SUBCOMMITTEE HEARING ON S-CORPS: ENSURING PARITY, GROWTH AND DEVELOPMENT FOR SMALL BUSINESSES

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SUBCOMMITTEE HEARING ON S-CORPS: ENSURING PARITY, GROWTH AND DEVELOPMENT FOR SMALL BUSINESSES

Wednesday, June 18, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:02 a.m., in Room 1539, Longworth House Office Building, Hon. Melissa Bean [chairwoman of the Subcommittee] presiding.

Present: Representatives Bean, Ellsworth, and Buchanan.

OPENING STATEMENT OF CHAIRWOMAN BEAN

Chairwoman BEAN. Good morning. We are calling this hearing to order. Thank you all for being here today.

Entrepreneurs face many challenges when starting their businesses. Small-business owners must secure capital, develop their products and services, identify markets, secure a workforce and keep their customers happy. One of the most important decisions they will make is how to structure or incorporate their company.

In the Small Business Committee, we have explored business concerns about scarce capital, rising insurance and gas costs, but what sometimes gets overlooked is how disparities in the tax rules for different types of company entities can have long-term impacts on its business and its owners.

Today's hearing will examine one of the most common business classifications in the tax code, the S Corporation, and review suggestions for potential reforms that might better reflect the intentions of our tax code and more effectively support a growth economy.

In 1958, Congress created a corporate structure known as the Subchapter S Corporation to promote the growth of small businesses. As the S Corporation has evolved, it has become a cornerstone of the small-business community. Currently there are approximately 4 million S Corporations nationwide, up from 500,000 in 1985. These companies range from local community banks to home businesses to manufacturing firms.

Despite the growth in the number of S Corps, there are concerns that certain requirements are either unnecessarily burdensome or create obstacles to expansion. Many of these provisions were written almost 60 years ago, and it is important that Congress revisit these measures to see that they are still best serving our Nation's economic objectives.

One of the challenges for S Corps, as with many small businesses, is raising capital. For instance, S Corps have limitations on eligible shareholders and investors, and these regulations provide little flexibility in obtaining equity financing.

Small businesses also face challenges in offering health and retirement benefits. Currently, the tax code provides C Corps tax advantages unavailable to S Corps when it comes to these types of programs. Would providing equal tax treatment improve the ability of small businesses to offer health insurance coverage and reduce the number of Americans without health insurance, or should S Corps change their corporate structure if they want to provide those types of benefits.

Today we will hear testimony to examine these questions and explore where changes might be advantageous. With our economy facing serious difficulties, it is more important than ever to ensure that our tax policy does not unnecessarily impede small firms' growth potential.

I would like to thank our witnesses for coming here to share your experience and your expertise on the issue of tax code disparities, and look forward to your testimony.

I will now yield to Ranking Member Buchanan for his opening statement.

OPENING STATEMENT OF MR. BUCHANAN

Mr. BUCHANAN. I want to thank the Chair for calling this important hearing to examine the challenges and the possibilities facing S Corps as they strive to compete in the modern, global marketplace.

I would also like to extend my thanks to our witnesses, who have taken their valuable time out of their schedule to provide the Subcommittee with the benefits of their experience and testimony today.

Today we meet on the 50th anniversary—I didn't know that, but that is interesting—the 50th anniversary of the passage of legislation permitting the formation of S Corporations. For the past half-century, S Corps have offered small-business owners around the Nation the ability to benefit from limited-liability corporation.

And myself, my wife and I started our first company in 1976, and we had C Corps, and then a lot of things rolled into S Corps, which were huge because the double taxation, as you know, and the liability factor, both of those. So it was a big thing for us because it provided us capital on our company's gross, so it was important.

Today, however, in the last 7, 8 years, and being a new Member of Congress, last year and a half, we are doing a lot more with limited-liability companies. So I am interested to see if the S Corp, in some ways, has become a little obsolete and what we can do to fix it or, you know, where we are at on that.

But, as everybody knows, times have changed, and what was right 50 years ago might not apply today. So that is why we have this hearing. Back then, it probably seemed good enough to make possible a business framework where a few owners would be able to prosper directly from investment while avoiding having their enterprise double-taxed by the Federal Government. But yet, we explore potential reforms that promote parity in growth and development for S Corporations, leading to some of the following questions I would like to have us talk about today a little bit.

First is the Sub-S, should it be given additional expansion in terms of legal protection?

