



**WRITTEN STATEMENT OF ANNETTE NELLEN**

**ON BEHALF OF THE**

**THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**

**BEFORE**

**THE UNITED STATES SENATE**  
**COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP**

**HEARING ON**

**TAX REFORM: REMOVING BARRIERS TO SMALL BUSINESS GROWTH**

**JUNE 14, 2017**

## **INTRODUCTION**

Chairman Risch, Ranking Member Shaheen, and Members of the Senate Committee on Small Business & Entrepreneurship, thank you for the opportunity to testify today at the hearing on "Tax Reform: Removing Barriers to Small Business Growth." My name is Annette Nellen. I am a professor and director of San José State University's graduate tax program, teaching courses in tax policy and reform, tax research, accounting methods, property transactions, employment tax, leadership and ethics. I am the Chair of the Tax Executive Committee of the American Institute of CPAs (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 reduce the burden and complexity of tax compliance faced by small businesses to ensure that tax rules support rather than discourage growth of businesses, particularly small business. Small businesses are the backbone of the U.S. economy, accounting for 54% of all U.S. sales and providing 55% of all jobs.<sup>1</sup>

Unfortunately, federal tax laws hinder growth for both small businesses and the U.S. economy. The increased time and effort needed to comply with the ever changing tax laws forces small businesses to devote extra time and dollars to tax compliance instead of growing their businesses. Time spent learning and complying with current tax laws often does not save time in future years as rules and tax compliance may change. According to a National Taxpayers Union Foundation study, the U.S. economy loses \$233.8 billion annually from dedicating 6.1 billion hours complying with tax laws.<sup>2</sup>

Of course, we recognize that tax compliance is necessary. To help small businesses grow, we offer suggestions where Congress and the Internal Revenue Service (IRS) can help reduce the compliance burden, increase transparency and provide certainty.

## **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

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<sup>1</sup> U.S. Small Business Administration, Small Business Trends, "[Small Business, Big Impact!](#)".

<sup>2</sup> National Taxpayers Union Foundation, [Study: \\$233.8 Billion, 6.1 Billion Hours Lost to Rising Tax Complexity](#), April 8, 2015. Also see IRS National Taxpayer Advocate Annual Report to Congress, [IR-2013-3](#) (1/9/13).

other [\*Principles of Good Tax Policy\*](#)<sup>3</sup> as explained in a report we recently updated and issued.<sup>4</sup> Our tax system must be administrable, support 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
- Information Security
- Neutrality
- Transparency and Visibility
- Accountability to Taxpayers
- Certainty
- Effective Tax Administration
- 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 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, leading to nontransparent tax results and increased complexity. These rules also create marginal rates in excess of the statutory tax rate. In addition, multiple tax regimes, such as the alternative minimum tax (AMT), which applies in addition to the regular income tax makes it almost impossible for taxpayers, including small business owners, to easily know their effective and marginal tax rates. Multiple tax regimes also makes it difficult for owners to develop effective businesses plans. We urge Congress to use tax reform as an opportunity to remove phase-outs and multiple tax regimes, and develop the best definition of taxable income or adjusted gross income by creating simple, transparent, tax rules applied consistently across all rate brackets, eliminating additional complex and hidden taxes.

We also urge you to make tax provisions permanent. For all businesses, and small businesses in particular, uncertainty in the Internal Revenue Code (IRC or "Tax Code") creates unnecessary confusion and anxiety. 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. Statutory changes result in new regulations, revenue procedures, notices and new or modified tax forms which take time and resources to understand and address. America's entrepreneurs need a Tax Code that is simple, transparent, and certain.

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<sup>3</sup> AICPA concept statement, "[Tax Policy Concept Statement 1, Guiding Principles for Good Tax Policy: A Framework for Evaluating Tax Proposals](#)," dated January 2017.

<sup>4</sup> For an explanation of why and how the AICPA Principles of Good Tax Policy were updated, see "[Tax Principles for the Digital Age](#)," May 1, 2017.

## **AICPA PROPOSALS**

In the interest of good tax policy and effective tax administration for small businesses, we appreciate the opportunity to 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. Mobile Workforce
10. Retirement Plans
11. Civil Tax Penalties
12. Tax Administration
13. IRS Deadline Related to Disasters
14. Other Small Business Tax Issues

### **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>5</sup> In 2014, there were almost 25 million individual tax returns that included a non-farm sole proprietorship.<sup>6</sup>

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 legal obligations (such as holding annual meetings of a board of directors). They prefer business structures that are simple and provide legal and tax advantages, such as the flow-through of early stage losses. As a business grows, however, it may need to change its structure to raise additional equity funding (such as, having employees become shareholders).

