AICPA

November 13, 2017

The Honorable Orrin G. Hatch
Chairman
U.S. Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Ron Wyden
Ranking Member
U.S. Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

RE: Tax Cuts and Jobs Act

Dear Chairman Hatch and Ranking Member Wyden:

The American Institute of CPAs (AICPA) applauds the Senate Committee on Finance (the "Committee") for its efforts in reforming our nation's outdated Internal Revenue Code ("Tax Code").

We recognize the intent of the tax reform bill, the *Tax Cuts and Jobs Act* (hereinafter referred to as "the Proposal"), is to move us closer to a fairer, simpler Tax Code that drives economic opportunities for individuals and families, while leveling the playing field for American businesses in the United States (U.S.) and abroad. For example, we commend the preservation of the deduction for business interest expense for small businesses, repeal of the alternative minimum tax (AMT), expansion of the exception for small taxpayers from the uniform capitalization rules under section 263A, and simplification of the "kiddie tax." These provisions would eliminate a significant amount of compliance burdens for small businesses and help reduce the complexity and unfairness of the current Tax Code.

The AICPA is a long-time advocate for an efficient and pro-growth tax system based on principles of good tax policy. We look forward to working with Congress as this process moves forward to ensure that the proposed reforms are fair and meet the needs of both taxpayers and tax practitioners. In this regard, we highlight some of the key issues we have identified for your consideration.

1. Cash Method of Accounting

The AICPA commends the Committee on its expansion of the number of taxpayers who may use the cash method of accounting. We support the increase of the qualifying threshold from $5 million of average gross receipts, without further restricting its use for the millions of U.S. businesses currently utilizing this method. The cash method of accounting is simpler in application than the accrual method, has fewer compliance costs, reduces controversy and enforcement costs, and does not require taxpayers to pay tax before receiving the related income. The proposed change would encourage small business growth and reduce compliance costs, creating an environment for increased economic growth.

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2. Certain Special Rules for Taxable Year of Inclusion

The AICPA recommends that the Committee clarify that the rules associated with the recognition of income is limited to taxpayers using the accrual method of accounting. Application of this rule to taxpayers using the cash method of accounting would undermine the basic concepts underlying that method, that income and expenses are best recognized when received and paid.

3. Tax Rates for Pass-through Entities

The AICPA has long championed parity in the marginal income tax rates between C corporations and pass-through entities. The proposal to create a 17.4% deduction on qualified business income limited to 50% of wages would create a pass-through rate trending to the low- to mid-30% range for many taxpayers. In comparison, a corporate tax rate of 20% would result in a strong incentive for businesses to operate as a corporation as opposed to a pass-through entity. Currently, pass-throughs generate more than 50% of business income reported to the Internal Revenue Service (IRS) because their single-tax regime is tax-efficient. Providing an effective rate on pass-throughs at 32% and above will dampen this growth segment of the U.S. economy and push many taxpayers into the corporate double-tax regime.

Pass-throughs are the preferred form of entity for most small and new businesses and the proposed rate disparity would discourage their formation. The Tax Code should not drive taxpayers' decisions on how to form their businesses. Under the principle of neutrality, it is important to minimize the effect of the tax law on a taxpayer's decision. Congress should encourage businesses to make decisions motivated by economic and business factors such as interest rates, supply and demand, inflation, technology, and human capital, rather than by tax considerations.

We also urge Congress to reconsider excluding higher-income service firms from the preferential tax rates and deductions proposed for other pass-through businesses. Professional service~~s~~ firms, such as accounting firms, are an important sector in our economy and heavily contribute to the nation's goals of creating jobs and better wages. Without the benefit of a fair and consistent rate reduction for all pass-through entities, the incentive to start or grow a business is diminished, with a corresponding loss of jobs and reduction in wages.

