TESTIMONY BEFORE THE SUBCOMMITTEE ON ECONOMIC GROWTH, TAX, AND CAPITAL ACCESS

COMMITTEE ON SMALL BUSINESS UNITED STATES HOUSE OF REPRESENTATIVES

Thomas J. Nichols, J.D., CPA[1]
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Representative Kelly, Ranking Member Velazquez and other members of the Subcommittee, thank you very much for the opportunity to testify today regarding the important role closely held businesses play as employers and in the American economy, as well as some of the governmental and regulatory challenges they face today.

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. I am also a long-standing member of the Board of Directors of the Business Law Section of the State Bar of Wisconsin, in which capacity I am heading up the Business Entity Modernization Package project to update the state's corporate, partnership and limited liability company statutes, which we are hoping to get introduced and enacted in the upcoming 2016 legislative session. The views expressed today are informed by and benefit from all of those business and professional activities.

A. Overview

Let me begin by saying that I sincerely appreciate the bipartisan support private enterprise enjoys in the U.S. Congress. I know there are many divisive issues confronting Congress these days, but the important role Main Street Businesses play in the economy and in creating jobs is not one of them. This is for good reason. Today's closely held businesses employ most of the private sector workforce, and are the primary force in creating new jobs in the United States.

In addition, I can say from personal experience that small, closely held businesses often provide an atmosphere of loyalty and mutual respect that simply cannot be replicated in bigger firms. Owners and employees of small firms often perceive themselves as part of an extended family. Though the owners and the employees may not always make as much as their publicly held counterparts, they are often happier in this more welcoming setting. At the same time, such

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

businesses typically do not have the financial wherewithal to absorb and comply with many of the regulatory burdens discussed below.

Smaller firms also provide an important safety net of job stability and diversity within the U.S. economy. Just as investors should seek to diversify their portfolios to mitigate the impact of unexpected negative developments affecting specific companies and sectors, public policy should seek to foster a broad variety of business enterprises. Not only does this help protect against regional and sectorial downturns, it also affords security and opportunity to individual employees that only multiple employment alternatives can provide.

Finally, as any economist will tell you, there is no better way to foster innovation and progress in an economy than by having numerous and different business enterprises competing to provide goods and services to their customers. A broad enterprise base, spread across the country, is infinitely superior to concentrating activity within a relatively few extremely large employers. Public policy should seek to encourage this diversity by removing barriers to the establishment, growth and survival of smaller firms and startups.

The S corporation is a successful example of this type of policy. The S corporation was created back in 1958 in an attempt to encourage family and closely-held businesses. It combined the liability protection of C corporations with the single layer of tax enjoyed by partnerships and sole proprietorships. Today, there are 4.6 million S corporations and they are located in every community and every sector of the economy. The S corporation is doing exactly what Congress intended, and its single-layer tax structure should be made the foundation of any tax reform effort moving forward.

The remainder of this written testimony highlights certain problem areas affecting closely held businesses, including late passage of extenders legislation, section 409A, not allowing employers to reimburse employees for individual market premiums and overly restrictive de minimis capitalization requirements.

B. Main Street Businesses as Employers

Any discussion of the U.S. economy needs to focus on jobs. And any discussion of jobs needs to start with Main Street Businesses. Let me emphasize three key facts to make this point.

