \$5,000 of startup expenditures in the tax year in which the active trade or business begins. This amount is reduced dollar for dollar once total startup expenditures exceed \$50,000, with the excess amortized ratably over 15 years. Thus, once startup expenditures exceed \$55,000, all of these expenditures are amortized over 15 years. The rationale for the \$5,000 expensing was to "help encourage the formation of new businesses that do not require significant startup or organizational costs."<sup>13</sup> These dollar amounts, added in 2004, are not adjusted for inflation. Only for tax years beginning in 2010, the \$5,000 was

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<sup>10</sup> House Republican's Tax Reform Task Force, *A Better Way: Our Vision for a Confident America - Tax*, June 24, 2016; <http://abetterway.speaker.gov/assets/pdf/ABetterWay-Tax-PolicyPaper.pdf>.

<sup>11</sup> Center for American Progress, "Ending the Pass-Through Tax Loophole for Big Business," August 2016; <https://cdn.americanprogress.org/wp-content/uploads/2016/08/05070331/PassthruTaxationAug.pdf>.

<sup>12</sup> IRS Publication 536; <https://www.irs.gov/pub/irs-pdf/p536.pdf>.

<sup>13</sup> P.L. 108-357 (10/22/04), American Jobs Creation Act, Sec. 902; Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted In the 108<sup>th</sup> Congress*, [JCS-5-05](#), May 31, 2005, p. 504.

increased to \$10,000 and the \$50,000 phase-out level was increased to \$60,000. This change was described as "promoting entrepreneurship."<sup>14</sup>

The AICPA recommends increasing the \$5,000 and \$50,000 amounts of section 195 and adjusting them annually for inflation. These changes will further simplify tax compliance for small businesses by reducing (or eliminating) the number of such businesses that must track and report amortization of startup expenses over a 15-year period. In addition, as was suggested for the 2004 and 2010 legislative changes, the larger dollar amounts will better encourage entrepreneurship. Higher dollar amounts also reflect the costs for legal, accounting, investigatory, and travel that are frequently incurred when starting a new business. Also, in light of the increased, inflation-adjusted dollar amounts under section 179<sup>15</sup> to help small businesses, it is appropriate to similarly increase the section 195 dollar amounts and adjust them annually for inflation.

## **8. Alternative Minimum Tax Repeal**

Congress should repeal AMT for both individuals and corporations. The current system's requirement for taxpayers to compute their income for purposes of both the regular income tax and the AMT is a significant area of complexity of the Tax Code requiring extra calculations and recordkeeping. AMT also violates the transparency principle in masking what a taxpayer is allowed to deduct or exclude, as well as the taxpayer's marginal tax rate. Owners of small businesses, including those businesses operating through pass-through entities and C corporations of a size beyond the AMT exception for small C corporations, are increasingly at risk of being subject to AMT.

The AMT was created to ensure that all taxpayers pay a minimum amount of tax on their economic income. However, small businesses suffer a heavy burden because they often do not know whether they are affected until they file their taxes. They must constantly maintain a reserve for possible AMT, which takes away from resources they could allocate to business needs such as hiring, expanding, and giving raises to workers.

The AMT is a separate and distinct tax regime from the "regular" income tax. IRC Sections 56 and 57 create AMT adjustments and preferences that require taxpayers to make a second, separate computation of their income, expenses, allowable deductions, and credits under the AMT system. This separate calculation is required for all components of income including business income for sole proprietors, partners in partnerships and shareholders in S corporations. Small businesses must maintain annual supplementary schedules used to compute these necessary adjustments and preferences for many years to calculate the

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<sup>14</sup> The one year change to the §195 dollar amounts was made by P.L. 111-240 (9/27/10), the Small Business Jobs Act of 2010, Sec. 2031(a); Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 111<sup>th</sup> Congress*, [JCS-2-11](#), March 2011, p. 474.

<sup>15</sup> P.L. 114-113 (12/18/15), Sec. 124(a).

treatment of future AMT items and, occasionally, receive a credit for them in future years. Calculations governing AMT credit carryovers are complex and contain traps for unwary taxpayers.

Sole proprietors who are also owners in pass-through entities must combine the AMT information from all their activities in order to calculate AMT. The computations are extremely difficult for business taxpayers preparing their own returns and the complexity also affects the IRS's ability to meaningfully track compliance.

### **9. Border Adjustment Provisions**

It is important to consider how border adjustment provisions (a/k/a destination-based cash flow tax) would impact small businesses. Recent tax reform discussions have included suggestions to exclude export sales from revenue and disallow a deduction for imported goods and services. These provisions could impact businesses of all sizes, including small businesses.

