



WRITTEN STATEMENT OF TROY K. LEWIS

ON BEHALF OF THE

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

BEFORE

THE UNITED STATES SENATE
COMMITTEE ON FINANCE

HEARING ON

BUSINESS TAX REFORM

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INTRODUCTION

Chairman Hatch, Ranking Member Wyden, and Members of the Senate Committee on Finance, thank you for the opportunity to testify today on business tax reform. My name is Troy Lewis. I am an Associate Teaching Professor at Brigham Young University. I am also a sole tax practitioner and the Immediate Past Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). I am pleased to testify today on behalf of the AICPA.

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, local 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.

As the Committee tackles this rare opportunity to enact bold, pro-growth business reform, we urge Congress to take a holistic approach to provide tax reform to all of America's businesses. Fair and equitable tax reform will drive economic growth and job creation, enhancing the competitiveness of all types of American businesses not only in the United States (U.S.) but also abroad.

The AICPA is a long-time advocate for an efficient and pro-growth tax system based on principles of good tax policy.¹ We need a tax system that is fair, stimulates economic growth, has minimal compliance costs, and allows taxpayers to understand their tax obligations. These features of a tax system are achievable if principles of good tax policy are considered in the design of the system.

AICPA PROPOSALS

In the interest of good tax policy and equitable and effective tax administration, we appreciate the opportunity to address the following issues:

1. Cash Method of Accounting
2. Tax Rates for Pass-through Entities
3. Distinguishing Compensation Income
4. Interest Expense Deduction
5. Cost Recovery
6. Definition of Compensation
7. Alternative Minimum Tax Repeal
8. Mobile Workforce

¹ AICPA, "[Guiding Principles for Good Tax Policy: A Framework for Evaluating Tax Proposals](#)," January 2017.

1. Cash Method of Accounting

The AICPA supports the expansion of the number of taxpayers who may use the cash method of accounting.² The cash method of accounting is simpler in application than the accrual method, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the related income. Therefore, entrepreneurs often choose this method for small businesses.

We are concerned with, and oppose, any new limitations on the use of the cash method for any business, including those businesses whose income is taxed directly on their owners' individual returns (such as, partnerships and S corporations). Requiring businesses to switch to the accrual method upon reaching a gross receipts threshold unnecessarily creates a barrier to growth.³

The AICPA believes that further restricting the use of the cash method of accounting for businesses would:

- a. Discourage natural small business growth;
- b. Impose an undue financial burden on their individual owners;
- c. Increase the likelihood of borrowing;
- d. Impose complexities and increase their compliance burden; and
- e. Treat similarly situated taxpayers differently (merely because income is taxed directly on their owners' individual returns).

Congress should not further restrict the use of the long-standing cash method of accounting for the millions of U.S. businesses (e.g., sole proprietors, personal service corporations, and pass-through entities) currently utilizing this method.

2. Tax Rates for Pass-through Entities

If Congress, through tax reform, lowers the income tax rates for C corporations, all types of business entities should receive a rate reduction. Our laws should continue to encourage, or more accurately – not discourage, the formation of pass-through entities as these business structures provide the flexibility and control desired by many owners that is not available within the more formal corporate structure. The vast majority of America's businesses are structured as pass-through entities (partnerships, S corporations, limited liability companies or sole proprietorships).⁴ Tax reform should not disadvantage these entities or require businesses to engage in complex entity changes to obtain favored tax status.

² AICPA letter, "[Investment in New Ventures and Economic Success Today Act of 2017 \(S. 1144\)](#)," June 22, 2017.

³ A required switch to the accrual method affects many small businesses in certain industries, including accounting firms, law firms, medical and dental offices, engineering firms, and farming and ranching businesses.

⁴ See Census Bureau, [County Business Patterns](#); Census Bureau, [Nonemployer Statistics](#).

Tax reform should recognize the importance of consistent tax rates on business income generated from all of America's pass-through entities, including professional service firms. Inequities would arise from having significantly different income tax rates based on an overly simplistic approach such as one based solely on the structure, sector or the general nature of a business' activities.

Professional service firms are an important sector in our economy and heavily contribute to the nation's goals of creating jobs and better wages.⁵ For example, according to the current employment statistics from the U.S. Bureau of Labor, the Accountants and Auditors service industry has a job growth outlook of 11% (as opposed to the average growth rate of 7% for all occupations) for the years 2014-2024.⁶ Furthermore, the jobs created by professional service firms are driving a more educated workforce for delivery of advanced services and products. These jobs are often coveted due to higher wages as well as health care, retirement and other benefits.

Excluding professional 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 service pass-throughs are increasingly competing on an international level with businesses organized as corporations, require a significant investment in tangible and intangible assets, and rely on the contribution of salaried, nonequity professionals to generate a significant portion of the revenue.⁷ Artificially limiting the use of a lower business rate, regardless of industry, would penalize a business for operating as a pass-through entity.

