



April 15, 2013

Dave Camp
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington D.C. 20515

Re: NSBA Comments on the Ways And Means Committee Discussion Draft on Provisions to Reform the Taxation of Small Businesses and Pass-through Entities

Dear Chairman Camp:

The National Small Business Association (NSBA) is the nation's first small-business advocacy organization with more than 65,000 members in every industry and every state across the country. A uniquely member-driven and staunchly nonpartisan organization, NSBA is pleased to provide these comments on the Ways And Means Committee Discussion Draft on Provisions to Reform the Taxation of Small Businesses and Pass-through Entities released March 12, 2013.

We would like to commend you and the committee for the process by which you are considering these matters. Providing a draft of proposed legislation well before mark-up and receiving comments from the public is the best way to ensure a thoughtful legislative process.

In general, we believe that the provisions in this draft are constructive and would take positive steps toward reducing the complexity of the tax system for small businesses that are pass-through entities. The draft would reduce the likelihood that small firms will make inadvertent mistakes that can have a dramatic adverse impact on their business. However, we also believe that the various discussion drafts released to date overlook issues of significant importance to small firms, as outlined below.

We look forward to working with you and other members of the committee to improve our badly broken tax system.

These comments address: (1) fundamental tax reform, (2) the small-business discussion draft, (3) alternative means of addressing pass-through entity problems and (4) other small-business issues that we believe the committee should address.

Fundamental Tax Reform

Federal taxes are routinely ranked among the top issues facing small businesses and pose a huge and unique financial and administrative burden for small-business owners. Results from the NSBA 2013 Taxation Survey indicate that the majority (55 percent) cited administrative

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burdens, while 45 percent highlighted financial burdens as the most significant challenges to their business posed by federal taxes. In 2013, 38 percent of small businesses reported they spend more than 80 hours per year dealing with federal taxes—that's two full work weeks—the majority spent more than 40 hours per year. Just imagine the collective business and job growth that could be done absent that burden. Furthermore, nearly half of small businesses spend \$5,000 or more annually on the administration (i.e.: accountant fees) of federal taxes alone. This is before they even pay their actual taxes!

The time and money spent, coupled with the fact that 84 percent of small-business owners must pay an external tax practitioner or accountant to handle their taxes ought to be a clear signal that the tax code is far too complex.

The current tax system is irretrievably broken and constitutes a major impediment to the economic health and international competitiveness of American businesses of all sizes, with widespread competitive disadvantages to small firms. To promote economic growth, job creation, capital formation, and international competitiveness, fundamental tax reform is required.

To that end, NSBA was the first small-business organization in the country to support the Fair Tax (*H.R. 25*). It would dramatically reduce the tax bias against work, savings and investment, and would substantially reduce complexity and compliance costs. Additionally, the Fair Tax would make the U.S. an extremely attractive location to manufacture goods and put U.S. produced products on even footing with foreign produced goods.

While we firmly believe the Fair Tax is the best path forward, NSBA understands the political landscape and need to move forward on broad reform, even if in a different iteration. As such, NSBA has developed nine principles as part of the NSBA Tax Reform Checklist to which any broad tax reform package ought to adhere. The nine principles are:

- Designed to tax only once
- Stable and predictable
- Visible to the taxpayer
- Simple in its administration and compliance
- Promote economic growth and fairness between large & small businesses
- Use commonly understood finance/accounting concepts
- Grounded in reality-based revenue estimates
- Fair in its treatment of all citizens
- Transparent

The Small Business Discussion Draft

Section 179 Expensing

Section 179 expensing is one of the most important provisions in the tax code to small businesses. It simplifies tax accounting, aids cash flow and reduces the cost of capital for small firms. More than one in three NSBA members take advantage of this break as it encourages

small businesses to invest in new equipment by letting them expense much of the cost up front, instead of depreciating it over time.

The amount that may be expensed is scheduled to fall from \$500,000 currently to \$25,000 starting in 2014. The discussion draft would place the limit at \$250,000. While NSBA commends you for identifying this important issue and addressing it in a very significant way, we would urge you to retain the threshold at its present \$500,000 level.

Limitation on use of cash method of accounting

The ability to use the cash method of accounting is very important to small businesses, as it provides flexibility and simplicity. Cash accounting—widely seen as a more simple, straightforward method of accounting—is utilized by 42 percent of small businesses, according to our survey and 51 percent report using cash accounting for purposes of filing their taxes. The discussion draft would retain that option for all firms with less than \$10 million in gross receipts. It would expand the availability of the cash method for C corporations under \$10 million in gross receipts and limit the special rules in current law for larger farming and personal service corporations. It deserves support because it establishes simpler and more uniform rules and preserves the cash method of accounting for small firms.