Many service providers, such as accounting firms, are locally-operated small businesses. However, the demands on our profession have evolved over the last 20 years as more of our clients are engaging in global markets to remain competitive. As a result, small accounting firms frequently participate in global alliance networks to service their clients since they do not have in-house expertise on international tax issues and treaties or knowledge of the tax rules of foreign countries. The forced reliance on such services, which may be considered "imported" and therefore nondeductible, may impact their ability to continue to service their clients in the U.S.

### **10. Mobile Workforce**

The AICPA [supports](#) legislation similar to H.R. 2315, the Mobile Workforce State Income Tax Simplification Act of 2015, from the 114<sup>th</sup> Congress, which provides a uniform national standard for non-resident state income tax withholding and a *de minimis* exemption from the multi-state assessment of state non-resident income tax.<sup>16</sup> We expect the same cosponsors to soon introduce a similar bill.

The current situation of having to withhold and file many state nonresident tax returns for just a few days of work in various states is too complicated for both small businesses and their employees. Businesses, including small businesses and family businesses that operate

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<sup>16</sup> AICPA [testified](#) at the U.S. House Committee on Small Business Subcommittee on Economic Growth, Tax, and Capital Access hearing: "Keep It Simple: Small Business Tax Simplification and Reform, Main Street Speaks," on April 13, 2016, available at <https://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/aicpa-comments-mobile-workforce-subcom-small-bus-hearing.pdf>.

interstate, are subject to a multitude of burdensome and often bewildering non-resident state income tax withholding rules. These businesses currently face unnecessary administrative burdens to understand the variations from state to state. The issue of employer tracking and complying with all the different state and local tax laws is quite complicated and costly. The documentation takes a lot of time, not to mention the loss in economic productivity for small businesses.

Legislation very similar to H.R. 2315, which passed in the 114<sup>th</sup> Congress, would provide long-overdue relief from the current web of inconsistent state income tax and withholding rules on nonresident employees. Therefore, we urge Congress to pass this type of legislation that provides national uniform rules and a reasonable 30 day *de minimis* threshold before income tax withholding is required.

### **11. Retirement Plans**

Small businesses are especially burdened by the overwhelming number of rules inherent in adopting and operating a qualified retirement plan. Currently, there are four employee contributory deferral plans: 401(k), 403(b), 457(b), and SIMPLE plans. Having four variations of the same plan type causes confusion for many plan participants and small businesses. Congress should eliminate the unnecessary complexity by reducing the number of choices for the same type of plan while keeping the desired goal intact: affording employers the opportunity to offer a contributory deferral plan to their employees and allowing those employees to use a uniform plan to save for retirement.

Startup business owners are inundated with a myriad of new business decisions and concerns. These individuals may have expertise in their business product or service, but rarely are they experts in areas such as retirement plan rules and regulations. We encourage Congress to consider creating a uniform employee contributory deferral plan to ease this burden for small businesses.

### **12. Civil Tax Penalties**

Congress should carefully draft penalty provisions and the Executive Branch should fairly administer the penalties to ensure they deter bad conduct without deterring good conduct or punishing innocent small businesses owners (i.e., unintentional errors, such as those who committed the inappropriate act without intent to commit such act). Targeted, proportionate penalties that clearly articulate standards of behavior and are administered in an even-handed and reasonable manner encourage voluntary compliance with the tax laws.

On the other hand, overbroad, vaguely-defined, and disproportionate penalties create an atmosphere of arbitrariness and unfairness that can discourage voluntary compliance.

The AICPA has concerns<sup>17</sup> about the current state of civil tax penalties and offers the following suggestions for improvement:

**a. Trend Toward Strict Liability**

The IRS discretion to waive and abate penalties where the taxpayer demonstrates reasonable cause and good faith is needed most when the tax laws are complex and the potential sanction is harsh. Legislation should avoid mandating strict liability penalties. Over the past several decades, the number of increasingly severe civil tax penalties have grown, with the Tax Code currently containing eight strict liability penalty provisions (for example, the accuracy penalty on non-disclosed reportable transactions).<sup>18</sup>

**b. An Erosion of Basic Procedural Due Process**

Taxpayers should know their rights to contest penalties and have a timely and meaningful opportunity to voice their feedback before assessment of the penalty. In general, this process would include the right to an independent review by the IRS Appeals office or the IRS's FastTrack appeals process, as well as access to the courts. Pre-assessment rights are particularly important where the underlying tax provision or penalty standards are complex, the amount of the penalty is high, or fact-specific defenses such as reasonable cause are available.

