TESTIMONY BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES

COMMITTEE ON WAYS & MEANS UNITED STATES HOUSE OF REPRESENTATIVES

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Chairman Tiberi, Ranking Member Neal and other members of the Subcommittee on Select Revenue Measures, thank you very much for the opportunity to testify today regarding the Small Business and Pass-Through Entity Tax Reform Discussion Draft (the "Discussion Draft").

I have been representing closely held businesses ever since I began practicing tax and business law in 1979. I have been a member (and a past Chair) of the ABA Tax Section's Committee on S Corporations since 1986 and am currently Chairman of the Board of Advisors of the S Corporation Association. The views expressed today are informed by and benefit from all of those business and professional relationships. Although in my practice I have represented all forms of closely held business entities, I understand that there are other witnesses here today with specific expertise in the partnership and C corporation areas. Therefore, I will focus my comments primarily on the impact of the Discussion Draft on S corporations.

A. Overview

Let me begin by saying that I am sincerely appreciative of the ongoing bipartisan efforts of the Ways & Means Committee to enact genuine Tax Reform in this country. There is no question that preparing and seeking public comment on Discussion Drafts, such as the one we are addressing today, takes substantially more time, patience and effort than other more cloistered forms of decision-making. However, this more open and transparent process is much more likely to result in a long-lasting consensus on tax policy that will truly benefit our economy over the short and long term.

Chairmen Camp has identified three fundamental principles to help shape the course of Tax Reform, namely leveling the playing field for US employers (by lowering the top corporate tax rates and refraining from picking winners and losers within the American economy) and providing for parity for small businesses, while at the same time ensuring that low income and middle income Americans pay no more in taxes than they do under current law.

In this same spirit, I would like to reiterate the following three basic principles that have been adopted by the S Corporation Association and several dozen other national business organizations to guide the Tax Reform process:

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1. Tax Reform needs to be comprehensive and address the individual, passthrough, and corporate tax codes at the same time;
2. Congress should continue to foster progress toward a single level tax system for all businesses; and
3. Congress should continue to strive to keep the tax rates paid by businesses and individuals as low as possible.

In this regard, the bipartisan Tax Reform Act of 1986 stands out as an excellent template for Tax Reform. It expanded the tax base by eliminating numerous preferences and privileges for specific taxpayer groups, thereby creating room to dramatically decrease the tax rates for C corporations, passthrough businesses, and individuals alike. This approach allowed many, if not most, owners and managers to get out of the tax planning business and immerse themselves in the operations of their real businesses instead. It is my hope that the current Tax Reform effort will build on the policies and lessons learned in 1986.

As others have noted, the Discussion Draft before us today has three principal components – a more limited Option 1 to address limitations of the existing S corporation and partnership rules, a more aggressive Option 2 that would replace the existing S corporation and partnership rules with a new, uniform set of rules, and, finally, a set of Core Provisions that would apply to either option.

My testimony will begin with the Core Provisions and work from there.

B. Core Provisions

Generally speaking, the Core Provisions in the Discussion Draft (Subtitle B) are reforms that have been considered and vetted for years and should be included in any Tax Reform effort. Provisions to establish permanent higher thresholds for the section 179 expensing rules (Section 211), to expand the exemption from the uniform capitalization rules (Section 214), to make uniform the treatment of organizational and startup costs (Section 215), and to integrate the compliance dates of businesses, trusts, and their shareholders and beneficiaries (Part 2) are all laudable improvements.

One Core Provision change that might not fit that description is the provision to amend the cash basis accounting rules. Sections 212 and 213 of the Discussion Draft would make several changes to the rules regarding accrual versus cash basis accounting for tax purposes. In general, they would allow all businesses (except those maintaining inventories, such as manufacturers and retailers) with gross receipts of less than $10 million (an increase from $5 million) to utilize the cash basis method of accounting for tax purposes.

However, they would expand the application of the mandatory accrual provisions to S corporations and all partnerships (not just partnerships with C corporations as partners), as well as eliminate exceptions for farming businesses and qualified personal service corporations with gross receipts in excess of the preferred amount. The net effect of this change would be to limit the ability of S corporations and partnerships with receipts above the new threshold to use cash

basis accounting, something that they are currently able to do. In this regard, it is worth noting that closely held businesses do not have access to the public markets to "monetize" illiquid assets on their Balance Sheets.