If Congress decides to lower income tax rates for C corporations<sup>7</sup> (which are generally larger businesses), all business entity types including small businesses should also receive a rate reduction. Tax reform should not disadvantage sole proprietorships and pass-through entities

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<sup>5</sup> See Census Bureau, [County Business Patterns](#); Census Bureau, [Nonemployer Statistics](#).

<sup>6</sup> IRS, [Sole Proprietorship Returns, Tax Year 2014](#).

<sup>7</sup> House Republican's Tax Reform Task Force, "[A Better Way: Our Vision for a Confident America](#)," June 24, 2016.

at the expense of furthering larger C corporations, or require businesses to engage in complex entity changes to obtain favored tax status.

## **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 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).

We acknowledge that reasonable compensation has been the subject of controversy and litigation (hence, the numerous court decisions helping to define it). Therefore, the IRS should 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 reasonable and 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 and owner participation levels;
- 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 Committee Chairman Dave Camp's 2014 discussion draft,<sup>8</sup> a proposal was included to treat 70% 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 many situations. **If Congress moves forward with a 70/30 rule, or other percentage split, we recommend making the proposal a safe harbor option.** 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. **Appropriate reporting requirements, when the safe harbor option is not used, would also address the enforcement challenges currently faced by the IRS. For example, the modification of Form 1125-E would fully disclose factors considered in determining compensation that the IRS currently struggles to track.**

### **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

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<sup>8</sup> H.R. 1 (113rd Congress), [The Tax Reform Act of 2014](#), Sec. 1502; also see [Section-by-Section Summary](#), pages 32-33.

the accrual method upon reaching a gross receipts threshold unnecessarily creates a barrier to growth.<sup>9</sup>

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

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

The AICPA believes 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 incur interest on small business loans 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 (such as 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 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 larger manufacturers, retailers, and other asset-intensive businesses a greater tax benefit.

Currently, small businesses can expense up to \$510,000 of acquisitions per year under section 179 and deduct all associated interest expense. One tax reform proposal<sup>10</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 usually purchase large amounts of new assets, this proposal would generally not provide any new benefit for smaller businesses (relative to what is currently available via the section 179

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<sup>9</sup> A required switch to the accrual method affects many small businesses in certain industries including accounting firms, law firms, medical and dental offices, engineering firms, and farming and ranching businesses.

<sup>10</sup> House Republican's Tax Reform Task Force, "[A Better Way: Our Vision for a Confident America](#)," June 24, 2016.



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 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. According to the current rules, these losses are not deducted in the 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 taxpayer 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% 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>11</sup> for a 90% 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>12</sup> and the initial startup losses incurred are "passed down" and reported on the owners' tax returns. Because individual taxpayers report

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<sup>11</sup> *Id.*

<sup>12</sup> Center for American Progress, "[Ending the Pass-Through Tax Loophole for Big Business](#)," August 2016.



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>13</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>14</sup> These dollar amounts, added in 2004, are not adjusted for inflation. Only for tax years beginning in 2010, the \$5,000 was increased to \$10,000 and the \$50,000 phase-out level was increased to \$60,000. This change was described as "promoting entrepreneurship."<sup>15</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>16</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

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<sup>13</sup> IRS Publication [536](#).

<sup>14</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 108th Congress, [JCS-5-05](#), May 31, 2005, p. 504.

<sup>15</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 111th Congress, [JCS-2-11](#), March 2011, p. 474.

<sup>16</sup> P.L. 114-113 (12/18/15), Sec. 124(a).

businesses, including those businesses operating through pass-through entities and certain 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 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. Mobile Workforce**

The AICPA [supports](#) the Mobile Workforce State Income Tax Simplification Act of 2017, [S. 540](#), 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>17</sup>

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 interstate, are subject to a multitude of burdensome, unnecessary and often bewildering non-resident state income tax withholding rules. These businesses struggle to understand and keep up with 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, consumes a lot of time and is costly.

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<sup>17</sup> For additional details, see AICPA [written statement](#), "AICPA Statement for the Record of the April 13, 2016 Hearing on "Keep it Simple: Small Business Tax Simplification and Reform, Main Street Speaks," dated April 7, 2016.

S. 540 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 S. 540 that provides national uniform rules and a reasonable 30 day *de minimis* threshold before income tax withholding is required.