**c. Repeal Technical Termination Rule**

We recommend<sup>19</sup> the repeal of section 708(b)(1)(B) regarding the technical termination of a partnership.<sup>20</sup> A technical termination most often occurs when, during a 12-month period there is a sale or exchange of 50 percent or more of the

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<sup>17</sup> See the "AICPA Tax Penalties Legislative Proposals," submitted to Congress in April 2013; <http://www.aicpa.org/Advocacy/Tax/TaxLegislationPolicy/DownloadableDocuments/AICPA-legislative-proposals-penalties-2013.pdf>; and the "AICPA Report on Civil Tax Penalties," submitted April 2013; <http://www.aicpa.org/Advocacy/Tax/TaxLegislationPolicy/DownloadableDocuments/AICPA-report-civil-tax-penalty-reform-2013.pdf>.

<sup>18</sup> Section 6662A, 6664(d).

<sup>19</sup> AICPA submitted comments to the House Committee on Ways and Means on the Tax Reform Act of 2014, dated January 12, 2015; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Comments-on-2014-Camp-Draft-General-Comments-Final.pdf>.

<sup>20</sup> AICPA submitted letters and written statements on Option 1 and Option 2 of Chairman Camp's Small Business Tax Reform Draft: See Option 1 comments at "AICPA testimony on Small Business and Pass-through Entity Tax Reform," dated May 17, 2013; [http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/2013.05.13\\_Testimony\\_on\\_Small\\_Business\\_and\\_Pass-Through\\_Entity\\_Tax\\_Reform\\_Discussion\\_Draft.pdf](http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/2013.05.13_Testimony_on_Small_Business_and_Pass-Through_Entity_Tax_Reform_Discussion_Draft.pdf), and Option 2 comments, dated July 30, 2013; <http://www.aicpa.org/Advocacy/Tax/Partnerships/DownloadableDocuments/AICPA-Option-2%20comments-7-30-13.pdf>.

total interest in partnership capital and profits. Because this 12-month time frame can span a year-end, the partnership may not realize that a 30 percent change (a minority interest) in one year followed by a 25 percent change in another year, but within 12 months of the first, has caused the partnership to terminate.

In practice, this earlier required filing of the old partnership's tax return often goes unnoticed because the business is unaware of the accelerated deadline due to of the equity transfer. Penalties are often assessed upon the business as a result of the missed deadline. This technical termination area is often misunderstood and misapplied. The acceleration of the filing of the tax return, to reset depreciation lives and to select new accounting methods, serves little purpose in terms of abuse prevention and serves more as a trap for the unwary.

**d. Late Filing Penalties of Sections 6698 and 6699**

Sections 6698 and 6699 impose a penalty of \$200 per owner related to late-filed partnership or S corporation returns. The penalty is imposed monthly not to exceed 12 months, unless it is shown that the late filing is due to reasonable cause.

The AICPA proposes that a partnership, comprised of 50 or fewer partners, each of whom are natural persons (who are not nonresident aliens), an estate of a deceased partner, a trust established under a will or a trust that becomes irrevocable when the grantor dies, and domestic C corporations, be considered to have met the reasonable cause test and not be subject to the penalty imposed by section 6698 or 6699 if:

- The delinquency is not considered willful under section 7423;
- All partnership income, deductions and credits are allocated to each partner in accordance with such partner's capital and profits interest in the partnership, on a pro-rata basis; and
- Each partner fully reported its share of income, deductions and credits of the partnership on its timely filed federal income tax return.

**e. Failure to Disclose Reportable Transactions**

Taxpayers who fail to disclose a reportable transaction are subject to a penalty under section 6707A of the Tax Code. The section 6707A penalty applies even if there is no tax due with respect to the reportable transaction that has not been disclosed. There is no reasonable cause exception to this penalty.

Under section 6662A, taxpayers who have understatements attributable to certain reportable transactions are subject to a penalty of 20 percent (if the transaction was disclosed) and 30 percent (if the transaction was not disclosed). A more stringent reasonable cause exception for a penalty under section 6662A is provided in section 6664, but only where the transaction is adequately disclosed, there is substantial



authority for the treatment, and the taxpayer had a reasonable belief that the treatment was more likely than not proper. In the case of a listed transaction, reasonable cause is not available, similar to the penalty under section 6707A.