In this context, it is not clear that requiring farms, S corporations, service businesses and non-C corporation partnerships to pay tax on income that they have not yet collected is necessarily consistent with the overall goals of Tax Reform.

C. Subtitle C [Option 1]

For S corporations, Option 1 in the Discussion Draft includes many provisions that are contained in the bipartisan S Corporation Modernization Act (H.R. 892) introduced by Congressmen Reichert and Kind, which are consistent with the goals of Tax Reform stated above.

Section 231 would make permanent the reduction in the built-in gains tax recognition period to five years that is currently in place through the end of calendar years 2013. The built-in gains tax was initially intended to prevent C corporations from electing S status simply to avoid double tax in connection with the sale of the business. However, as Congress has recognized in a series of amendments that were initially effective in 2009 and have been in continuous effect ever since, a ten-year period is much longer than necessary to accomplish this purpose. Very few business owners can afford to wait even 5 years after they have decided to sell their business.

Moreover, this unduly long period unnecessarily froze capital in place, because corporation owners were very reluctant to sell assets subject to the punitive built-in gains tax regime, which triggers double tax at both the corporate and shareholder levels. These tax consequences are significantly more costly than those that apply to C corporations where the proceeds are to be reinvested in the business, or to S corporations that have not previously been C corporations. In this regard, it is important to note that the gains on assets sold after the expiration of the 5-year recognition period do not escape tax. They merely get taxed once, rather than being subjected to the punitive two-tax regime.

Section 232 would increase the threshold for triggering the tax on passive investment income for S corporations from 25% to 60%. It would also eliminate the complete termination of S status for corporations exceeding that threshold for three consecutive years. The increase in the percentage to 60% would bring this threshold in line with the corresponding percentage in the C corporation personal holding company rules. This change makes sense because both the C corporation personal holding company tax and the S corporation passive investment income tax are designed to address the same issue, namely so-called “incorporated pocketbooks”. Elimination of the S corporation status termination provision is also good policy that is consistent with recommendations made by the Joint Committee on Taxation. These termination provisions constitute a significant trap for the unwary, because the passive investment income tax can usually be avoided with proper and sophisticated tax planning.

Section 233 would expand the eligible current beneficiaries for electing small business trusts to include nonresident alien individuals. In addition to allowing for foreign family members to benefit from estate planning trusts, this provision would also enable S corporations to procure capital from individuals outside of the country. It is also unlikely to result in a meaningful loss of revenue to the federal government, inasmuch as income passed through from an S corporation to an electing small business trust is automatically taxed at the highest individual income tax rate. In fact, expanding upon this provision to allow C corporations, partnerships and other currently ineligible shareholders to become owners of S corporations on these terms would seem to be good policy for the same reasons. As long as the income attributable to these new owners would automatically be taxed at the highest individual rate, enabling S corporations to tap these additional sources of capital would appear to entail no significant countervailing policy considerations.

Sections 234 and 235 contain two provisions designed to facilitate charitable contributions by S corporations by making the rules for them more consistent with those that apply to individuals. As such, they certainly seem consistent with the goals and policies of Tax Reform.

Section 236 would enable newly-electing S corporations to make that election on the tax return for the taxable year for which it is to be effective, rather than during the first 2 ½ months of the taxable year itself. Although most sophisticated taxpayers are well aware of the earlier date by which such elections need to be made under current law, the proposed provision would enable start-up and other small business entities to make that election as part of the process of preparing income tax returns for that initial year, which may be the only time that such owners have outside accounting help to assist in making those determinations. Again, this provision is consistent with the goals of facilitating proper tax planning and compliance by smaller closely held business entities.

As mentioned earlier, I am focusing my comments primarily on the impact of the Discussion Draft on S corporations, and so I will not go into comparable detail with respect to the proposed partnership provisions contained in Part 2 of Option 1. However, I note that several of the changes outlined in Part 2, including the mandatory adjusted basis changes and the expanded "hot asset" rules, could be potentially problematic if applied to S corporations as proposed in Option 2.