## **10. 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.

## **11. Civil Tax Penalties**

Congress should carefully draft penalty provisions and the Administration 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>18</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

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<sup>18</sup> See AICPA whitepaper, "[AICPA Tax Penalties Legislative Proposals](#)," dated April 2013; and the "[AICPA Report on Civil Tax Penalties](#)," submitted April 2013.

penalty provisions (for example, the accuracy penalty on non-disclosed reportable transactions).<sup>19</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 the repeal of section 708(b)(1)(B) regarding the technical termination of a partnership. A technical termination most often occurs when, during a 12-month period there is a sale or exchange of 50% or more of the 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% change (a minority interest) in one year followed by a 25% 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, is considered to have met the reasonable cause test and is not subject to the penalty imposed by section 6698 or 6699 if:

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<sup>19</sup> Section 6662A, 6664(d).

- 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% (if the transaction was disclosed) and 30% (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>20</sup> of elections (not all-inclusive) for which section 9100 relief currently is not granted by

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<sup>20</sup> AICPA comment letter, "[Tax Reform Administrative Relief for Various Statutory Elections](#)," dated January 23, 2015.

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, *U.S. Corporation Income Tax Return*, 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. The AICPA has submitted recommendations<sup>21</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.

## **12. Tax Administration**

As we approach the 20<sup>th</sup> anniversary of the [Report of the National Commission on Restructuring the IRS](#) ("Restructuring Commission"), we recommend that any effort to modernize the IRS and its technology infrastructure should build on the foundation established by the Restructuring Commission. The current degradation of the IRS taxpayer services is unacceptable. The percentage of calls from taxpayers the IRS answered between 2004 and 2016 has dropped from 87% to 53%, however, the need for taxpayer assistance increased (the number of calls the IRS received increased from 71 million to 104 million).<sup>22</sup>

As tax professionals, we represent one of the IRS's most significant stakeholder groups.<sup>23</sup> As such, we are both poised and committed to being part of the solution for improving IRS taxpayer services. We recently submitted a letter<sup>24</sup> to House Ways and Means Committee and Senate Finance Committee members in collaboration with other professional organizations. Our recommendations include modernizing IRS business practices and technology, re-establishing the annual joint hearing review, and enabling the IRS to utilize the full range of available authorities to hire and compensate qualified and experienced professionals from the

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<sup>21</sup> AICPA comment letter to the IRS, "[Recommendations – Automatic Penalties Assessments Policy with the Late Filing of Form 5471](#)," dated March 26, 2013.

<sup>22</sup> National Taxpayer Advocate, [Annual Report to Congress 2016, Executive Summary: Preface, Special Focus and Highlights](#), 2016, page 16.

<sup>23</sup> 60% of all e-filed returns in 2016 were prepared by a tax professional, according to the [Filing Season Statistic for Week Ending Dec. 2, 2016](#).

<sup>24</sup> AICPA comment letter, "[Ensuring a Modern-Functioning IRS for the 21st Century](#)," dated April 3, 2017.



private sector to meet its mission. The legislative and executive branches should work together to determine the appropriate level of service and compliance they want the IRS accountable for and then dedicate appropriate resources for the Service to meet those goals.

Additionally, we recommend the IRS create a new dedicated practitioner services unit to rationalize, enhance, and centrally manage the many current, disparate practitioner-impacting programs, processes, and tools. Enhancing the relationship between the IRS and practitioners would benefit both the IRS and the millions of taxpayers, including small businesses, served by the practitioner community. As part of this new unit, the IRS should provide practitioners with an online tax professional account with access to all of their clients' information. The IRS should offer robust practitioner priority hotlines with higher-skilled employees that have the experience and training to address complex issues. Furthermore, the IRS should assign customer service representatives (a single point of contact) to geographic areas in order to address challenging issues that practitioners could not resolve through a priority hotline.

### **13. IRS Deadlines Related to Disasters**

Similar to IRS's authority to postpone certain deadlines in the event of a presidentially-declared disaster, Congress should extend that limited authority to state-declared disasters and states of emergency. Currently, the IRS's authority to grant deadline extensions, outlined in section 7508A, is limited to taxpayers affected by federal-declared disasters. State governors will issue official disaster declarations promptly but often, presidential disaster declarations in those same regions are not declared for days, or sometimes weeks after the state declaration. This process delays the IRS's ability to provide federal tax relief to impacted businesses and disaster victims. Taxpayers have the ability to request waivers of penalties on a case-by-case basis; however, this process causes the taxpayer, tax preparer, and the IRS to expend valuable time, effort, and resources which are already in shortage during times of a disaster. Granting the IRS specific authority to quickly postpone certain deadlines in response to state-declared disasters allows the IRS to offer victims the certainty they need as soon as possible.

