July 27, 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: July 18, 2017 Hearing on “Comprehensive Tax Reform: Prospects and Challenges”

Dear Chairman Hatch and Ranking Member Wyden:

The American Institute of CPAs (AICPA) respectfully submits the enclosed statement for the record of the hearing on July 18, 2017 on “Comprehensive Tax Reform: Prospects and Challenges.” We applaud the Committee’s efforts for considering comprehensive tax reform to simplify the tax system and make the tax rules more understandable and accountable.

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.

If you have any questions, please feel free to contact me at (408) 924-3508, or annette.nellen@sjsu.edu; or Melissa Labant, AICPA Director of Tax Policy & Advocacy, at (202) 434-9234, or melissa.labant@aicpa-cima.com.

Sincerely,

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

OF

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

SUBMITTED FOR THE RECORD OF THE

JULY 18, 2017

HEARING OF

THE UNITED STATES SENATE

COMMITTEE ON FINANCE

ON

COMPREHENSIVE TAX REFORM: PROSPECTS AND CHALLENGES
INTRODUCTION

The American Institute of CPAs (AICPA) applauds the leadership taken by the Senate Committee on Finance for considering comprehensive tax reform that examines all aspects of the Internal Revenue Code (IRC or “Tax Code”) to simplify the tax system and make tax rules more understandable and accountable.

The proliferation of new income tax provisions since the Tax Reform Act of 1986 has led to compliance hurdles for taxpayers, enforcement challenges for the Internal Revenue Service (IRS or “Service”) and administrative complexity for taxpayers and practitioners. The consequence of noncompliance, resulting in the tax gap, is estimated at $458 billion per year. Additionally, trust in the tax administration system and a sense of fairness is lost by taxpayers trying to keep up with the changing tax landscape. To help alleviate these challenges and promote principles of good tax policy, we offer suggestions on how to address the prospects and challenges of comprehensive tax reform.

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.

GOOD TAX POLICY

First, we should consider the features of an ideal tax system. The AICPA urges the Committee to consider comprehensive tax reform that focuses on simplification and other Principles of Good Tax Policy as explained in a report we recently updated and issued. Our tax system must be administrable, support economic growth, have minimal compliance costs, and allow taxpayers to understand their tax obligations.

We think these features are achievable if the following twelve principles of good tax policy are considered in the design of the system:

- Equity and Fairness
- Convenience of Payment
- Information Security
- Neutrality
- Certainty
- Effective Tax Administration
- Simplicity
- Economic Growth and Efficiency

---

3 For an explanation of why and how the AICPA Principles of Good Tax Policy were updated, see “Tax Principles for the Digital Age,” May 1, 2017.
Our profession has long-advocated for a transparent tax system. For example, we urge Congress to use a consistent definition of taxable income without the use of phase-outs. Provisions, such as phase-out rules, that limit or eliminate the use of certain deductions and exclusions for those taxpayers in higher tax brackets, perpetuate the flaws of the current system, leading to nontransparent tax results and increased complexity. These rules also create marginal rates in excess of the statutory tax rate. In addition, multiple tax regimes (such as the alternative minimum tax (AMT), which applies in addition to the regular income tax) make it almost impossible for taxpayers to easily know their effective and marginal tax rates. We urge Congress to use tax reform as an opportunity to remove phase-outs and multiple tax regimes, and develop the best definition of taxable income by creating simple, transparent, tax rules applied consistently across all rate brackets.

We also urge you to make tax provisions permanent. For many taxpayers, individuals and businesses alike, uncertainty in the Tax Code creates unnecessary confusion and anxiety. Complexity can also result in taxpayers not taking full advantage of provisions intended to help them, resulting in higher taxes and greater compliance costs. While our Tax Code has always had a tendency to change, in recent years the rate of change has accelerated. Statutory changes result in new regulations, revenue procedures, notices and new or modified tax forms which take time and resources to understand and address. Taxpayers need a Tax Code that is simple, transparent, and certain.