Overlooking professional and personal services reflects a view of the industry that may have applied in the 1950's, but certainly does not represent the current integrated global environment. In today's economy, professional and personal service pass-throughs increasingly compete on an international level with businesses organized as corporations. They require a significant investment in tangible and intangible assets subject to economic risks, and rely on the contribution of salaried, nonequity professionals to generate a significant portion of their revenue. Artificially limiting the use of a lower business rate (through the restricted availability of a deduction), would penalize these businesses for operating as pass-through entities.

4. Deduction for State and Local Taxes

The AICPA recommends that Congress preserve the full deduction for state and local taxes paid or accrued in carrying on a trade or business. Under current tax law, C Corporations may deduct state and local income taxes in determining their taxable income. Similarly, owners of pass-through entities may deduct state and local income taxes on income earned by the pass-through entity, whether paid at the entity level or directly by the partner/owner.

The AICPA recommends that Congress allow owners of pass-through entities to take an "above-the-line" deduction for state and local taxes paid or accrued in carrying on a trade or business, whether paid at the entity level or directly by the partner/owner.

5. Nonqualified Deferred Compensation

The AICPA opposes the nonqualified deferred compensation (NQDC) provision, which accelerates income to the service provider when there is no substantial risk of forfeiture of the compensation. At a minimum, Congress should provide an exception to the rules for partners and employees of partnerships. We also recommend a minimum two-year delay of the effective date to all other individuals to which the proposal would apply.

Without an exclusion or exception to the proposal, severe negative impacts to businesses and their service providers, including employees, would: a) limit the natural growth of businesses, including partnerships; b) place U.S. businesses at a competitive disadvantage compared to foreign businesses that utilize NQDC arrangements; and c) interrupt millions of employees' personal financial plans by taxing vested existing balances by 2026.

Partnerships, generally unable to access public capital markets, must derive working capital from sources such as the unfunded, unsecured promise to pay retirement income to partners and employees. Partnerships utilize these arrangements as mandatory components of their partners' and employees' compensation packages to fulfill this need.

Additionally, retired individuals would include in income an amount attributable to future NQDC payments no later than 2026 without having received the corresponding amount of cash, which would create a cash flow deficit and financial burden. In order for individuals to have the ability to pay the tax on the NQDC includable in their income upon vesting (or in 2026 for the grandfathered NQDC), partnerships would need to advance cash to them, an obligation not considered by the partnership when the arrangement was established. A significant depletion of a partnership's working capital would occur.

The Proposal places an unfair restriction on a business's use of NQDC arrangements as part of a service provider's retirement package. NQDC arrangements are often used as a retirement vehicle in partnerships where there is a mandatory retirement age (*e.g.*, age 58). Mandatory retirement age requirements are important for partnerships to provide smooth management transitions and paths of advancement at all levels throughout the partnerships. In order to ensure that their partners have an adequate income stream to accommodate their retirement, they provide them with NQDC arrangements. This technique is prevalent throughout various industries, regardless of the size of a partnership.

6. International Tax Provisions

Treatment of Deferred Foreign Earnings

The AICPA recommends that the repatriation tax imposed by the Proposal only apply to those taxpayers who would receive the benefit of the dividend received exemption created by the Proposal.

Under the Proposal, "any shareholders of a specified foreign corporation must include in income its pro rata share of the undistributed, non-previously-taxed post-1986 foreign earnings of the corporation," calculated as of a date specified in the Proposal. The rate of tax on such foreign earnings would depend on the whether the foreign earnings have been retained in the form of cash or cash equivalents or reinvested in the foreign subsidiary's business. Under an election, payment of the tax imposed would take place over an 8-year period.

The AICPA is concerned that non-corporate shareholders would have this repatriation tax imposed on their subsidiaries' deferred foreign earnings, yet would not receive the benefit of the dividend received exemption on future earnings included in the Proposal. We recognize the rationale for imposing a one-time tax on deferred earnings held by corporate owners. Those shareholders will generally not have U.S. tax imposed on their future foreign earnings and would have the ability to use the cash generated for U.S. based operations. However, non-corporate shareholders would remain subject to U.S. tax on any future foreign earnings which they elect to repatriate.