All business owners have: uncertainty and risk to manage; increased administrative and reporting responsibilities at the state, local and/or federal level; a potentially significant investment in assets;⁸ and ultimately an obligation to their customers and employees. 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.

⁵ In 2014 (the latest data available), the U.S. professional services industry comprised about 883,000 firms and employed 8.6 million Americans. The industry achieved combined annual revenues of \$1.6 trillion in 2015. Selectusa.gov; [Professional Services Spotlight](#).

⁶ Bureau of Labor Statistics website, Publications, Business and Financial, [Accountants and Auditors](#).

⁷ The U.S. is the world's most desired location for professional services firms. In today's integrated global environment, businesses find it critical to access the talent, institutions, business processes, and client base offered in the U.S.; Selectusa.gov; [Professional Services Spotlight](#).

⁸ Although professional service firms are not as heavily invested in *tangible* assets as manufacturing firms, they generally have a substantial investment in *intangible* assets. For example, accounting, legal, engineering, computer consulting and other professional service practices require continuing and substantial investment in software, hardware, assembling and training a workforce, marketing, cyber security, office facilities and malpractice insurance.

3. Distinguishing Compensation Income

If Congress provides a reduced rate for active business income of sole proprietorships and pass-through entities, we recognize that it will place additional pressure on the distinction between the profits of the business and the compensation of owner-operators. We recommend determining compensation income by codifying traditional definitions of “reasonable compensation” supplemented, if necessary, by additional guidance from the U.S. Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS).

The definition of reasonable compensation should reflect the type of business, the time spent by owners in operating the business, owner expertise and experience, and the existence of income-generating assets in the business (such as other employees and owners, capital and intangibles). Other relevant factors include available guidance (if any) used to help determine reasonable compensation for the geographic area and years of experience (such as, wage data guides provided by the U.S. Bureau of Labor Statistics), and the book value and estimated fair market value of tangible and intangible assets that generate income for the business.

Former Ways & Means Committee Chairman Dave Camp’s 2014 discussion draft⁹ included a proposal to treat 70% of pass-through income of an owner-operator as employment income. While this proposal presented a simple method, it would result in an inequitable outcome in many situations. If Congress moves forward with a 70/30 rule, or other percentage split, we recommend limiting it to active owners and making the proposal a safe harbor option. For example, the proposal must make clear that the existence and the amount of the safe harbor is not the required amount permitted but that the reasonable compensation standard utilized for corporations will remain available to taxpayers. These rules will provide a uniform treatment among closely-held business entity types.

4. Interest Expense Deduction

Another important issue for small businesses, as well as for professional service firms, is the ability to deduct interest expense. New business owners incur interest on small business loans to fund operations prior to revenue generation, working capital needs, equipment acquisition and expansion, and to build credit for future loans. These businesses rely on financing to survive. Equity financing for many start-up businesses is simply not available. A limitation in the deduction for interest expense (such as to the extent of interest income) would effectively eliminate the benefit of a valid business expense deduction for many small businesses, as well as for many professional service firms. If a limit on the interest expense deduction is connected with a proposal to allow for an immediate write-off of acquired depreciable property, it is important to recognize that this combination adversely affects service providers and small businesses while offering larger manufacturers and retailers a greater tax benefit. As a result, business formations by small start-ups are hindered.

⁹ H.R. 1 (113th Congress), [The Tax Reform Act of 2014](#), Sec. 1502; also see [Section-by-Section Summary](#), pages 32-33.

Currently, small businesses can expense up to \$510,000 of depreciable acquisitions per year under section 179 and deduct all associated interest expense. One tax reform proposal¹⁰ under consideration would eliminate the benefit of interest expense while allowing immediate expensing of the full cost of new equipment, and depreciable real estate, in the first year. However, since small businesses do not usually purchase large amounts of new assets, this proposal would generally not provide any new benefit for smaller businesses (relative to what is currently available via the section 179 expensing rule). Instead, it only eliminates an important deduction for many businesses, which are forced to rely on debt financing to cover their operating and expansion costs.

At a minimum, we suggest allowing small (and perhaps “mid-size”) businesses to continue to deduct net interest expense.

5. Cost Recovery

In general, the AICPA supports cost recovery legislation, such as Senator Thune's Investment in New Ventures and Economic Success Today Act of 2017, [S. 1144](#), which would simplify, for businesses and their owners, certain accounting rules and key parts of the IRC.¹¹

Many of the cost recovery provisions (such as, the expansion of the deduction for start-up and organizational expenses, the expensing of inventory by small and mid-sized businesses, and the exception for small and mid-sized businesses from capitalization of certain costs to inventory) would contribute to simplifying the tax rules and encourage economic growth and efficiency. We also appreciate that S. 144 updates the schedule of cost recovery periods for depreciable property under Revenue Procedure 87-56 to include a range of technology and other types of property that did not exist in 1987 would provide clarity, eliminate controversy, and provide a more accurate reflection of depreciation.