AICPA PROPOSALS

In the interest of good tax policy 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. Definition of “Compensation”
6. Mobile Workforce
7. Retirement Plans
8. Civil Tax Penalties
9. IRS Taxpayer Services
10. IRS Deadline Related to Disasters
11. Emerging Issues
1. **Cash Method of Accounting**

The AICPA supports the expansion of the number of taxpayers who may use the cash method of accounting.\(^4\) 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 service businesses, 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.\(^5\)

The AICPA believes that limiting the use of the cash method of accounting for service 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 (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 United States (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 business entity types should receive a rate reduction. The majority of businesses are structured as pass-through entities (such as, partnerships, S corporations, or limited liability companies).\(^6\) Tax reform should not disadvantage these entities or require businesses to engage in complex entity changes to obtain favored tax status.

Congress 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 business owners that is not available within the more formal corporate structure. Entrepreneurs generally do not want to create entities that require extra legal obligations (such


\(^{5}\) 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.

\(^{6}\) See Census Bureau, [County Business Patterns](https://www.census.gov/countybusinesspatterns/); Census Bureau, [Nonemployer Statistics](https://www.census.gov/cew/nonemploy.html).
as holding annual meetings of a board of directors). They prefer business structures that are simple and provide legal and tax advantages.

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 using traditional definitions of “reasonable compensation” supplemented, if necessary, by additional guidance from the U.S. Department of the Treasury.

We encourage Congress to consider codifying the existing judicial guidance on the definition of reasonable compensation that reflects the type of business (for example, labor versus capital intensive), 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).

Reasonable compensation has been the subject of controversy and litigation (hence, the numerous court decisions helping to define it). Therefore, Congress should direct the IRS to take additional steps to improve compliance and administration in this area. For example, a worksheet maintained with the taxpayer’s tax records would allow businesses to indicate the factors considered in determining compensation in a reasonable and consistent manner.

Changes to payroll tax rules, such as a requirement for partnerships and proprietorships to charge reasonable compensation for owners’ services and to withhold and pay the related income and other taxes, will also facilitate compliance for small businesses. We suggest that partners and proprietors are not treated as “employees,” but rather owners subject to withholding – a new category of taxpayer – similar to a partner with a guaranteed payment for services. Similar rules requiring reasonable compensation currently exist in connection with S corporations. The broader inclusion of partners and proprietors in more well-defined compensation rules should facilitate and enhance the development of appropriate regulations and enforcement in this area.

There are advantages to using a reasonable compensation approach for owners of all business types, including:

- Fairness that respects the differences among business types and owner participation levels;
- A reduced reliance by taxpayers and the IRS on quarterly estimated tax payments;
- Diminished reliance on the self-employment tax system; and
- Simplification due to uniformity of collection of employment tax from business entities, and an ability to rely on a deep foundation of case law (in the S corporation and personal service corporation areas) to provide regulatory and judicial guidance.
In former Ways & Means Committee Chairman Dave Camp’s 2014 discussion draft, a proposal was included to treat 70% of pass-through income of an owner-operator as employment income. While this proposal presents a simple method, it would result in an inequitable result in many situations. If Congress moves forward with a 70/30 rule, or other percentage split, we recommend 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 a maximum 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. Appropriate recordkeeping, when the safe harbor option is not used, would also address the enforcement challenges currently faced by the IRS.

4. **Interest Expense Deduction**

Another important issue for small businesses, as well as professional service firms, is the ability to deduct their 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 for many small businesses, as well as many professional service firms. If a limit on the interest expense deduction is paired 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, retailers, and other asset-intensive businesses a greater tax benefit.

Currently, small businesses can expense up to $510,000 of acquisitions per year under section 179 and deduct all associated interest expense. One tax reform proposal under consideration would eliminate the benefit of interest expense while allowing immediate expensing of the full cost of new equipment 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 takes away an important deduction for many businesses who are forced to rely on debt financing to cover their operating and expansion costs.

We suggest allowing small (and perhaps “mid-size”) businesses to continue to deduct net interest expense. Given the reliance on this deduction and the importance to the economy, we would also suggest allowing all businesses (except for the large manufacturers, retailers and other asset intensive businesses which will benefit the most from the immediate expensing of all equipment) to continue to deduct net investment interest.

---

7 H.R. 1 (113th Congress), *The Tax Reform Act of 2014*, Sec. 1502; also see *Section-by-Section Summary*, pages 32-33.
5. 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 would substantially impact the small and labor-intensive businesses’ ability to build and retain a competitive workforce.

6. 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 withholding and a de minimis exemption from the multi-state assessment of state non-resident income tax.9

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 quite complicated and costly. The documentation takes a lot of time, not to mention the loss in economic productivity for small businesses.