For example, a company that engaged in a "listed" transaction which gave rise to a deduction of \$25,000 over the course of two years and inadvertently failed to report the transaction may be subject to a \$200,000 penalty per year, for a total penalty of \$400,000. The penalty can apply even if the deduction is allowable.

We propose an amendment of section 6707A to allow an exception to the penalty if there was reasonable cause for the failure and the taxpayer acted in good faith for all types of reportable transactions, and to allow for judicial review in cases where reasonable cause was denied. Moreover, we propose an amendment of section 6664 to provide a general reasonable cause exception for all types of reportable transactions, irrespective of whether the transaction was adequately disclosed or the level of assurance.

**f. 9100 Relief**

Section 9100 relief, which is currently available with regard to some elections, is extremely valuable for taxpayers who inadvertently miss the opportunity to make certain tax elections. Congress should make section 9100 relief available for all tax elections, whether prescribed by regulation or statute. The AICPA has compiled a list<sup>21</sup> of elections (not all-inclusive) for which section 9100 relief currently is not granted by the IRS as the deadline for claiming such elections is set by statute. Examples of these provisions include section 174(b)(2), the election to amortize certain research and experimental expenditures, and section 280C(c), the election to claim a reduced credit for research activities.

**g. Form 5471 Penalty Relief**

On January 1, 2009, the IRS began imposing an automatic penalty of \$10,000 for each Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, filed with a delinquent Form 1120 series return. When imposing the penalty on corporations in particular, the IRS does not distinguish between: a) large public multinational companies, b) small companies, and c) companies that may only have insignificant overseas operations, or loss companies. This one-size-fits-all approach inadvertently places undue hardship on smaller corporations that do not have the same financial resources as larger corporations.

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<sup>21</sup> AICPA letter on "Tax Reform Administrative Relief for Various Statutory Elections," submitted January 23, 2015; <http://www.aicpa.org/advocacy/tax/downloadabledocuments/aicpa-letter-to-congress-on-9100-relief-1-23-15submitted.pdf>.



The AICPA has submitted recommendations<sup>22</sup> regarding the IRS administration of the penalty provision applicable to Form 5471. Our recommendations focus on the need for relief from automatic penalties assessed upon the late filing of Form 5471 in order to promote the fair and efficient administration of the international penalty provisions of the Tax Code.

### **13. Tax Administration**

Our profession is committed to improving the taxpayer and tax preparer experience when interacting with the IRS. The AICPA Council passed a resolution regarding tax administration<sup>23</sup> and fully supports rebuilding the agency into a modern and efficient 21st century administrator of the nation's tax system.

In order for small businesses and their tax practitioners to receive the assistance they need on tax issues, it is essential for the IRS to focus on:

- a. Utilizing modern and secure technology;
- b. Developing and continuing to hire and train knowledgeable employees; and
- c. Tailoring their processes and systems around the needs and wants of their "customers."

By focusing on the factors listed above, the IRS will become a "Service First" agency that meets the needs of small business owners.

## **CONCLUDING REMARKS**

Small businesses and their tax practitioners are interested in, and need, tax simplification. Compliance burdens for entrepreneurs and small businesses are currently too heavy, both in terms of time required and out-of-pocket expense. While there are certainly costs associated with simplifying tax legislation, it is important to recognize that reforming our tax system will eliminate significant compliance burdens.

The proliferation of new income tax provisions since the 1986 tax reform effort has led to compliance hurdles for taxpayers, administrative complexity, and enforcement challenges for the IRS. We encourage you to examine all aspects of the Tax Code to identify barriers

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<sup>22</sup> AICPA submitted comments to the IRS, dated March 26, 2013; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Comments-on-Form-5471-Penalties-3.26.13.pdf>.

<sup>23</sup> AICPA Council Resolution Regarding Tax Administration, May 17, 2015; <https://www.aicpa.org/Advocacy/Tax/downloadabledocuments/council-resolution-on-tax-administration.pdf>.

for small businesses and their owners. The AICPA has consistently supported tax reform simplification efforts because we are convinced such actions will significantly reduce small businesses' compliance costs and fuel economic growth.<sup>24</sup> We look forward to working with the Committee in the 115<sup>th</sup> Congress as you continue to address the needs of small businesses.

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<sup>24</sup> The AICPA maintains a tax reform resource center website at:  
<http://www.aicpa.org/InterestAreas/Tax/Resources/Specializedguidance/Taxreform/Pages/tax-reform-resource-center.aspx>.