D. Subtitle C [Option 2]

As I mentioned, Option 2 would repeal Subchapters S and K (S corporations and partnerships) and replace them with a single, unified passthrough structure. In general, Option 2 of the Discussion Draft would significantly relax (though not eliminate) certain S corporation eligibility and tax provisions, while further restricting the partnership tax rules and requiring all S corporations to comply with those newly-revised rules.

From the S corporation perspective, there are certain features of Option 2 that are beneficial and should be considered under any Tax Reform effort. To start with, Option 2 embraces a new, superior line of demarcation between passthrough businesses and those subject

to the corporate tax – namely whether a business has chosen to access the capital markets and public ownership.

The current limitations on both the number and types of shareholders eligible for S corporation ownership are wholly arbitrary and have been eclipsed by the advent and increased utilization of limited liability companies and other forms of partnerships. These forms of business enjoy passthrough tax treatment, the same as S corporations, but without similar limits on the number of shareholders or partners or restrictions on the permissible types of such shareholders or partners.

There is a sound policy rationale for distinguishing among entities based on public versus privately held status. For example, in my experience privately held companies typically sell for somewhere in the range of 5 to 12 times earnings, whereas publicly held companies often trade at multiples of 10 to 20 times earnings. As a practical matter, making this change may not dramatically expand the number of corporations electing passthrough corporation status, given that the vast majority of S corporations currently have only a small number of shareholders and there are also provisions for treating members of the same family as only one shareholder for this purpose. However, this is a more logical cutoff point for S corporation status, and would bring it in line with the corresponding cutoff for partnerships. *See* Code § 7704.

As the Draft notes, there are also several outstanding issues not addressed in the Discussion Draft, including the appropriate treatment of payroll taxes in the new passthrough structure and the future of special business structures such as REITS, MLPs and ESOPs. As an advisor to the S Corporation Association, I would be remiss if I didn't mention the tremendous success of the S corporation ESOP structure and its contribution to the economic participation and retirement security of ESOP company employees.

Regarding the correct treatment of payroll taxes, I do not have a silver bullet solution that would address everyone's concerns, but I do have a couple of rules that I believe should apply to any proposed solution. First, any change in the current rules should be easier, not more difficult, to comply with and enforce than the existing rules. My analysis is that the proposals considered by Congress in recent years would fail that test, making compliance and enforcement more, rather than less, difficult. And second, any solution should strive to continue the bright line between a compensation-based, contributory system and a welfare system funded by general revenues. Applying payroll taxes to what is legitimate business income would simply layer yet another tax on business income and move the tax code in the wrong direction.

With regard to the specifics of Option 2, here is a more detailed analysis:

1. <u>Enhanced S Corporation Provisions</u>.

New section 703 of the Code would create a new type of tax entity, namely the "passthrough corporation". The eligibility restrictions for this new type of tax entity would not be as restrictive as the current S corporation rules. For example, as noted earlier, in lieu of the current somewhat arbitrary 100-shareholder restriction, this new provision would merely prohibit publicly held corporations from electing S status.

New section 703 also would eliminate the rule limiting eligible shareholders to citizen or resident individuals, estates and certain trusts and exempt organizations. As noted earlier, this could open up new avenues for raising capital to current and future S corporations.

The last change reflected in new section 703 is the elimination of the current single-class-of-stock rule. This could also open up new sources of capital for S corporations. However, as explained in more detail later, new section 712 of the Code would adopt a provision designed to limit the flexibility of special allocations in all passthrough entities, including former S corporations.

New section 721 of the Code would allow the tax-free contribution of property to a passthrough corporation irrespective of the 80% control requirement that currently applies to S corporations. However, again as explained in more detail later, new section 731 of the Code would require the recognition of gain at both the entity and owner levels upon distributions of property by all passthrough entities.

Finally, new sections 773 and 774 of the Code would enact the five-year built-in gains and 60% passive investment income tax reforms described earlier with respect to Option 1.