Unification of deduction for start-up and organizational expenditures

This provision of the discussion draft would integrate the two existing Internal Revenue Code sections that allow expensing (rather than amortization) of start-up and organizational expenses. It establishes an overall cap of \$10,000 rather than two \$5,000 caps. There are times under current law when the distinction between start-up and organizational expenses is not particularly clear although in most cases it makes little difference how the expenses are characterized. While not of major importance to our membership, this provision is a simplification that deserves support.

Tax Return Due Date Simplification

While good intentioned, NSBA does not support this provision as drafted. It would establish a variety of different due dates generally, March 15 for partnerships, March 31 for S corporations and April 15 for C corporations. It is likely to cause confusion at first and lead to penalties for late filing because it accelerates partnership and LLC returns considerably. In our judgment, all pass-through entities should be required to file by April 15 with a uniform automatic extension (preferably six months). This would be a simpler rule and allow taxpayers sufficient time to file their tax return. We would also support the same rule with respect to C corporations.

OPTION 1

Expansion of qualifying beneficiaries of an electing small-business trust

An electing small business trust (ESBT) may be a shareholder of an S corporation under current law. A nonresident alien individual, however, may not be a shareholder of an S corporation and

may not be a potential current beneficiary of an ESBT. The discussion draft would allow non-resident aliens to be current beneficiaries of an electing small business trust. This provision is positive, however, most small businesses do not avail themselves of such complex arrangements.

We believe it would be much simpler and better policy to instead eliminate the non-resident alien shareholder restriction contained in Internal Revenue Code §1361(b)(1)(C). This would require the partnership withholding rules (Internal Revenue Code §1446) to be amended to apply to S corporations with non-resident alien shareholders to ensure that income which is effectively connected to a U.S. trade or business is subject to tax. The non-resident alien restriction can also trigger inadvertent loss of S corporation status when a resident alien shareholder leaves the U.S. and becomes a non-resident alien.

Extension of time for making an S corporation election

This proposal would extend the time for filing a S election to the due date (with extensions) for filing the corporation's tax return. This proposal is of tremendous importance to small start-ups that do not have teams of tax attorneys at their disposal are not well advised. These firms often do not consider taxes until they retain an accountant at year-end, only to find that the time for establishing an S election has lapsed. NSBA supports this provision.

Repeal of rules relating to guaranteed payments

The repeal of the rules relating to guaranteed payments is a material simplification in the law that will make it less likely that business owners will inadvertently run afoul of rules that are, in our judgment, of virtually no utility and very unclear. This provision deserves to be enacted.

OPTION 2

As discussed above, we believe the current tax system is a complex morass and economically destructive, and poses a significant disadvantage to America's small businesses. According to NSBA's Economic Reports, reducing the tax burden is among small businesses top issues for Congress and the administration to address. Although the actual out-of-pocket cost is a huge issue, the sheer complexity of the tax code, along with the mountains of paperwork it necessitates, is actually a more significant problem for America's small businesses.

We understand the reasoning underlying option 2 and laud its intent. In general, it would move S corporations toward the more flexible partnership model. Nevertheless, we are reluctant to endorse a proposal that would radically change these well established and reasonably well understood provisions. The gains are unlikely to outweigh years of uncertainty surrounding the meaning of the new provisions. The expense of learning and complying with the new rules, while not dramatic, will not be trivial either, particularly given that the provisions relating to pass-through entities generally work reasonably well compared to other aspects of the tax system.

There are a few discrete steps, discussed in the next section, which would solve most of the remaining problems with S corporations without having to create years of uncertainty. We would recommend you proceed along those more modest lines.

Alternative Means of Addressing the Concerns of Pass-through Entities

A few discrete, simple and understandable changes would eliminate many of the complexity problems associated with S Corporations. One, addressed by the discussion draft, is the inordinately short S corporation election period that can snare start-ups that wait too long to seek professional advice. In addition, eliminating three of the restrictions found in Internal Revenue Code §1361(b) would achieve flexibility nearly as broad as partnerships and eliminate most of the ways that firms inadvertently lose their S corporation status.

Eliminating the more than 100 shareholder limit (or raising it) will become increasingly important as alternative means of raising small amounts of capital from large numbers of people become common. For example, Title III of the JOBS Act required the Security and Exchange Commission (SEC) to issue regulations permitting crowdfunding by the end of 2012. While the SEC has not yet done so, they will. Improving small firms' access to capital is a major goal of the small-business community and NSBA strongly supported the JOBS Act. We are actively involved in promoting a reasonable and timely implementation by the SEC. Yet, the current S corporation restrictions relating to shareholder number will make it very difficult for S corporations to crowdfund, precluding a new and innovative way for them to raise needed capital.