6. Definition of Compensation

Tax reform discussions have considered whether the tax system should use the same definition for taxable compensation of employees as it does for the compensation that employers may deduct.

We are concerned, particularly from a small business perspective, about any decrease of an employer's ability to deduct compensation paid to employees, whether in the form of wages or fringe benefits (health and life insurance, disability benefits, deferred compensation, etc.). We are similarly concerned about expansion of the definition of taxable income for the employees, or removal of the exclusion for fringe benefits. Such changes in the Tax Code

¹⁰ House Republican's Tax Reform Task Force Blueprint, "[A Better Way: Our Vision for a Confident America](#)," June 24, 2016.

¹¹ AICPA letter, "[Investment in New Ventures and Economic Success Today Act of 2017 \(S. 1144\)](#)," June 22, 2017.

would substantially impact the small and labor-intensive businesses' ability to build and retain a competitive workforce.

7. Alternative Minimum Tax Repeal

The AICPA supports the repeal of the alternative minimum tax (AMT).¹² The current system's requirement for taxpayers to compute their income for purposes of both the regular income tax and the AMT is a significant area of complexity of the Tax Code requiring extra calculations and recordkeeping. The AMT also violates the transparency principle because it masks the amount a taxpayer can deduct or exclude, as well as the taxpayer's marginal tax rate. Small businesses, including those operating through pass-through entities and certain C corporations, are increasingly at risk of being subject to the AMT.

The AMT was created to ensure that all taxpayers pay at least a minimum amount of tax on their economic income. However, businesses suffer a heavy burden because they often do not know whether they are affected by the AMT until they file their tax federal income tax returns. Therefore, they must constantly maintain a reserve for possible AMT, which takes away from resources they could allocate to business needs such as hiring, expanding, and giving raises to workers.

The AMT is a separate and distinct tax regime from the "regular" income tax. IRC sections 56 and 57 create AMT adjustments and preferences that require taxpayers to make a second, separate computation of their income, expenses, allowable deductions, and credits under the AMT system. This separate calculation is required for all components of income including business income for sole proprietors, partners in partnerships and shareholders in S corporations. Businesses must maintain annual supplementary schedules, used to compute these necessary adjustments and preferences, for many years in order to calculate the treatment of future AMT items and, occasionally, receive a credit for them in future years. Calculations governing AMT credit carryovers are complex and contain traps for unwary taxpayers.

Sole proprietors who are also owners in pass-through entities must combine the AMT information from all their activities in order to calculate AMT. The computations are extremely difficult for business taxpayers preparing their own returns and the complexity affects the IRS's ability to meaningfully track compliance.

8. Mobile Workforce

The AICPA supports the Mobile Workforce State Income Tax Simplification Act of 2017, [S. 540](#), which provides a uniform national standard for non-resident state income tax

¹² AICPA written testimony before the House Committee on Ways And Means, Subcommittee on Select Revenue Measures, March 03, 2011, "[Hearing on Small Businesses and Tax Reform](#)," and AICPA comments to the House Committee on Ways and Means on the [Tax Reform Act of 2014](#), January 12, 2015.

withholding and a *de minimis* exemption from the multi-state assessment of state non-resident income tax.¹³

The current situation of having to withhold and file many state nonresident tax returns for just a few days of work in various states is too complicated for both small businesses and their employees. Businesses, including small and family businesses that operate interstate, are subject to a multitude of burdensome, unnecessary and often bewildering non-resident state income tax withholding rules. These businesses struggle to understand and keep up with the variations from state to state. The issue of employer tracking and complying with all the different state and local tax laws is complicated and costly. The documentation takes extra time, adding to the loss in economic productivity for small businesses.

S. 540 would provide long-overdue relief to all businesses from the current web of inconsistent state income tax and withholding rules on nonresident employees. Therefore, we urge Congress to pass S. 540 that provides national uniform rules and a reasonable 30 day *de minimis* threshold before income tax withholding is required.

CONCLUDING REMARKS

The AICPA has consistently supported business tax reform efforts that are based on the principles of good tax policy, as we are convinced it will promote simplification, reduce business compliance costs and stimulate economic growth. As Congress drafts tax reform legislation, we encourage you to provide equality, certainty and clarity for all business owners. Businesses, regardless of entity structure, sector or the general nature of its activities, should similarly thrive under comprehensive tax reform.

The AICPA appreciates the opportunity to submit this testimony and we look forward to working with the Committee as you continue to address business tax reform.

¹³ For additional details, see AICPA [written statement](#), "AICPA Statement for the Record of the April 13, 2016 Hearing on "Keep it Simple: Small Business Tax Simplification and Reform, Main Street Speaks," April 7, 2016.