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

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

A. Overview

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

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

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

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

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

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

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

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

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

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

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

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

B. Historical Perspective

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

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

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

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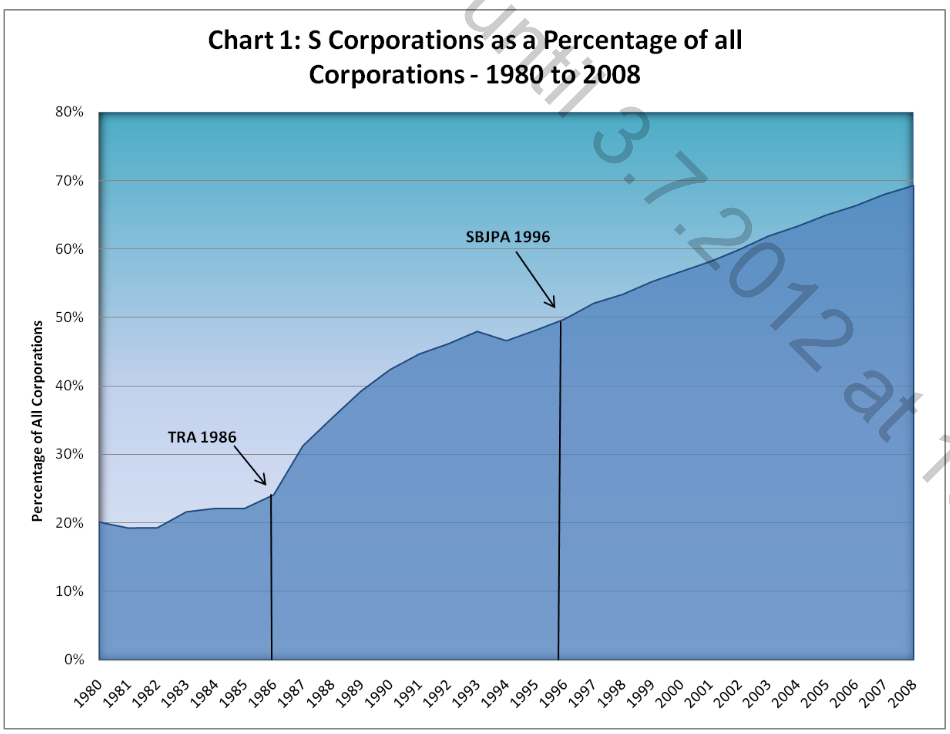
[3] I.R.C. § 1 (1979).
[4] I.R.C. § 11 (1979).
[5] 46% + 70% x (1-46%) = 83.8%.
[6] I.R.C. § 1014.
[7] I.R.C. § 337 (1986).

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

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

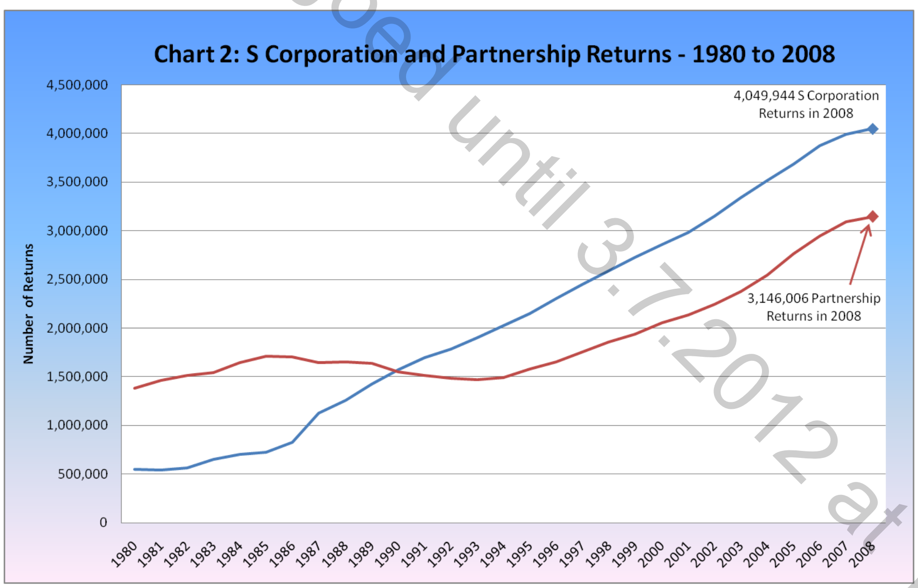
C. Tax Reform Act of 1986

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



These TRA ’86 changes brought about a dramatic shift in the tax structure for closely-held business owners throughout America. As shown in Chart 1, the number of corporations electing to have corporate income passed through to the shareholders and taxed at the individual level ("S corporations") grew from a little over 20 percent in 1986 to almost 70 percent in 2008 (the last year for which such statistics are currently available). In addition, with the enactment of limited liability company statutes throughout the states during the 1990's and promulgation of the "check-the-box" Treasury Regulations in 1997, business owners were provided with the additional flexibility to have a corporate-like business entity under state law treated as a "partnership" under the Code, which also involved "pass-through" taxation at the individual, rather than at the entity, level.

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



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

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

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

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

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

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

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

D. Today's Tax Structure

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

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

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

Chart 3: Top Marginal Tax Rates (2012)

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

		C Corporation		S Corporation		Partnership / Sole Proprietorship
Additional Income		$ 100,000		$ 100,000		$ 100,000
Less: Entity Income Tax	(35%)	(35,000)		(-0-)		(-0-)
Net Entity Income		$ 65,000		$ 100,000		$ 100,000
Less: Individual Income Tax	(15%)	(9,750)	(35%)	(35,000)	(34.50%)[a]	(34,500)
Less: Self-Employment Tax		(-0-)		(-0-)	(2.858%)[b]	(2,858)
After-Tax Income		$ 55,250		$ 65,000		$ 62,642
Overall Tax Rate:		44.75%		35%		37.36%

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

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

[10] This can be achieved, of course, by an actual asset sale, whereby the buyer purchases all of the assets of the business directly from the business entity. Comparable treatment can usually be achieved even if the acquisition is structured as the purchase of stock or other interests in the entity itself (rather than of its assets). For C corporations, this can usually be accomplished by making an election under Section 338 of the Code. For S corporations, this can usually be accomplished by making an election under Section 338(h)(10) of the Code. For partnerships, this can usually be accomplished by making an election under Section 754 of the Code or by virtue of the deemed liquidation of the partnership upon acquisition.
[11] Code Section 1202 does provide for a 50 percent exclusion (60 percent for certain empowerment zone entities) of gain at the shareholder level in a limited number of circumstances. However, this exclusion does nothing to mitigate

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

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

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

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

[12] I.R.C. § 1361(b)(1)(A).

[13] *See* I.R.C. § 7704.

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

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

[16] *See* I.R.C. § 1374.

[17] *See* I.R.C. § 1375.

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

[19] *See* I.R.C. § 1372.

E. Future Planning

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

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

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

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

[22] These thresholds are not inflation-adjusted.

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

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

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

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

Chart 4: Top Marginal Tax Rates (2013)

Assumptions: Entity and owners in top tax bracket
Active owners paid reasonable compensation
Exemptions fully phased out; itemized deductions still reduced
Not personal service corporation
Partnership income not exempt from self-employment tax
Not portfolio, non-TOB income
No state income tax

	C Corporation	S Corporation		Partnership / Sole Proprietorship	
	Dividends	Passive / Trading	Active Non-Trading	Passive / Trading	Active Non-Trading
Additional Income	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000
Entity Income Tax	(35,000) [a]	(-0-)	(-0-)	(-0-)	(-0-)
Net Entity Income	$ 65,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000
Individual Income Tax	(26,512) [b]	(40,788) [b]	(40,788) [b]	(40,788) [b]	(40,205) [d]
Individual Net Inv Inc. / SE Tax	(2,470) [c]	(3,800) [c]	(-0-)	(3,800) [c]	(3,745) [e]
After-Tax Income	$ 36,018	$ 55,412	$ 59,212	$ 55,412	$ 56,050
Overall Tax Rate:	63.98%	44.59%	40.79%	44.59%	43.95%

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

This new tax also adds a level of cost and complexity for S corporations and other pass-through entities. For example, if an S corporation has a mix of active and passive shareholders, right now the top tax rates applying to both groups are the same – 35 percent. Starting next year, however, the tax rate on active shareholders would be 40.8 percent, while passive shareholders would face a top rate of almost 45 percent (after taking into account the 3.8 percent tax on net investment income). Not only does this higher rate reflect a higher tax burden on the business, it also has the effect of draining resources from the business. S corporations typically try to distribute enough earnings for their shareholders to pay the tax on the income passed through from the business. With the single class of stock restriction, these distributions must be proportional, which means that, starting in 2013, many S corporations will need to distribute 45 percent of their earnings just to pay the business' taxes, compared to 35 percent today.

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

F. Tax Proposals

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

1. <u>Expensing</u>

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

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

Over the years, I have come to more fully appreciate the wisdom of his statement. Most closely-held business owners correctly think of money spent on equipment and other capital expenditures as still at-risk in the business, and as not "earned" until it comes back to the business in the form of collections upon sales. From a tax policy perspective, allowing businesses to deduct their equipment and other capital expenditures makes more intuitive sense when you consider the fact that the seller of the equipment or other item will be required to take the entire sales proceeds into income. This is consistent with the perspective of many closely-held business owners, i.e., that it is the seller that experiences the income in this transaction.

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

2. <u>Cash Basis</u>

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

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

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

3. <u>Base Broadening</u>

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

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

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

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

4. <u>Forced C Corporation Treatment</u>

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

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

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

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

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

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

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

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

5. Buffett Rule

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

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

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

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

6. Forced Single Pass-Through Treatment

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

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

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

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

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

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