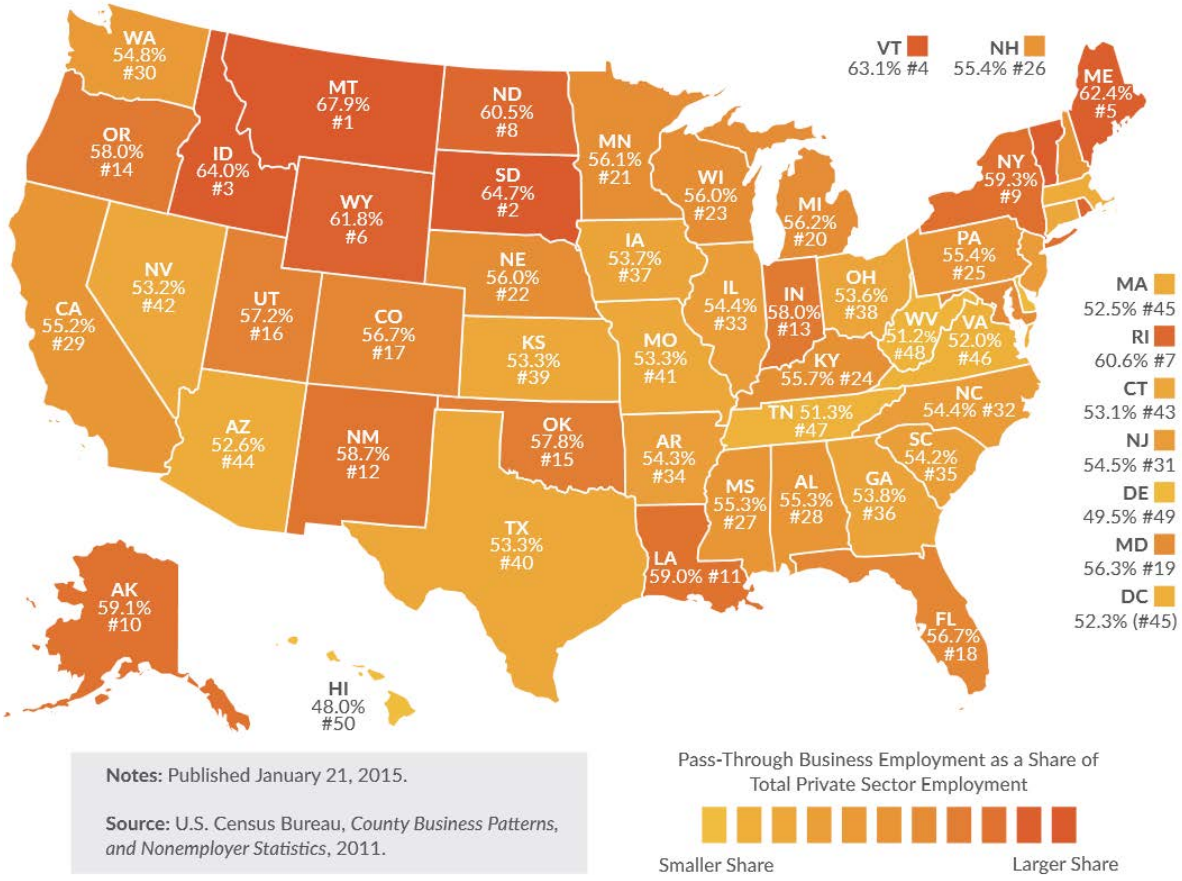
First, everybody in public policy has heard that small businesses create the majority of new jobs in our economy. The number varies from year to year but, even adjusting for statistical challenges and other concerns, studies of job creation have consistently found that smaller firms create the majority of new jobs in the United States. [2]

Second, this job creation adds up. As we know from the S Corporation Association's work with the Tax Foundation, today the majority of private sector workers wake up every morning and go to work at a business taxed as an S corporation, partnership, LLC, or sole proprietorship. These businesses today employ 11 out of 20 workers. In some states, like Maine and Montana, they employ 14 out of 20.

[2] Neumark, Wall, and Zhang (2011)

Figure 7. Pass-through Businesses Account for Most Private Sector Employment in Nearly all States

Pass-through Business Employment as a Share of Total Private Sector Employment, 2011



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Third and finally, what may be less understood but critically important is the role "startup" businesses play in all that job creation. On this front, the Kaufman Foundation has done some important work demonstrating that ***all*** net job creation in the US economy comes from startup businesses. As they reported back in 2010, "without startups, there would be no net job growth in the U.S. economy."

In summary, smaller employers represent the largest portion of the job base; they got that way by consistently creating the most jobs; and a critical source of that job creation is the startup sector and the millions of new jobs they contribute to the economy every year. So when it comes to job creation and employment, any conversation about growing the job base needs to start with the priorities of Main Street Businesses.