S. 540 would provide long-overdue relief 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.

7. Retirement Plans

Small businesses are burdened by the overwhelming number of rules inherent in adopting and operating a qualified retirement plan. Currently, there are four employee contributory deferral plans: 401(k), 403(b), 457(b), and Savings Incentive Match Plan for Employees (SIMPLE) plans. Having four variations of the same plan type causes confusion for many plan participants and small businesses. A suggested approach is to eliminate SIMPLE Individual

---

9 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.
Retirement Accounts (IRAs) and amend the rules of Simplified Employee Pensions (SEPs) to allow for salary reduction contributions, as previously permitted. In addition, Congress could eliminate the SIMPLE 401(k) plan because while the fees are similar to that of a 401(k) plan, the 401(k) is more flexible.

We also propose eliminating the top-heavy rules because they constrain the adoption of 401(k) plans and other qualified retirement plans by small employers. Since the top-heavy rules were enacted in 1982, there have been a number of statutory changes which have made the need for separate top-heavy rules unnecessary. The existing discrimination rules for retirement plans ensure that non-highly compensated employees receive nondiscriminatory benefits, such that the top-heavy rules often do not increase benefits in a meaningful way. In addition, the annual contribution limitations ensure that no employee’s benefits are excessive.

8. Civil Tax Penalties

Congress should carefully draft penalty provisions and the Administration should fairly administer the penalties to ensure they deter bad conduct without deterring good conduct or punishing innocent taxpayers (i.e., unintentional errors, such as those who committed the inappropriate act without intent to commit such act). Targeted, proportionate penalties that clearly articulate standards of behavior and are administered in an even-handed and reasonable manner encourage voluntary compliance with the tax laws. On the other hand, overbroad, vaguely-defined, and disproportionate penalties create an atmosphere of arbitrariness and unfairness that can discourage voluntary compliance.

The AICPA has concerns about the current state of civil tax penalties and offers areas\(^\text{10}\) for improvement, including the following key issues:

Trend Toward Strict Liability

The IRS discretion to waive and abate penalties where the taxpayer demonstrates reasonable cause and good faith is needed most when the tax laws are complex and the potential sanction is harsh. Legislation should avoid mandating strict liability penalties. Over the past several decades, the number of increasingly severe civil tax penalties have grown, with the Tax Code currently containing eight strict liability penalty provisions (for example, the accuracy penalty on non-disclosed reportable transactions).\(^\text{11}\)

An Erosion of Basic Procedural Due Process

Taxpayers should know their rights to contest penalties and have a timely and meaningful opportunity to voice their feedback before assessment of the penalty. In general, this process would include the right to an independent review by the IRS Appeals office or the IRS’s


\(^{11}\) Sections 6662A, 6664(d).
FastTrack appeals process, as well as access to the courts. Pre-assessment rights are particularly important where the underlying tax provision or penalty standards are complex, the amount of the penalty is high, or fact-specific defenses such as reasonable cause are available.

9100 Relief

Section 9100 relief, which is currently available with regard to some elections, is extremely valuable for taxpayers who inadvertently miss the opportunity to make certain tax elections. Congress should make section 9100 relief available for all tax elections, whether prescribed by regulation or statute. The AICPA has compiled a list of elections (not all-inclusive) for which section 9100 relief currently is not granted by the IRS as the deadline for claiming such elections is set by statute. Examples of these provisions include section 174(b)(2), the election to amortize certain research and experimental expenditures, and section 280C(c), the election to claim a reduced credit for research activities.

9. IRS Taxpayer Services

Whether addressed within or outside of tax reform, we urge Congress to address IRS taxpayer services, and recommend that any effort to modernize the IRS and its technology infrastructure should build on the foundation established by the Report of the National Commission on Restructuring the IRS (“Restructuring Commission”).

As tax professionals, we represent one of the IRS’s most significant stakeholder groups. As such, we are both poised and committed to being part of the solution for improving IRS taxpayer services. In March, we submitted a letter to House Ways and Means Committee and Senate Finance Committee members in collaboration with other professional organizations. Our recommendations include modernizing IRS business practices and technology, re-establishing the annual joint hearing review, and enabling the IRS to utilize the full range of available authorities to hire and compensate qualified and experienced professionals from the private sector to meet its mission. The legislative and executive branches should work together to determine the appropriate level of service and compliance they want the IRS accountable for and then dedicate appropriate resources for the Service to meet those goals.

To enable the IRS to achieve the improvements required for a 21st century tax administration system, the IRS needs a modern technological infrastructure. Currently, the IRS has two of the oldest information systems in the federal government making the information technology

---

13 60% of all e-filed returns in 2016 were prepared by a tax professional, according to the Filing Season Statistic for Week Ending Dec 2, 2016.
functions one of the biggest constraints overall for the IRS. Without modern infrastructure, the IRS is unable to timely and efficiently meet the needs of taxpayers and practitioners.

Additionally, we recommend the IRS create a new dedicated practitioner services unit to rationalize, enhance, and centrally manage the many current, disparate practitioner-impacting programs, processes, and tools. Enhancing the relationship between the IRS and practitioners would benefit both the IRS and the millions of taxpayers, including small businesses, served by the practitioner community. As part of this new unit, the IRS should provide practitioners with an online tax professional account with access to all of their clients’ information. The IRS should also offer robust practitioner priority hotlines with higher-skilled employees that have the experience and training to address complex issues. Furthermore, the IRS should assign customer service representatives (a single point of contact) to geographic areas in order to address challenging issues that practitioners could not resolve through a priority hotline.

10. IRS Deadlines Related to Disasters

Similar to IRS’s authority to postpone certain deadlines in the event of a presidentially-declared disaster, Congress should extend that limited authority to state-declared disasters and states of emergency. Currently, the IRS’s authority to grant deadline extensions, outlined in section 7508A, is limited to taxpayers affected by federal-declared disasters. State governors will issue official disaster declarations promptly but often, presidential disaster declarations in those same regions are not declared for days, or sometimes weeks after the state declaration. This process delays the IRS’s ability to provide federal tax relief to impacted businesses and disaster victims. Taxpayers have the ability to request waivers of penalties on a case-by-case basis; however, this process causes the taxpayer, tax preparer, and the IRS to expend valuable time, effort, and resources which are already in shortage during times of a disaster. Granting the IRS specific authority to quickly postpone certain deadlines in response to state-declared disasters allows the IRS to offer victims the certainty they need as soon as possible.

The AICPA has long supported a set of permanent disaster relief tax provisions and we acknowledge both Congress’s and the IRS’s willingness to help disaster victims. To provide more timely assistance, however, we recommend that Congress allow the IRS to postpone certain deadlines in response to state-declared disasters or states of emergency.

11. Emerging Issues

Online crowdfunding and the sharing economy are quickly expanding mediums through which individuals obtain funds, seek new sources of income, and start and grow businesses. Individuals may understand the steps through which they can use these new crowdfunding and sharing economy opportunities to their advantage. However, many small businesses do not

15 National Taxpayer Advocate, Annual Report to Congress 2016, Executive Summary: Preface, Special Focus and Highlights, 2016, page 31-32. The report references a 2016 GAO report (GAO-16-468) which found that some of technology the IRS currently uses was placed in service 56 years ago.

have the guidance necessary to accurately comply with the complex, out-of-date, or incomplete tax rules in these emerging areas.

Lawmakers and tax administrators must regularly review existing laws, against new changes in the ways of living and doing business, to determine whether tax rules and administration procedures need modification and modernization. We urge Congress and the IRS to develop simplified tax rules and related guidance in the emerging sharing economy and crowdfunding areas.\(^{17}\) Some of the areas in need of modernization include information reporting (such as to avoid reporting excluded income, such as a gift as income), simplicity in reporting and tracking rental losses from year to year, and simplified approaches for recordkeeping for small businesses. Offering clarity on these issues will allow taxpayers to follow a fair and transparent set of guidelines while the IRS benefits from a more efficient voluntary tax system.

**CONCLUDING REMARKS**

As Congress tackles the complex issues inherent in drafting tax legislation, we encourage you to consider tax reform that will provide simplicity, certainty and clarity for taxpayers. The AICPA has consistently supported tax reform simplification efforts because we are convinced such actions will reduce taxpayers’ compliance costs and encourage voluntary compliance through an understanding of the rules. The AICPA appreciates the opportunity to submit this written testimony and we look forward to working with the Committee as you continue to address comprehensive tax reform.