2. Application of C Corporation Rules to Partnerships.

As noted earlier, new section 731 of the Code would require gain to be recognized by the entity upon all distributions of appreciated property, as well as requiring gain to be recognized by an individual owner whenever the fair market value of cash or other property distributed to that owner by the entity exceeds his or her basis. Although corporations (including S corporations) are currently subject to comparable tax treatment on distributions, eliminating the possibility of tax-free distributions of property for passthrough entities would mean that what is generally considered to be the most significant advantage of partnership tax treatment would no longer be available.

New section 771 of the Code would appear to preclude tax-free reorganization treatment for S corporations, something for which they are currently eligible. However, it is unclear whether this particular result was intended, inasmuch as there is no reference to it in the Technical Explanation for the Disclosure Draft.

3. More Restrictive Partnership Rules.

New section 712 of the Code would constrain special allocations for partnerships (including passthrough corporations) by requiring all such allocations to be in the form of a flat percentage of three separate categories of tax incidents, namely ordinary income, capital gains and tax credits. These provisions are likely to be less restrictive than the current S corporation single-class-of-stock rules. However, just how much less restrictive will not be clear unless and until regulations and other administrative guidance are promulgated pursuant to this provision.

Also under Option 2, new section 734 of the Code would create a complicated new regime designed to equalize gain among all owners in connection with all distributions of property by the entity. Similarly, since the partnership rules would now be applicable to S corporations, the rules relating to tracking pre-contribution gain and loss on contributed property under current section 704(c) of the Code would need to be contended with. These changes would all require detailed and ongoing calculations that are currently not necessary for S corporations.

New section 740 of the Code would preclude the recognition of loss on the sale of a partial interest in a passthrough entity, another difference from current S corporation treatment. Also, just as under Option 1, new section 742 of the Code would require mandatory basis adjustments to equalize internal and external basis on all sales of partnership interests.

Finally, new section 751 of the Code would still require the bifurcation of all sale and distribution transactions to account for disproportionate distributions and/or sales of so-called "hot assets," a category which would be expanded to include all inventory property, as well as cash basis accounts receivable and depreciation and other recapture.

In sum, under Option 2, S corporations would now be subject to a whole new regime of taxation – a more rigorous version of the current partnership rules. This would unavoidably impose transition costs, as well as an ongoing and substantial additional compliance burden.

4. Withholding.

Under Option 2, new section 3411 of the Code would impose a new withholding requirement on all income passed through by partnerships or passthrough corporations. The statutory language appears to contemplate varying percentages, based on type of income. However, it is unclear whether a passthrough entity would be entitled to take into account an individual shareholder's or partner's tax situation. For example, would an owner that is in a lower tax bracket be entitled to have less withheld from his or her passthrough income? Alternatively, would an owner who is experiencing substantial losses through a different passthrough entity be entitled to avoid having tax withheld at the source in light of the fact that no income tax will ultimately be due?

While many S corporations and partnerships do currently deal with similar withholding mechanisms for out-of-state business operations, the withholding rates are typically quite small and home state withholding and tax are typically adjusted to account for these out-of-state taxes. It is possible that such a regime might be appropriate or necessary at the federal level for compliance purposes. However, it is important to recognize that it would entail significant initial compliance costs and could create an ongoing business burden if not designed to avoid disrupting the operations of taxpayers currently complying with the tax deposit rules.

E. Summary

In summary, the S corporation enhancements contained in Option 1 would indeed encourage and foster additional economic activity in the American economy and I strongly support them.

The provisions contained in Option 2 are more aggressive and deserve closer scrutiny. Certain aspects of Option 2, particularly the new bright line between corporate and passthrough treatment, are extremely valuable and should be made part of any Tax Reform effort.

The advantages of other aspects, including the need for S corporations to comply with a new and much more complicated tax regime, however, may not justify the substantial costs involved in requiring them to convert and comply with that new system. One goal of the Discussion Draft appears to be to restrict partnership flexibility so as to reduce the potential for abusive tax structures. The partnership tax structure has always been much more flexible than the S corporation structure, and hence more subject to potential abuse. In fact, much of the complexity of the partnership regime is attributable to Congress's efforts to eliminate this abuse potential.

But for the 4.5 million existing S corporations accustomed to dealing with the restrictions applicable to S corporations, forcing them to comply with these old and new compliance-focused partnership provisions would likely impose a substantial cost with little offsetting economic benefit. New start-up owners are likely to be similarly discouraged. I am supportive of Congress's efforts to rein in tax shelters and other perceived tax abuses, but disrupting the tax mechanics for tax-compliant S corporations is unlikely to further that goal.

Once again, I would like to thank the Chairman and Ranking Member for holding this hearing and inviting me to testify. As someone on the front lines of business taxation, I sincerely hope that the Tax Reform effort is productive and successful, and results in improved rules for all businesses and individuals alike. It is a tremendous undertaking, but done right, well worth it.

<u>**CURRICULUM VITAE**</u>

Thomas J. Nichols is a shareholder in the Milwaukee law firm of Meissner Tierney Fisher & Nichols S.C., where he has been practicing corporate and tax law since 1979. The firm itself is over 160 years old, and is the second oldest firm in the state of Wisconsin. Mr. Nichols represents a wide array of clients ranging from start-ups, physician groups, software, publishing, sales, restaurant, real estate and other closely-held concerns to insurance company, manufacturing and mutual fund advisory clients.

Mr. Nichols is Chairman of the Board of Advisors of the S Corporation Association and a recent Chair of the S Corporations Committee of the ABA Section of Taxation, on which he has been active since 1987. In this capacity, Mr. Nichols has participated, as primary draftsperson or otherwise, in the preparation of the Committee's comments on the large majority of regulations that have been promulgated by the Treasury to implement the current S corporation provisions enacted in the Subchapter S Revision Act of 1982 and subsequent legislation, including those concerning pass-through income and loss, adjusted basis, corporate accounts, the single class of stock requirement, open account indebtedness, qualified subchapter S subsidiaries, the built-in gains tax, passive income, self-employment tax, back-to-back loans, the new net investment income tax and other S corporation rules. Mr. Nichols has also worked with the House and Senate legislators and staff personnel on pending Tax Reform efforts, and has been a member of various ABA Tax Section Task Forces dealing with tax reform, including assisting in the preparation of its August 3, 2006 Comments on Additional Options to Improve Tax Compliance Prepared by the Staff of the Joint Committee on Taxation (for which he was listed as the contact person for S corporations). Mr. Nichols also participated extensively in Wisconsin's federalization of its S corporation statutes, where a number of his recommendations were adopted as statutory amendments. In addition, at the request of the Wisconsin Department of Revenue, Mr. Nichols reviewed and revised drafts of the Department's Publication 102, "Wisconsin Tax Treatment of Tax Option (S) Corporations and Their Shareholders," both in 1987 and again in 1998.

Mr. Nichols has also been and is actively involved in the development and updating of Wisconsin's business entity statutes, including the adoption of provisions on cross-species mergers and conversions between corporations, partnerships, limited liability companies and non-profit corporations, as well as updating Wisconsin's partnership statutes to reflect the Revised Uniform Partnership Act. He is a member of the Board of Directors of the Business Law Section of the State Bar of Wisconsin and Chair of its Partnerships Committee, as well as a Member and Past Chairman of the Wisconsin Taxation Committee of the Wisconsin Institute of Certified Public Accountants. Mr. Nichols is also the columnist for The Choice of Entity Corner for the Journal of Passthrough Entities published by CCH, Incorporated; a member of the National Health Lawyers Association and a Fellow of the American College of Tax Counsel.

Mr. Nichols has spoken and written extensively on tax and business entity topics, including testimony before the U.S. House of Representatives Ways & Means Committee, the ABA Tax Section, the New York University Institute on Federal Taxation, the American Law Institute–American Bar Association (ALI-ABA), the Accounting Continuing Professional Education Network (ACPEN), the Tulane Tax Institute, the State Bar of Wisconsin, the Wisconsin Institute of Certified Public Accountants, the Corporate Practice Institute and numerous other groups and institutions. Mr. Nichols is AV-rated by Martindale-Hubbell, and has been selected for inclusion in the *Best Lawyers in America®* and *Super Lawyers®* publications.