The challenge for policymakers is that business startup activity has *declined* sharply in recent years, with the percentage of new firms falling from 16 percent of all firms in the late

[3] http://taxfoundation.org/article/overview-pass-through-businesses-united-states

1970s to just 8 percent in 2011.[4] The decline is even greater in the last decade, with the most recent Census Bureau data available from 2011 showing that Americans created 27% fewer businesses that year than in 2006.[5] Thus, the critical role of Main Street Businesses in creating and maintaining the job base is not guaranteed. Without start-ups and growing small businesses, the job-creating engine of the American economy could come to a halt.

To help facilitate the continued growth of start-ups and smaller employers, there are a number of things that Congress could do. My testimony will focus on some specific challenges that closely held businesses face today that Congress could address in ways that could help to reverse this trend and enable private and startup businesses to resume their critical role as a source of jobs, innovation and growth.

C. Unnecessary Impediments

Although there are undoubtedly many more items that could be listed, I will focus on a limited number of issues that regularly arise in my practice where compliance with the income tax system is made much more difficult for closely held businesses without any apparent offsetting positive revenue impact for the government.

1. Late Passage of Extenders

In recent years, an increasing number of significant tax code provisions have been extended on a year-to-year basis, rather than being incorporated permanently into the Internal Revenue Code. Many of these provisions are of critical importance to small business, including being able to expense up to $500,000 of capital expenditures (rather than just $25,000) each year, applying a five-year (rather than ten-year) built-in gains tax period and allowing a 15-year (rather than a potentially 39-year) recovery period for qualified leasehold property, qualified restaurant property and qualified retail improvements ("qualified property").[6] Fifty percent bonus depreciation also falls into this category, though it is less critical for smaller businesses if the section 179 and qualified property provisions are extended.

The purpose of most of these provisions is to incentivize businesses to make capital expenditures to improve productivity (which historically has been a prerequisite to increased wages) and to otherwise grow their companies and the economy. And while these provisions are listed as "tax expenditures," I would argue that they are not. Rather, they much more effectively match the timing of taxation with the actual realization of income.

To use a simple example, suppose a small business owner has $100,000 of cash left after paying all of his or her expenses during the year, and decides to invest that money in a machine that the owner hopes will raise the incomes of both the owner and his or her employees in the upcoming years. It is important to recognize that, when making this decision to forgo personal consumption and invest in the business, the owner has no assurance that those hopes will be

[4] http://www.kauffman.org/~/media/kauffman_org/resources/2014/entrepreneurship%20policy%20digest/september%202014/entrepreneurship_policy_digest_september2014.pdf

[5] http://fivethirtyeight.com/features/the-slow-death-of-american-entrepreneurship/

[6] I.R.C. §§ 179, 1374, 168(e)(3)(E).

realized. The owner is taking a risk. It is just as important to realize that the $100,000 will be income to another business and taxed as such. Finally, and most pressing, the business owner now has no money left to pay any tax on the income the owner has yet to receive from this new investment, and maybe never will. In this example, expensing more accurately reflects the true income of the business.

Given the substantial policy considerations underpinning these expensing provisions, there is no excuse for repeatedly delaying their extension until after the investment period. It works at cross purposes with the desired policy benefits, and it creates a dynamic where businesses must overpay their taxes during the course of the year, draining them of capital.

Delaying confirmation of the five year built-in gains tax period has similarly destructive consequences. In the past several years, small business owners have asked me repeatedly whether the five-year or ten-year period will apply. The only response I could give them is that the final built-in gains period will "probably" be five years, but that they can't count on it. This has created a number of excruciatingly difficult situations for my clients. For example, several of my farming clients were attempting to sell agricultural land – either to raise capital or to finance their pending retirement – while farmland prices were at their peak. Unfortunately, for those in the critical 6 to 10-year "limbo" period, this uncertainty constituted a huge stumbling block, and now it appears that the optimal time for selling is gone.

I had another client who wanted to sell his business, but could ill afford to do so if the double-tax built-in gains regime was applicable. I recommended that he and the buyer reach agreement and have all the documents prepared, but wait until actual passage of the extenders legislation to sign and close the deal. His response was that he was in poor health and may not be able to wait.

As with expensing, a five-year period for the built-in gains tax is well supported by policy considerations. The built-in gains tax was originally enacted in the Tax Reform Act of 1986 and was intended to prevent C corporations from converting to S Corporation status and selling some or all of their business subject only to the single-tax S Corporation regime. To be honest, I have never understood why paying only one tax upon the sale of a business was considered a loophole to be closed. Regardless, it is generally recognized that a ten-year waiting period is much longer than necessary in order to achieve the initial policy goal. Given the uncertainties and vagaries of conducting business, business owners are extremely unlikely to elect S Corporation status with concrete plans to sell after waiting for a period of five or more years.

The expensing and built-in gains tax provisions are clearly supported by policy considerations, and should be permanently incorporated into the Internal Revenue Code. There is simply no good policy reason for repeatedly extending them for a year or two only. Absent permanence, at the very least Congress needs to get back into the habit of extending these provisions before they expire rather than after, and for multiple years at a time.

2. Section 409A and Deferred Compensation

Another example of an unforced error in our income tax system is section 409A of the Internal Revenue Code. It imposes rigid guidelines for deferred compensation plans, violation of which triggers substantial penalties on employees, including a 20 percent penalty tax (on top of the already substantial federal and state income tax) plus interest (at the overpayment rate +1 percent) for the entire period during which income was deferred, even though the corresponding income tax deduction to their employers has also been deferred.

The "abuse" this provision was intended to prevent is the postponement of taxable income attributable to deferred compensation paid to employees. However, this analysis failed to take into consideration the fact that that same deferral also postponed the corresponding tax deduction to the employees' employers.[7] For most closely held business enterprises, the tax benefit being postponed for the employer is actually greater than the tax cost for the employee. As you can imagine, closely held employers therefore almost never adopt these plans in order to achieve untoward tax benefits. In fact, they are nearly always adopted in order to achieve perfectly legitimate business objectives (e.g., conservation of scarce cash resources, continued employee stake in the ongoing concern, etc.).

Section 409A creates an unnecessary impediment to accomplishing those objectives. For example, in our practice, we have had to restate Phantom Stock Plan documents in order to comply with these new rules, notwithstanding the fact that the net effect of such plans effectively deferred deductions to S Corporation owners that were worth more than any tax savings enjoyed by their lower-income employee beneficiaries. Some of our clients have simply decided not to adopt perfectly legitimate deferred compensation vehicles in light of the additional complexity imposed by these new rules.

This provision represents such poor policy that the full American Bar Association Section of Taxation has come out against it.[8]

3. Employer Funding of Individual Policies

You might have thought that the Affordable Care Act should not constitute a serious regulatory impairment for very small businesses who do not qualify as "applicable large employers" (50 or more employees). Unfortunately, this is not the case. The Affordable Care Act is being implemented in a way that has serious negative consequences for even very small enterprises.

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[7] I.R.C. § 404(a)(5).

[8] Letter on behalf of ABA Section of Taxation to William M. Thomas, Chairman of House Committee on Ways and Means; Charles E. Grassley, Chairman of Senate Committee on Finance; Charles B. Rangel, Ranking Member of House Committee on Ways and Means; and Max S. Baucus, Ranking Member of Senate Committee on Finance (July 31, 2006).

The Internal Revenue Service has taken the questionable position that Health Reimbursement Arrangements ("HRAs"), Employer Payment Plans ("EPPs") and Health Flexible Spending Arrangements ("Health FSAs") somehow run afoul of the market reform provisions of the Affordable Care Act when an employer reimburses its employees for premiums on health insurance purchased in the individual market. The explanation given is that such plans violate the "no annual limit" and "preventive services" Affordable Care Act requirements, notwithstanding the fact that the individual policies so procured do and are required to comply in full with those (and all other) Affordable Care Act requirements. The weakness of this position is further belied by the fact that, in the same announcement, the Service took the position that employer HRAs could reimburse employees for premiums on coverage offered by the same or even other employers. The bottom line is that an employer can't reimburse his or her employees for premiums for insurance purchased in the individual market, but the employer can reimburse them for the cost of coverage provided by the employer or by other employers.[9]

This contorted position is particularly burdensome for small, closely held businesses who simply are not in a position to establish self-insured plans that can be tailored to meet employer and employee needs. As a consequence, a disproportionate number of our smaller clients have been negatively impacted. One client of ours had a health insurance plan that differed from what many of his employees preferred. In order to accommodate their concerns, he had established a long-standing HRA that provided generous reimbursement for premiums on health insurance policies selected by the individual employees. Both he and his employees liked this plan, but unfortunately, under the above-described IRS interpretation, they couldn't keep it. I have been surprised by how widespread the negative reaction to this IRS position has been. In fact, without specifically raising this issue, I've been contacted by practitioners, both in my capacity as Chairman of the Board of Advisors for the S Corporation Association as well as in my capacity as a member of the Board of Directors of the Business Law Section of the State Bar of Wisconsin, questioning how the Service could have reached such a result.

The penalties for running afoul of this questionable position are draconian. Having an HRA that allegedly violates the Affordable Care Act "no annual limit" and "preventive services" requirements results in a penalty of $100 per day per employee ($36,500 per year). Thus, a small employer with only 10 employees covered by his HRA could be facing a penalty of $365,000 in any given year, all for just reimbursing those employees for the premiums on policies that are fully compliant with those and all other Affordable Care Act requirements. Such awkward and onerous requirements and penalties unavoidably serve to dampen entrepreneurial spirit for small business owners who cannot afford to hire and maintain expensive compliance departments.

Fortunately, I am not the only person raising this issue. In fact, there is currently bipartisan legislation in both the House and the Senate to correct this interpretation.[10] I would urge you to accelerate the passage of this bill, perhaps as part of the extenders legislation.

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[9] S*ee* Notice 2013-54, Q&A 4, 6; I.R.S. Letter 2014-0039 (Sept. 22, 2014); I.R.S. Letter 2014-0037 (Sept. 22, 2014).

[10] Small Business Healthcare Relief Act, H.R. 2911, 114th Cong. (1st Sess. 2015); Small Business Healthcare Relief Act, S. 1697, 114th Cong. (1st Sess. 2015).

4. De Minimis Capitalization Requirements

The Internal Revenue Service has adopted comprehensive regulations relating to the capitalization of capital expenditures. As explained above, there are sound policy reasons for allowing both big and small taxpayers to deduct those expenditures currently but, as it stands now, there remain many such capital expenditures that are not subject to immediate expensing under either section 179 or the bonus depreciation rules.

Recognizing this, the Service included a de minimis safe harbor election to prevent either taxpayers or the Service from having to capitalize and account for smaller expenditures of $5,000 or less. However, this $5,000 de minimis safe harbor amount only applies to taxpayers who have so-called "applicable financial statements," which are defined to include only financial statements required to be filed with the Securities and Exchange Commission, audited financial statements used for credit purposes, owner reporting or another "substantial non-tax purpose," and financial statements required to be provided to federal or state governments or agencies. Entities that do not have "applicable financial statements" are subject to a much lower de minimis standard of $500.[11] Many, many small, closely held businesses do not have audited financial statements or file financial statements with the SEC or other governmental authorities, and thus are subject to the much lower $500 limit.

There's a real question as to why the de minimis standard is so much lower for small, closely held businesses. Such businesses are much less likely to have in-house accounting staffs to establish and maintain fixed asset records, and keeping track of such smaller expenditures will often have no impact on government revenue collected, given the fact that the aggregate capital expenditures of many small businesses are well below the section 179 expensing limit. This is, of course, assuming that Congress passes the extenders legislation discussed above.

Once again, I would like to thank Representative Kelly and Ranking Member Velazquez for holding this hearing and inviting me to testify. As someone integrally involved in the day-to-day concerns of small and closely held businesses, I sincerely appreciate any and all efforts you undertake to alleviate the unnecessary governmental burdens that they now face.

[11] Treas. Reg. § 1.263-1(f).