This past year, multiple states along Southeastern U.S. were affected by Hurricane Matthew, including Florida, Georgia, North and South Carolina, and Virginia. From October 6 through 10, Matthew traveled north along the southeast coast. A federal state of emergency was declared for Florida on October 6 and later extended to include Georgia and South Carolina. Tax preparers and taxpayers living in the affected regions not only lost access to power and the internet, but lost tax documents and financial information due to flooding and destruction of both their homes and businesses. On October 13, 2016, the IRS issued [IR-2016-132](#) offering federal tax relief to regions of North Carolina. The relief arrived two days before the major October 15 extended tax filing deadline – which caused tax practitioners unnecessary stress and burden for the days leading up to the issuance of the relief. Three days *after* the extended filing deadline, on October 18, the IRS issued relief for Florida and Georgia – which was, unfortunately, too late to make a substantial difference.



More recently, on March 13, 2017, Winter Storm Stella hit the Northeast and Mid-Atlantic U.S. covering many states in multiple feet of snow two days before the March 15 business return due date. Before 2:00 pm (ET) on the first day of the storm, governors in New York and other states began issuing emergency declarations while the AICPA and state CPA societies along the northeast received calls from members needing federal filing relief from the IRS. Two days later, at approximately 4:30 pm (ET) on the March 15 filing due date, the IRS finally issued [IR-2017-61](#) offering business taxpayers affected by Winter Storm Stella additional time to file. Receiving federal extensions are helpful, but the sooner the IRS can grant this relief, the greater the beneficial impact on victims.

The AICPA has long supported a set of permanent disaster relief tax provisions<sup>25</sup> and we acknowledge both Congress's and the IRS's willingness to help disaster victims. To provide more timely assistance, however, we recommend that Congress allow the IRS to postpone certain deadlines in response to state-declared disasters or state of emergencies.

#### **14. Other Small Business Tax Compliance Issues**

There are several other small business tax compliance burden proposals that we support, including:

##### **a. Listed Property**

We suggest removing "computer or peripheral equipment" from the definition of "listed property" in order to simplify and modernize the traditional tax treatment of computers and laptops.<sup>26</sup> Classifying computers and similar property as "listed property" under section 280F is clearly outdated in a business environment where employees are increasingly expected to work outside of traditional business hours. Various forms of technology, including laptops, tablets and cell phones, are all converging to serve similar purposes. The costs for the internet and service plans are now frequently sold in "bundles" and shared between multiple devices and it has become arguably impossible to segregate the cost of service between a cell phone, tablet, and laptop. The AICPA believes legislative change to update the treatment of mobile devices is the best simplification, similar to section 2043 of the Small Business Jobs Act of 2010, where cell phones were removed from the definition of listed property for taxable years beginning after December 31, 2009.

##### **b. Executive Compensation**

The AICPA supports that section 409A requirements should apply only to public companies.<sup>27</sup> Section 409A, which applies to compensation earned in one year but paid in a future year, was enacted to protect shareholders and other taxpayers from

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<sup>25</sup> AICPA comment letter, "[Request for Permanent Tax Provisions Related to Disaster Relief](#)," dated November 22, 2013.

<sup>26</sup> AICPA [written statement](#), "Targeted Tax Reform: Solutions to Relieve the Tax Compliance Burden(s) for America's Small Businesses," dated July 22, 2015.

<sup>27</sup> *Id.*

executives guarding their own financial interests without concern for the financial interests of the organization, its shareholders or other creditors.

The rules apply to a broad array of compensation arrangements, including many business arrangements that are not thought of as deferred compensation. Nonpublic companies often want arrangements with employees to allow for sharing equity or providing capital accumulation for long-term employees, and constraining the nonpublic business owner by rules designed to protect absentee shareholders should not occur.

Many nonpublic entities have noncompliant plans that are not correctable under the existing administrative correction programs. The cost of a noncompliant 409A plan is excessive given the unintended violations. In addition to accrual base income recognition, the additional 20% tax applies to the recipient, often a person unknowingly affected by the violations. Requiring private companies to pay for the specialized tax guidance needed to ensure that a compensatory arrangement is 409A compliant should not occur. The cost of imposing 409A requirements on nonpublic companies is far in excess of any benefit derived.

**c. Elimination of Top-Heavy Rules (for Retirement Plans)**

Small businesses are especially burdened by the overwhelming number of rules inherent in adopting and operating a qualified retirement plan. Therefore, we support repealing the sole remaining top-heavy rule, which limits the adoption of 401(k) and other qualified retirement plans by small employers and requires a minimum contribution or benefit.<sup>28</sup> The determination of top-heavy status is difficult and the required 3% minimum contribution is often made for safe harbor 401(k) plans. Without the top-heavy rules, more small businesses would adopt plans to benefit their employees.

**d. Provide Full Deductibility of Health Insurance**

We recommend allowing full deductibility of health insurance costs in calculating the self-employment tax for self-employed individuals.<sup>29</sup> This suggestion would provide that deductions allowed in determining income subject to Survivors, and Disability Insurance (OASDI) and health insurance (HI) taxes remain consistent amongst taxpayers regardless of whether they are employees or self-employed individuals. Currently, employees receive this deduction for their health insurance costs while self-employed individuals are not allowed a deduction in determining their net income subject to these taxes. The calculation of income subject to a particular tax should remain consistent amongst all taxpayers.

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<sup>28</sup> Since top-heavy rules were enacted in 1982, there have been a number of statutory changes which have significantly decreased their effectiveness. For additional details see AICPA comment letter, "[AICPA Suggestions to Tax Reform Working Group on Savings and Investments](#)," dated March 6, 2015.

<sup>29</sup> For additional details, see "[2017 AICPA Compendium of Tax Legislative Proposals – Simplification and Technical Proposals](#)," December 14, 2016.

**e. Increase the Passive Income Percentage to 60% and Eliminate the Three Year Termination for S Corporations**

The AICPA recommends increasing the threshold of an S corporation's income that is considered passive without incurring an entity-level tax to 60% (from 25%).<sup>30</sup> Additionally we recommend eliminating the current rule that terminates an S corporation's pass-through status if the S corporation has excess passive income for three consecutive years.

Currently, if an S corporation has excess passive income for three consecutive years, even though incurring a corporate-level tax is a possibility due to the taxable income limitation, the S election is subject to termination, creating uncertainty in S corporation operations. Under current law, if the S corporation unknowingly has \$1.00 of accumulated earnings and profits, the S election is terminated if the S corporation has excess passive investment income for three consecutive years. The IRS routinely grants waivers of the involuntary termination under section 1362(d)(3). S corporations without C corporation earnings and profits may receive an unlimited amount of passive investment income and are not subject to the S election termination.

**f. Guidance Needed on Emerging Issues**

Online crowdfunding and the sharing economy are quickly expanding mediums through which individuals obtain funds, seek new sources of income, and start and grow businesses. Individuals may understand the steps through which they can use these new crowdfunding and sharing economy opportunities to their advantage. However, many tax preparers and their clients do not have the guidance necessary to accurately comply with the complex, out-of-date, or incomplete tax rules in these emerging areas.

Lawmakers and tax administrators must regularly review existing laws, against new changes in the ways of living and doing business, to determine whether tax rules and administration procedures need modification and modernization. We urge Congress and the IRS to develop simplified tax rules and related guidance in the emerging sharing economy and crowdfunding areas.<sup>31</sup> Some of the areas in need of modernization include information reporting (such as to avoid reporting excluded income, such as a gift, as income), simplicity in reporting and tracking rental losses from year to year, and simplified approaches for recordkeeping for small businesses. Offering clarity on these issues will allow taxpayers to follow a fair and transparent set of guidelines while the IRS benefits from a more efficient voluntary tax system. In addition, it is not recommended to bypass these evolving opportunities of connecting businesses and customers, and generating funds for equity and sales, due to entrepreneurs concerned about uncertain tax effects.

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<sup>30</sup> *Id.*

<sup>31</sup> AICPA [written statement](#), "The 2017 Filing Season: IRS Operations and the Taxpayer Experience," dated April 6, 2017.

## **CONCLUDING REMARKS**

Tax compliance requirements have become an everyday burden for small businesses. The current complexity and uncertainty of the Tax Code forces small businesses to utilize critical resources and can hinder their ability to grow and create jobs. As Congress tackles the complex issues inherent in drafting tax legislation, we encourage you to consider tax reform that will provide simplicity, certainty and clarity for small business 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. The AICPA appreciates the opportunity to testify and we look forward to working with the Committee as you continue to address the needs of small businesses and their owners.