Inbound Transfers of Intangible Property

The AICPA applauds the provision regarding the treatment for intangible property distributed from a Controlled Foreign Corporation (CFC) to a domestic corporation which is a U.S. shareholder of that CFC. Under this provision, the fair market value of the intangible property is treated as not exceeding the adjusted basis of the property immediately before the distribution. However, this beneficial treatment is only permitted for distributions received by a domestic corporation from a CFC with respect to its U.S. shareholder which occur before the last day of the third taxable year of such CFC that begins after December 31, 2017.

We believe that the positive policy objectives of this provision, which encourage businesses to transfer foreign located intangible property to the U.S., warrant making the provision permanent. In addition, such permanent extension should also apply this treatment to newly acquired foreign based intangible property to further promote the policy objectives.

7. Tax Preparation Expenses

We encourage retention of the deduction for tax preparation expenses to recognize that this is a cost for most individuals to properly comply with their federal, state and local tax obligations.

8. Accounting for Inventories & Long-Term Contracts

The AICPA commends the Committee on its efforts to simplify the inventory rules for small businesses. Exempting taxpayers that meet the $15 million gross receipts test from the requirement to account for inventories under section 471 will reduce compliance costs, taxpayer controversy with the Internal Revenue Service, and other non-tax administrative costs.

The AICPA also supports the expansion of the exception for small construction contracts from the requirement to use the percentage-of-completion method under section 460. However, section 460 also applies to manufacturers of unique equipment. The Committee may want to consider expanding the exception to include small manufacturers of unique equipment, as it would ensure that all small business taxpayers subject to section 460 are entitled to the same exemption.

9. Head of Household Paid Preparer Due Diligence

The AICPA applauds the efforts of the Committee to reduce fraudulent claims for head of household status. However, the proposed process would add to the multiple layers of due diligence requirements with which tax practitioners are already required to comply, such as section 6694 preparer penalty regulations and the Department of the Treasury's ("Treasury") Circular 230 rules. We urge Congress to consider simplified approaches that recognize taxpayers are responsible for the accuracy of their returns. We question whether this increased burden and administrative strain on an overwhelming number of taxpayers and tax preparers who are compliant would achieve the result of a significant deterrence on fraudulent filers.

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As Congress moves forward with tax reform, we urge you to consider appropriate transitional provisions. For example, we recommend providing penalty relief for estimated payments due prior to the later of June 30, 2018, or 120 days after the effective date of the legislation. Taxpayers and preparers need sufficient time to determine the appropriate estimated tax payments for businesses and individuals that may have a dramatically different tax liability in the 2018 year as a result of the Proposal.

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 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 welcome the opportunity to discuss these comments on the *Tax Cuts and Jobs Act* or to answer any questions that you may have. If you have any questions, please contact Jeffrey A. Porter, Chair of the AICPA Tax Reform Task Force, at (304) 522-2553, or jporter@portercpa.com; Melissa Labant, AICPA Director of Tax Policy & Advocacy, at (202) 434-9234, or melissa.labant@aicpa-cima.com; Amy Wang, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9264, or amy.wang@aicpa-cima.com; Lakecia Foster, AICPA Director of Congressional & Political Affairs, at (202) 434-9208, or lakecia.foster@aicpa-cima.com; or me at (408) 924-3508 or annette.nellen@sjsu.edu.

Sincerely,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: Members of the Senate Finance Committee
Representative Kevin Brady, Chairman, House Ways and Means Committee
Representative Richard Neal, Ranking Member, House Ways and Means Committee
The Honorable Steve Mnuchin, Secretary of the Treasury
The Honorable Gary Cohn, Director, President's National Economic Council
The Honorable David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury