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

James S. Redpath, CPA

April 8, 2014

Chairman Camp, Ranking Member Levin, and other members of the Committee, thank you for the opportunity to testify today.

My name is Jim Redpath. I am a certified public accountant and the Managing and Tax Partner at HLB Tautges Redpath, Ltd., a 125 person full-service accounting firm serving clients in the greater Minneapolis/St. Paul metropolitan area since 1971. I have been a tax accountant for over 30 years, working primarily with closely held businesses, many of which are S corporations or C corporations considering S corporation status.

Let me begin by thanking the Committee, and particularly the Chairman, for his hard work to improve the tax code. At our firm, we help hundreds of closely held businesses make better decisions that create value, create jobs and contribute to the stakeholders' well-being. Those efforts are hindered by a tax code that is too complex, offers conflicting incentives, and creates temporary windows of opportunity that encourage tax motivated decisions rather than good business decisions.

The rules governing S corporations are an excellent example. The S corporation is a fantastic concept that promotes private businesses, capital investment and increased employment. However, there are restrictions on S Corporations. Since their inception in 1958, S corporations have been required to 1) be domestic enterprises, 2) have a limited number and type of shareholders and 3) have a single class of stock. A violation of any of the above mentioned restrictions, whether intentional or inadvertent, results in a termination of the S corporation status.

Similar to an S corporation, an LLC enjoys liability protection and is subject to a single layer of tax. However, unlike an S corporation, there are few, if any, limitations on the structure or ownership of LLC's. LLC's can have foreign or corporate shareholders and multiple classes of ownership.

As you might expect, this flexibility makes the LLC very popular with business start-ups. Last year, our firm was involved in creating many business entities for clients. Of those, virtually all were LLCs. The advent of the LLC has created, in many cases, a superior business structure. That said, there are numerous reforms Congress can enact to help level the tax treatment of these two business structures.

S Corporation Extenders

I have clients that would certainly benefit from several items that would be permanently extended in the Chairman's discussion draft, including the R&D tax credit and small business Section 179 limitations.

Today, however, my testimony will focus solely on those provisions particular to S corporations.

<u>The Built in Gains Tax 5-Year Recognition Period</u>

In 1986 Congress repealed the General Utilities Doctrine and the related Section 337, both of which allowed C corporations to sell their assets, liquidate and pay a single level of tax. The result was that, for the first time, the tax code would impose a double tax on the sale of corporate assets followed by liquidation.

The House version of the 1986 Tax reform Act included a two year rule "designed to prevent avoidance" of this new double tax. The Senate version had no anti-avoidance rule. One would expect a negotiation between the two bodies to result in a holding period somewhere between zero and two years. The final bill, however, went well beyond that scope by enacting the Section 1374 built-in gains (BIG) tax, with a *10-year* recognition period. The stated purpose was similar to the House-passed bill: to prevent a C corporation from converting to an S corporation, when a sale is imminent, to avoid the impact of the repeal of the General Utilities Doctrine and Section 337.

As a result, if an S corporation sells property it owned prior to conversion before the end of the 10-year recognition period, the BIG tax applies to the extent of the gain existing on the date of the conversion. Normal S corporation flow-through taxation also applies to the gain. The combined tax rate ranging from 50% to 60% is punitive enough to ensure that no company knowingly triggers the BIG tax.

The BIG tax was meant to treat the S corporations like C corporations and subject them to double taxation. However, the BIG tax is generally worse. The double taxation occurs whether or not the profits are distributed to the owners and the second level of tax may be at ordinary rates, not dividend rates.

I find the BIG tax provision causes many S corporations to hold onto unproductive or old assets that should be replaced. Ten years is a long time and certainly not cognizant of current business-planning cycles. Many times I have experienced changes in the business environment or the economy which prompted S corporations to need access to their own capital, that if taken would trigger this prohibitive tax. This results in business owners not making the appropriate decision for the business and its stakeholders, simply because of the BIG tax.

This distortion of business behavior is widespread. Most C corporations who want to be taxed as a flow-through entity convert to S corporations. Converting to an LLC is probably preferred (see above), but such a conversion is a taxable event which makes it prohibitively expensive. In my experience, no one is willing to go through that tax pain to gain LLC status. So converting to S corporation is the only real option. According to the IRS, tens of thousands of corporations convert to S Corporations each year. The BIG tax effectively "locks up" the capital of these companies for an entire decade following conversion, prohibiting access to capital to make new investments and create jobs.

In fact, I have several clients right now that have locked-up capital due to the BIG tax. For example, I work with a road contractor who is holding old equipment and rigs, sitting out in the bone-yard, which could be sold and reinvested to expand the business and hire more people. That investment potential is being stymied by the BIG tax. This is just one of many examples.

Also, many clients would like to sell their business to up and coming entrepreneurs and employee groups, but can't because of the prohibitive BIG tax

Congress recognizes that 10 years is simply too long. It has passed temporary legislation reducing this 10 year period three times in recent Congresses. This change both preserves the original intent of the law to prevent getting around the repeal of the General Utilities Doctrine and Section 337 and removes punitive restrictions allowing S corporations to deploy their assets earlier. The most recent 5 year recognition period expired at the end of 2013, so now these businesses are faced with a snap-back to the untenable 10 year recognition period.

Having a 5 year BIG holding period is just plain good tax policy, but routinely enacting tax law on a temporary basis is not. Making the shorter holding period *permanent* is critical.

A temporary extension of the 5-year recognition period only provides a window of opportunity for S corporations. Although much better than the 10 year recognition period, the temporary extension results in tax motivated transactions as the expiration date approaches that may not be in the best interest of the company or its stakeholders.

Making the 5-year recognition period permanent would preserve the original intent of the 1986 Tax Act and provide S corporations stability and certainty, so they can make business decisions that are best for the company, its owners and stakeholders.

Basis Reduction for Charitable Contributions by S Corporations

Another area of imbalance between S corporations and other pass-through business structures is the treatment of charitable contributions of appreciated assets. For most taxpayers, gifts of appreciated property produce a deduction equal to the property's fair market value. S corporations who donate appreciated property, however, will incur a future tax liability because of the way the current rules work.

This unintended consequence was remedied as part of the 2006 Pension Reform Act, and represented a significant improvement in the tax treatment of gifting by S corporations. As with the BIG provision, the charitable provision has been extended by Congress numerous times since its adoption in 2006. It expired again at the end of 2013.

Making this provision permanent would help level the playing field between S corporations and other types of businesses and ensure that S corporation owners are able to fully benefit from the value of their donations to charities.

S Corporation Modernization

Beyond these two extenders, there exists a significant opportunity for improving the S corporation rules to ensure that S corporations can compete with LLCs on a more level playing field. That is the motivation for the bipartisan S Corporation Modernization Act (H.R. 892), sponsored by Representatives Dave Reichert (R-WA) and Ron Kind (D-WI). I am pleased that the Chairman's tax reform discussion draft recognizes the importance of adapting the S corporation rules to today's business environment by including several of these reforms.

In addition to the permanent BIG holding period reduction and charitable deduction provisions, the draft includes the expansion of qualifying beneficiaries for electing small business trusts to include nonresident alien individuals. This provision would allow businesses to continue to be owned and operated by a family even as the family grows beyond the borders of the United States. In addition, this provision would increase S corporations' access to capital and their ability to expand abroad or partner with businesses operating outside the United States.

It also makes modifications to the passive income limitations for S corporations. The provision would conform the current 25% limitation on passive income to the 60% personal holding company limitation. The provision would also repeal the termination event for S corporations who exceed the passive income threshold for three consecutive years. Both of these provisions were recommended by the Joint Tax Committee staff in their 2001 Simplification report.[1] These rules have proven to be a trap for unwary S corporations, penalizing them with a punitive corporate-level 'sting tax' and a possible termination of their S corporation status.

Conclusion

As I mentioned, the items I highlighted above are just a few of the areas in which the S corporation rules could be improved. Extending the built-in gains 5-year holding period and making it permanent is critical, as are the other permanent S corporation changes in the Chairman's reform draft. Adopting these provisions would help S corporations to deploy

[1] Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (JCS-3-01), April 2001, page 385.

locked-up resources, create more jobs and allow them to focus on making sound business decisions for the long term.

Once again I'd like to thank Chairman and the Committee for considering them.