Similarly, the non-resident alien shareholder restriction contained in Internal Revenue Code §1361(b)(1)(C) should be repealed. Instead, the partnership withholding rules (Internal Revenue Code §1446) should be amended to apply to S corporations with non-resident alien shareholders. Were non-resident alien shareholders permitted, the withholding rules would need to be amended to mirror the partnership rules to ensure that income effectively connected to a U.S. trade or business bears appropriate tax. The restriction on non-resident alien shareholders can also trigger inadvertent loss of S corporation status when a resident alien shareholder leaves the U.S. and becomes a non-resident alien.

The one class of stock restriction is a function of concerns about allocation of basis and other tax attributes. It is, however, a very substantial restriction on the capital structure of a small firm and impedes their ability to creatively raise capital like a C corporation or partnership (including LLCs). It is also an important way that small firms inadvertently lose their S corporation status, and should be repealed. Partnerships have dealt with these issues without material difficulty for a very long time. Typically, the partnership agreement governs the allocation of tax attributes but there are default rules that govern tax allocations in the absence of written partnership agreement provisions. Similarly, a revised S corporation statute, without the one class of stock restriction, could provide that an agreement between all stockholders would govern the allocation of tax attributes but that, in the absence of such an agreement, default rules promulgated by the IRS would govern.

Other Small Business Concerns

The Estate and Gift Tax

Ideally, the estate and gift tax should be fully repealed. Alternatively, Congress should enact legislation that contains an effective exemption, fully indexed for inflation, of \$3.5 million per decedent, the lowest possible estate and gift tax rate, and a stepped-up basis.

Health Insurance Tax

Repeal the Health Insurance Tax (HIT) included in the *Patient Protection and Affordable Care Act* (PPACA). Since virtually all large corporations self-insure, this tax, by taxing small group premiums, is aimed squarely at small businesses and will further raise the health insurance costs at a time they are expected to increase dramatically for other reasons.

Maintain full deductibility for health insurance purchased by the self-employed and other business owners

Large corporations can deduct the cost of maintaining health insurance for their employees. The law should not discriminate against the self-employed by denying them a deduction for health insurance costs. They are the only business entity that does not receive the tax option of deducting the full costs of their health insurance. The law should permanently provide for the deductibility of health insurance costs by the self-employed.

Ensure that individual tax rates on business income do not exceed corporate tax rates

We are concerned that Congress may substantially reduce tax rates for C corporations while maintaining much higher tax rates for pass-through entities. Given that the overwhelming majority of small businesses (83 percent, according to existing NSBA data) pay taxes on their business at the personal income level, addressing just one piece of the puzzle—such as corporate tax reform—will lead to even greater complexity and a massive tipping of the scales in favor of the nation's largest companies at the expense of small businesses.

Imposing higher tax rates on small firms will stymie any growth from what is widely recognized as the source of much of the economic growth and dynamism in the U.S. economy: small business. The tax rate applicable to business income derived from pass-through entities should not exceed that paid by C corporations. According to NSBA's 2013 Small Business Taxation Survey, the clear majority of small businesses (66 percent) support broad tax reform that will reduce both corporate and individual tax rates coupled with reduced deductions.

Integrate and simplify retirement savings and pension plans

When a small-business owner is considering his or her retirement needs and those of his or her employees, there are myriad different plans to consider with countless requirements and stipulations. Establishing an employee pension plan can be extremely complex, cumbersome and expensive. It can also lead to serious taxation issues for the small-business owner.

Among the various plans that must be considered for simplification and reform are: simplified employee pensions (SEPs), salary reduction simplified employee pensions, SIMPLE IRA plans, SIMPLE 401(k) plans, regular 401(k)s, profit-sharing plans, money purchase pension plan, Keogh plans, defined benefit plans, defined contribution plans, and employee stock ownership plans. Most of those plans are qualified plans subject to the minimum coverage requirements, minimum vesting standards, the actual deferral percentage test, the non-discrimination requirements, and the top heavy plan requirements.

This complexity and cost effectively discriminates against small firms. There is a serious need to integrate and simplify these various plans so that they are comprehensible and less expensive to maintain. Only this will increase the share of the small-business community that maintains plans for their employees.

Complexity and inconsistency within the tax code pose a significant and increasing problem for small businesses. The ever-growing patchwork of credits, deductions, tax hikes and sunset dates is a roller coaster ride without the slightest indication of what's around the next corner. Without comprehensive tax reform, the investment and hiring decisions of businesses must be made in an uncertain and confusing business environment. This is unsustainable and unacceptable.

Too often, critical pieces of legislation are pushed through without the proper consideration. We applaud you for instituting this process of extensive hearings and the release of serious discussion drafts in advance of a mark-up. Your leadership throughout the process will lead to a better legislative product with more understanding of how the tax code impacts all stakeholders. We look forward to working with you and the committee on these issues.

Sincerely,

A handwritten signature in black ink, appearing to read "Todd McCracken", with a long horizontal line extending to the right.

Todd McCracken
President