Secondly, should the number of owners permitted an S Corp, which used to be 100, should that be expanded? I am not quite sure how they came up with 100, but I think even before maybe it was less than 100. But I know some people are thinking about it should be 200 or something.

Thirdly, in a global economy where so much American business is financed by foreign investors, should S Corps have the same ability to raise the needed resources abroad as C Corporations do today?

I don't think we are talking about a matter that requires complete overhauling. It seems to me that we can achieve greater fairness, safety and opportunity by simply bringing the existing system into the modern age, the 21st century.

Again, I would like to thank the chairman for holding this today, and I would like to thank our witnesses again for taking the time out of their schedule. And I look forward to your comments and testimony today.

I yield back.

Chairwoman BEAN. Thank you.

We are now going to move to testimony from the witnesses.

Witnesses will have 5 minutes to deliver their prepared statements. The timer begins when the green light is illuminated. When 1 minute of time remains, the light will turn yellow. The red light will come on when your time is up.

And our first testimony is going to come from Cynthia Blankenship, who is vice chairman and chief operating officer of the Bank of the West in Irving, Texas. Bank of the West is a full-service independent bank specializing in customer service and small-business financing. She is testifying today as chairman of the Independent Community Bankers of America. ICBA is the only national trade association that exclusively represents community banks.

Thank you so much for being here.

STATEMENT OF MS. CYNTHIA L. BLANKENSHIP, VICE CHAIRMAN AND CHIEF OPERATING OFFICER, BANK OF THE WEST, IRVING, TEXAS, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

Ms. BLANKENSHIP. Thank you. Madam Chairwoman, Ranking Member Buchanan and members of the Committee, Cynthia Blankenship, vice chairman, chief operating officer of Bank of the West in Irving, Texas. I am also chairman of the Independent Community Bankers of America. I am pleased to have this opportunity to present the views of the Nation's community banks on S Corporation reform.

ICBA represents 5,000 community banks throughout the country. Bank of the West is part of a two-bank holding company with assets of $250 million. We have eight locations in the Dallas-Fort Worth metroplex.

Subchapter S businesses are found on Main Street, not Wall Street. Bank of the West itself is a Subchapter S entity. Many of our small-business customers are S Corps, as well.

For decades, community banks were completely shut out of electing S Corp status. In 1996, Congress passed the Small Business Job Protection Act that allowed small banks to elect S Corp status for the first time, starting in tax year 1997.

Unfortunately, many community banks continue to be obstructed from converting to S Corps and benefiting from Congress's intended relief because of technical rules and community bank-specific regulations.

Subchapter S is an important business option. There are more than 2,500 S Corp banks in the United States, representing one-third of the entire banking industry. My home State of Texas alone has 291 S Corp banks, which represents 44 percent of all the banks in Texas. Madam Chair, your home State of Illinois has 237 S Corp banks, which represents 35 percent of the banks in your State.

We must ensure our tax code is simple and does not unnecessarily impair small-business vitality and opportunities. ICBA urges additional Subchapter S reforms be enacted to keep pace with the growing small-business sector in America.

Currently, before making the S Corp election, community banks must first overcome difficult obstacles not faced by other corporate tax structures, such as the limited-liability corporations. The obstacles most often facing community banks include restrictions on the types of shareholders, the number of shareholders, the limitations on the options for raising capital, the complex treatment of the IRA shareholder, and the burden of the built-in gains tax.

ICBA recommends several reforms that would simplify the tax code and provide more flexibility. We recommend the maximum number of S Corp shareholders to go to 150. For all small businesses, raising capital is critical to start, survival and growth of the business. Arbitrary and restrictive limits on the number of Sub-S shareholders can jeopardize the ability for S Corps to raise capital.

By their nature, community banks were created by involving a large number of shareholders in the community. ICBA supports the bipartisan Community First Act introduced by Small Business Committee Chairwoman Velaquez that would increase the S Corp shareholder limit to 150 from 100.

We recommend allowing new IRAs as eligible S Corp shareholders. S Corp community banks seeking to raise capital are excluded from allowing new IRA shareholders. ICBA supports the bipartisan S Corporation Modernization Act, introduced by Representative Kind in the House, to address the IRA shareholder issue.

ICBA recommends allowing S Corp community banks to issue preferred stock. Current law only allows S Corps to have one class of stock outstanding. Community banks must maintain certain capital ratios to be considered well-capitalized for regulatory purposes. As a community bank grows in size, its earnings alone may not be sufficient to fund its growth. We recommend allowing a national limited-liability company bank charter. Community banks are small businesses, yet are often unable to use preferred business forms to other businesses such as the LLC.

Congress should also work to preserve the 35 percent top marginal tax rate on Subchapter S income. Maintaining cash flow is vital to the survival of any small business, and taxes are typically the second-highest expense after labor cost. During this difficult economic period, at a minimum, the current top tax rate of 35 should be preserved on both small-business Subchapter S and C Corporation income, not increased.

ICBA is concerned with the overly aggressive of IRS regulations and the threat of encroaching payroll taxes.

In conclusion, reforms to outdated and onerous Sub-S laws would provide a much-needed boost to many small businesses at a critical time. Additional simplification to the S Corporation area would go a long way in allowing community-based banks to convert to S Corp status, as Congress intended in 1996.

Thank you for allowing me to be here today.

[The prepared statement of Ms. Blankenship may be found in the Appendix on page 29.]

Chairwoman BEAN. Thank you for your testimony.

And we are now going to move to Rick Klahsen, who is managing director and partner of RSM McGladrey in Bloomington, Minnesota. RSM McGladrey is a leading national business consulting, accounting and tax firm that focuses on mid-sized companies. He is here to testify on behalf of the S Corporation Association. The S Corporation Association is the only organization in D.C. exclusively devoted to promoting and protecting the interests of America's 3.8 million S Corp owners.

Thank you for being here today. And I apologize to you, and all of you, if I sneeze during your testimony.

STATEMENT OF MR. RICK L. KLAHSEN, MANAGING DIRECTOR AND PARTNER, RSM MCGLADREY, BLOOMINGTON, MINNESOTA, ON BEHALF OF THE S CORPORATION ASSOCIATION

Mr. KLAHSEN. Thanks.

Chairwoman Bean, Ranking Member Buchanan and other members of the Subcommittee, thank you for the opportunity to testify today.

My name is Rick Klahsen. I am a managing director in the national tax department of RSM McGladrey and the national service line leader for tax advisory and compliance. RSM McGladrey, when combined with McGladrey & Pullen, is the fifth-largest business consulting, accounting and tax firm that focuses on mid-sized companies. I also serve on the board of advisors for the S Corporation Association and submit my testimony today on their behalf.

I want to thank you for holding this hearing, and I ask that my full testimony be inserted into the record.

Before Congress created S Corporations, entrepreneurs had two basic choices: They could form a basic C Corporation and face two layers of Federal tax, or they could form a partnership and put all of their personal assets at risk. The creation of the S Corporation in 1958 gave small-business owners a better option: a single layer of tax with full liability protection.

How significant was the creation of Subchapter S? Nearly a half-century later, S Corporations are the most popular corporate structure in America, with twice as many firms as C Corporations.

This growth has created its own challenges. The number of S Corporation returns has increased from less than 500,000 in 1978 to more than 4 million today. At the same time, the number of regular C Corporations peaked in 1986 at 2.6 million and has declined steadily since then.

The growth of pass-through businesses, coupled with the decline of C Corps, has shifted an increasing amount of business income from the corporate tax code to the individual tax code. This means that tax policy for businesses is increasingly affected by changes to the individual tax code. We believe policymakers in Washington need to be acutely aware of the dynamic between the individual tax rates and business income as they consider broad-based tax reform.

The growth of limited-liability companies and the need to update rules dating back five decades combine to make S Corporation reform an important part of any tax code reform. Over the years, the S Corporation Association has worked with policymakers and Congress, as well as allied trade associations, to develop a list of critical reforms Congress should consider.

These legislative priorities are included in House Bill 4840, the S Corporation Modernization Act, and its companion bill, Senate's 3063. Introduced by Ways and Means Committee Congressmen Ron Kind and Jim Ramstad, the bill is designed to simplify rules under which S Corporations operate, and it is endorsed by an impressive group of business associations.

Another bill is House Bill 3874, the Small Business Growth and Opportunity Act, introduced by Congressman Steve Kagen. The proposal would decrease the holding period of assets subject to the built-in gains tax from 10 years to 7 years. This latter provision is particularly important as Congress examines what provisions might be included in a possible stimulus package.

The built-in gains tax applies to any appreciated asset held by a corporation converting to S Corporation. Under built-in gains, these firms are required to hold these assets for at least 10 years or be subject to a punitive level of tax.

Hundreds of thousands of S Corporations nationwide are likely sitting on locked-up capital, as they cannot access or redeploy these assets due to prohibitive tax implications of built-in gains. In an economy where a 1 or 2 percent change in growth can mean the difference between a recession and moderate growth, eliminating that lock-in effect and allowing those assets to become fully productive could be significant.

Another challenge to the S Corporation community is a proposed reduction in the tax rate to C Corporations. The approach outlined in Treasury and in Congress would reduce the marginal tax rates on corporations while broadening the tax base.

The challenge is that many of the businesses that use Section 199, LIFO accounting, IC-DISC and other tax benefits eliminated as part of the base broadening are not C Corporations. In other words, the effort to cut the marginal tax on C Corporations would also significantly raise taxes on S Corporations and partnerships.

The S Corporation Association has met with the tax staffs at Treasury and Ways and Means Committee to discuss this adverse outcome for pass-through businesses.

A final important issue to the S Corporation community is how to appropriately tax income earned by S Corporation shareholders who actively work at their business. The S Corporation Association appreciates the concern that certain taxpayers are paying less than their fair share of payroll taxes. However, the IRS already has the tools necessary to identify these taxpayers and to force them to pay the correct level of tax.

While applying these rules may be time-intensive and costly, alternative proposals risk raising payroll taxes on family-owned businesses already fully compliant with the law. Getting the solution right to this challenge is important, and the S Corporation Association looks forward to working with the Ways and Means Committee and the Small Business Committee to ensure whatever reform is enacted does not adversely impact law-abiding business owners.

Chairwoman Bean, the S Corporation Association and I greatly appreciate the opportunity to testify today and to highlight various issues of concern to the S Corporation community. I thank you for the opportunity, and I am happy to answer any questions you might have.

[The prepared statement of Mr. Klahsen may be found in the Appendix on page 40.]

Chairwoman BEAN. Thank you for your testimony. You have raised some of the things I know we want to ask more questions about.

And now we would like to introduce Mr. Kerr, who is senior director of Government relations at the National Association of Enrolled Agents. He represents the interests of enrolled agents who are tax practitioners licensed by the IRS and serves as their liaison to the IRS. The National Association of Enrolled Agents is the professional society that represents 40,000 enrolled agents nationwide.

Thank you for being here.

STATEMENT OF MR. ROBERT KERR, SENIOR DIRECTOR OF GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. KERR. Thank you, Madam Chair, Mr. Buchanan, members of the Subcommittee, for the opportunity to testify before you today. My name is Bob Kerr, and I am the head of government relations at NAEA.

Enrolled agents are the only tax practitioners for whom IRS directly attests to their competence and ethical behavior. NAEA represents the interests of some 46,000 enrolled agents across the country. Our members usually work with those on the smaller end of the small-business scale and more typically see gross incomes in the tens of thousands, rather than the tens of millions.

I will discuss two issues today, reasonable compensation and record-keeping, and provide several approaches that would help S Corps and, to some extent, all small businesses operate more easily.

One of the advantages of an S Corp is that shareholder employees can receive both wages and profit distributions, both of which are subject to the shareholder's personal income tax rate, but only the wages are subject to payroll taxes. Not surprisingly, the tax advantage for distributions over wages leads to challenges for the corporation, namely in determining what constitutes the reasonable compensation required by IRS.

In the absence of clear guidance, people disagree on what constitutes "reasonable," and many EAs find themselves enmeshed in or refereeing, shall we call, spirited conversations with their S Corp clients as a result. Meanwhile, other small S Corps are completely unaware of the reasonable compensation requirements, which can lead to very unpleasant surprises during an audit.

With respect to reasonable comp, EAs and others are in a quandary when asked what is reasonable or when suggesting to a client that his comp is in fact not reasonable. I know there are those who believe that treating S Corp and partnership income similarly would solve that problem. I am not at all certain that we would buy into that solution, however.

At the same time, in the absence of a significant fix right now, we suggest that practitioners and S Corps could be helped by practical IRS guidance in determining what is reasonable compensation. This could take many forms, so we suggest an audit technique guide may be appropriate.

As to my second point, I can't imagine I am the first person to come before this Committee stating that record-keeping is the bane of a small-business man's or small-business woman's existence. Record-keeping is burdensome, and the code requires small businesses to keep a myriad of records. For instance, Section 274(d) requires stringent documentation for deductions both for cell phone use and for business use of an automobile. Section 280(a) requires in-home offices to be used for business activities solely and for deductions to be made as a proportion of the entire home. Further, there is no de minimis amount for expensing rather than depreciating business assets.

At the end of the day, small-business owners are not tax experts, though the complexity of our tax code really does dictate that small businesses retain tax experts to advise them of their obligations and to help them take advantage of tax code provisions such as Section 179 expensing or the business provisions of the recently passed stimulus bill.

NAEA has advocated for years for simplification wherever possible in the tax code. To that end, we applaud and encourage the conversations recently under way with respect to a safe harbor for in-home offices, and particularly note Chairwoman Velaquez's bill, H.R. 46. Further, Chairman Rangel in H.R. 5719 recently proposed removing cell phones from the Section 274(d) listed property, which is a move that would dramatically lower record-keeping requirements. We enthusiastically support such provisions.

Now, if I may be so bold, S Corps and small businesses would be greatly assisted if Congress measured complexity and gave it weight when considering various tax law changes. Further, both the IRS and tax professionals are well-placed to provide the information to S Corps and to small businesses as they organize. EAs far too often find these businesses in tax trouble not because of malice aforethought, but because of sheer ignorance or because of bad advice from unqualified preparers.

Congress could act to improve competence in the tax preparation industry by enacting H.R. 5716, the Taxpayer Bill of Rights, introduced by Representative Becerra. We believe that greater competency leads to better advice and better compliance.

For its part, in recent years, IRS has made decided efforts to educate small businesses, and should be supported and encouraged as it moves forward and as it continues to balance its compliance obligations with its assistance obligations.

This concludes my testimony. I will be happy to answer questions.

[The prepared statement of Mr. Kerr may be found in the Appendix on page 47.]

Chairwoman BEAN. Thank you for your testimony. You are certainly not the first one to bring up record-keeping as burdensome.

Mr. KERR. Didn't think I would be.

Chairwoman BEAN. We would now like to hear from Kevin Anderson, who is partner of the National Tax Office of BDO Seidman, LLP, in Bethesda, Maryland. His practice is focused in the areas of mergers and acquisitions, corporate structure and related tax accounting issues. BDO Seidman, LLP, is a national professional services firm providing assurance, tax, financial advisory and consulting services to his client companies.

Thank you for being here.

STATEMENT OF MR. KEVIN D. ANDERSON, PARTNER, NATIONAL TAX OFFICE, BDO NEIDMAN, LLP, BETHESDA, MARYLAND

Mr. ANDERSON. Thank you. Good morning, Madam Chair, Ranking Member Buchanan, members of the Committee. I am Kevin Anderson, and I am pleased to have this opportunity to present my own views on S Corporation reform and expansion.

I do wish to emphasize that I am here to offer my own personal views based upon my own experience, and I am not here to advance the interests of any particular client or those of my firm.

While it may come as a surprise to my other panelists, I am really not here to advance or oppose any particular provision but, really, to provide a little bit of guidance as to how I think Congress may wish to consider some of the proposals that are before them. I have an abiding interest in tax policy and have been a member of the Treasury Department Office of Tax Policy back in the 1990s.

The S Corporation has always had some features common to both corporations and partnerships, as you can tell from the other testimony that we have heard this morning. The flow-through regime, of course, is borrowed from the partnership area, whereas many of the other provisions are borrowed from the C Corporation area, and many of the rules that apply to C Corporations also apply to S Corporations.

And so, because an S Corporation has features that are common to both of the worlds, the partnership world and the C Corporation world, it is hard to know which of the provisions we would like to borrow from. Is it going to be a best-of-both-worlds scenario for S Corporations?

With respect to the issue of parity, for example, one of the objectives of this hearing, I would simply ask, what it is do we want parity with? Is it parity with business income? Is it parity with partnerships? Is it a parity with C Corporations? Is it, as I mentioned before, sort of a best of both worlds?

We have talked a little about tax rates. Other panelists have talked about the prospects for changes in the corporate or individual tax rates. And I think there is going to be some stress upon the S Corporation model if C Corporation rates go down or if individual rates go up after 2010, as they are scheduled to do, for example. So I think that those are one of the policy considerations that we will have to consider.

Clearly, any provision which makes the S Corporation form more readily available is going to have revenue implications. And in this day and age, sometimes we try to pay for things with offsets; sometimes we don't. But every provision in the last 10 years that has expanded the scope of the S Corporation model has been scored by JCT as a revenue loser. So that is also something that needs to be taken into account.

We have talked a little bit about simplicity. Simplicity is evidenced by the single class of stock requirement for S Corporations. And many of the provisions, quite frankly, that we are talking about here may actually make S Corporations more complex to comply with. And so one must not lose sight of simplicity.

Also would not like to lose sight of the small nature of S Corporations. They are, after all, in the code referred to as small-business corporations. But I think the documents that have been circulated for this hearing have made it clear, correctly, that the only way that S Corporations are kept small is through shareholder limitations and not by restrictions on their revenues or assets or their employees or the size of the business per se. So, at some point, we may have to consider thinking these are no longer small-business corporations, although many of them will continue to be.

We need to make sure that S Corporation income is taxed currently, as most of the provisions in the code already do, even for tax-exempt organizations. But the only exception that is contained in the existing rules are for stock owned by an employee stock ownership plan, or an ESOP.

Finally, we have talked a little bit about the built-in gains tax, which is a measure that addresses the so-called General Utilities repeal back from 1986. I think the big elephant in the room is that we do not tax conversions per se of C Corporations to S Corporations, whereas we would impose full measure of taxation on a conversion from C Corporation status to partnership status. And it is for that reason that we have a built-in gains tax. Quite frankly, 10 years was arbitrary. Seven years is just as arbitrary. The only thing that it has to advance it is that it is shorter than 10 years.

I will skip discussions about the specific proposals, although I would be happy to address them in questions and answers. I do appreciate the opportunity to provide my views. I think it is an important matter for the Committee, the Subcommittee to address. And I will be happy to address questions at a later time.

Thank you.

[The prepared statement of Mr. Anderson may be found in the Appendix on page 50.]

Chairwoman BEAN. Thank you very much for your testimony.

And now Congressman Buchanan is going to introduce our last witness, Byron Shinn.

Mr. BUCHANAN. Thank you, Madam Chair.

I am excited today we have someone from our congressional area. He has been a very highly regarded professional and business leader in Florida. He has worked as a public accountant for 30 years. He has his own firm, and his firm is a Sub S, so he knows a lot about Sub S's.

He is president of the CPA firm Shinn & Company located in Bradenton, Florida. He has been the past chairman and board member of the Florida State Board of Accountancy and also the past chairman of the Manatee Chamber of Commerce in our area, which is a good-sized county.

I welcome your testimony today. It is great to see you.

STATEMENT OF MR. BYRON SHINN, PRESIDENT, SHINN & COMPANY, P.A., CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS, BRADENTON, FLORIDA

Mr. SHINN. Thank you. Good morning, Madam Chairman, Ranking Member Buchanan and members of the Committee. My name is Byron Shinn. I am a CPA in Florida. I graduated from the University of South Florida in 1979, and I have worked in public accounting since my graduation.

I am currently a shareholder of a small-business S Corp, as Congressman Buchanan mentioned. I currently serve on the Probable Cause Panel of the State Board of Accountancy, where we have reviewed complaints against licensees. I am also on the advisory board of the University of South Florida's School of Accounting, and I have previously served on the National Ethics Committee for the National State Boards of Accountancy.

I wanted to talk to you as someone who is on the ground, in the trenches, dealing with small business. As a CPA that is face to face with those owners, over these last 30 years as we deal with what entity to be, once they have elected Sub-S, we have a distancing, if you will, between a C Corp and an S, and then you have partnerships.

And several years ago, Wyoming started the LLCs. LLCs then were supported by the IRS in the late 1980s to be acted on and treated like a partnership. So for those older entities that are still S Corps that would like to go to an LLC, we have a tax trap. We have cured tax traps in most places to help the businessperson run their business. We have a situation where we are moved from a C to an S by an election. We have a built-in gains tax that prevents abuses. We have opportunities for owners to move from a sole proprietorship to a partnership. And there is the disguised sale rules that have a 7-year period. So the opportunity to move built-in gains to 7 years is a convergence of similarities, similar to what we have done with fringe benefits.

I would like to point out that maybe, as we sit here and tinker with a lot of tax law and it becomes harder and harder, maybe we ought to just keep it simple. Why don't we provide an opportunity for them to make an election to move from an S, which they did back in the 1970s or 1980s or 1960s—it goes back to 1958—and allow a bridge for them to move to an LLC and operate as a partnership? Why wouldn't they want to do that? It is better raising of equity. You have disproportionate distributions. Or you can have a broader source of ownership. You can have partnerships. You can have IRAs. You can have other Sub-S's as owners of an LLC. But a partnership can't own a sub-S. So therein lies the trap.

Now, how do you avoid the abuses? Put in something similar to a built-in gain, the disguised sale rules. Just basically say, move the assets from a Sub-S to an LLC. And if you do it and you do it in whole, as long as it stays in that sphere of business assets in that entity, if you want to take it out, you want to distribute it out, you want to reshape the business, yeah, you ought to tax the heck out of them, just like you would in a normal situation. But if you are keeping the business in a hole, trying to make a go of it and raise capital—the other thing that is a real problem with S Corps is the opportunity—every small business goes through its ups and its downs.

You heard from the bigger S's, the banks. Well, they are having losses right now. The limitation on shareholders taking losses is limited to the basis in their stock. I know that is a tax terminology. But in a partnership or an LLC world, you can share in the debt generally as part of their basis to take losses. In a Sub-S, the shareholder is guaranteeing those debts. Those guarantees don't count as basis. That corporate debt doesn't count as basis. Why is that? It doesn't make sense. When I explain this to the owners of those companies that are S Corps, they scratch their head, and they say, it doesn't make sense.

Again, raising equity is very, very important. Whether we like it or not, there are pockets of prosperity right now, but we are in a recession. I am from Florida. It is real severe. In places it is worse than others. I am on the west coast of Florida. We are very real-estate-oriented. And unfortunately it has taken its toll.

As people look to try to get equities into their businesses, if you are an S Corp, it is really, really difficult because those investors want a preferred rate of return. They might want convertible debt. Those two items are not allowed in an S. They could trigger a termination.

One thing that was mentioned earlier was the abusiveness of payroll taxes in an S Corp. And as I have seen taxpayers come to me asking for my help, I have seen situations that are abusive. And I don't want to beat up on the small business. It is so hard to make a buck and do your part and make your payroll, pay the rent. A lot of my S Corps aren't the really large businesses that you referred to. I am in the ditches with the smaller businesses. I don't have any public companies as clients. I don't want them. I want to have the big four and the BDO Seidmans do those. But they are doing smaller businesses too.

Another thing I want you to think about is the passive loss rules. Right now in an S Corp, you maintain their identity. If you own your business and you have a building you are in, and you are renting out part of that building to a third party, your operating profits or losses are maintained separately. Those losses are currently limited. As real estate takes its hit and our banks go through their struggles, it is real important, I think, to allow for at least some tax savings to these small businesses. Because of the losses that are incurred, ought to be getting current tax benefits. It might take some of the pressure off the foreclosures we are seeing.

And lastly I listed in some of my written testimony some items of accounting method changes, some of which are currently in bills and had been discussed. The bonus to appreciation I fully support. The increase in the 179 expense, absolutely. And please just don't do it for 1 year. Make it stick; let it last for a while. The small-business person keeping up, they have to pay for the accountants. And it is part of their—how many times have I been told I am just administrative overhead.

Also, the write-off of bad debts. Banks are allowed to do reserves. Small businesses, we have to only write off the receivables when they go bad. But there is a history of percentages. We ought to think about it.

And lastly, the restauranteurs. The ones that get hit really tough, the FICA tip credit. We have a wonderful area for opportunity, but it is so narrow. If the restaurant is losing money, they don't get any benefit from it. If they are making too much, they can't get to it. The window to use the FICA tax credit is so small that it is almost useless. It is really sad.

So, lastly, I wanted to mention finances, since you are Finance and Tax. And I can get going on taxes, but as far as finances, the banking industry, because of the easy credit that was through the last few years and how we have gotten ourselves into this situation, the regulators have now come back and been very, very tough.

And all these small businesses—remember, most of these small businesses had to personally guarantee these loans. They also probably had to put up their houses as collateral. Well, as these houses—excuse me.

Chairwoman BEAN. You are starting to run out of time.

Mr. SHINN. Sorry.

So this equity is now gone. And they are really in a bad situation from a banking perspective.

So thank you for this time.

[The prepared statement of Mr. Shinn may be found in the Appendix on page 60.]

Chairwoman BEAN. Thank you for your testimony.

I guess, Mr. Anderson, you reminded us of some of the potential perils of rushing toward change too quickly. The rest of our witnesses were mostly advocating for specific changes. And I guess what I would like to do is challenge those of you who are recommending changes, is there a change that you would recommend against, that you can understand the rationale for some of the existing structure. If you have one, I would like you to share that.

And conversely, Mr. Anderson, any that you do think is antiquated by today's standards and current situations that you would say is something that you think is worthy of consideration for change. I will go to you first.

Mr. ANDERSON. I would be happy to go first and point to the written testimony that I had prepared and indicate that the passive income threshold is probably something that does merit an increase.

And, in my testimony, I indicated that I thought if there was a reason for the tax in the first place, is that it has analogies to the personal holding company tax for C Corporations. And although, as I mentioned, the thresholds are different, the terminology is different, the PHC tax kicks in at a 60 percent threshold. And I believe that is really why folks are advocating an increase from 25 to 60 percent.

That is probably at the top of my list.

Chairwoman BEAN. Okay. Thank you.

Does anyone else have any that they would want to preserve that are important differentials between the different types of entities? Mr. Kerr?

Mr. KERR. Absolutely. I mentioned in my testimony that some folks are interested in getting a real parity between partnerships and S Corps. Now, there are benefits to an S Corp; there are benefits to partnerships. And I think there is an attraction to the simplicity of the solution that we will just make them equal. But I would caution rushing in that direction without thinking real hard about why we have these two structures in the first place. And if we are going to move in that direction, then perhaps a semi-crazy notion is, well, let's just have one instead of two.

Chairwoman BEAN. Thank you.

Ms. Blankenship?

Ms. BLANKENSHIP. Well, I would like to recommend that 35 percent marginal tax rate be kept in place, because if you go back to lowering the tax rate on the C Corporations, then it really penalizes the S Corporations. And the S Corporations, by virtue of their entity structure, allow those small businesses to build greater equity and retain greater equity because of the tax structure.

And if you go back to decreasing the C Corp top level tax rate, then it would encourage, you know, maybe a flip-flop. And that is the last thing that you would want the small-business community to have to deal with, is going back and making those conversions back and forth.

So we need to continue to encourage that top marginal tax rate on the Subchapter S income and it not be increased, so we can continue to build our equity.

Chairwoman BEAN. Thank you.

Mr. Shinn?

Mr. SHINN. That is why I made the comment, if you can't—in trying to converge and bring together, like we have done with fringe benefits, it is going to be very, very difficult. But at the advent of the LLC, you have the corporate protection but you have the partnership flexibility from running the business and growing equity. And that is why I threw out the idea of trying to build some kind of a bridge where the S owner could think about—in certain situations, be allowed to go to an LLC form. Still a corporation for State charter purposes, but then give them the flexibility to operate its business.

And as long as they do it where they are moving the whole business, defer the tax, similar to the built-in gains, similar to the disguised sale. So you can still avoid the abusiveness but still get to the business focus.

And I challenge you to try to come up with something that would work, because that will open up a lot of opportunities for the small-business person that is running their business.

Chairwoman BEAN. All right. Thank you.

Mr. Klahsen?

Mr. KLAHSEN. In some respects my comments will echo those of Ms. Blankenship, in terms of the change that I would propose not be implemented is the change of the corporate rate to a lower rate than it currently is. I think the parity of the rates, the highest individual tax rates and the corporate rate, cause people to do things, you know, for more appropriate reasons. They aren't influenced solely by tax reasons.

And if you look at the proposed drop in the corporate tax rates and the offsets to pay for that, it has the potential impact of—if the individual rates increased to, say, 39.6 percent, you lose some of the benefits: the domestic manufacturers deduction, LIFO accounting, IC-DISC. The combination of those would result in a significantly higher rate of tax for S Corporations and other pass-throughs as compared to C Corporations. And we would, as a result, influence people's behavior, I believe, in inappropriate means.

Chairwoman BEAN. All right. Thank you.

Mr. Buchanan?

Mr. BUCHANAN. I am just going to open it up with the same thing. One of the things I think that with pass-through incomes on S Corps and LLCs, that we have to have a better understanding up here. I happened to be chairman of the Florida Chamber. We represented 137,000 businesses. Most of those businesses, 95 percent, were 50 employees or less. So you have a lot of LLCs, you have a lot of Sub S corporations.

But one of the things I try to get people to understand—some do understand—if we raise taxes in general, up from 35 percent, that a lot of people that are in these small businesses that are personal tax rates up to 40 or 45 or 43 percent, a lot of this money, you know, ends up affecting all the small businesses. In turn, they can't buy the equipment and capital.

Most people I know—and I have seen zillions of them, as you have—have made $400,000, let's say, at the bottom line. But when you really look at it, by the time they spend some money on capital and some other things, maybe some debt, the capital are retiring, debt in their business and other things, they really end up maybe with $100,000. They have added, you know, a couple other employees, that type of thing.

So I would like to first just have you comment on the impact it would have on small business, of any kind of a tax increase on personal income, you know, your thoughts on that. If we went from 35 to 39 or 45 to 44, what does that do to your businesses, your clients, small business in general?

And you start off wherever you would like to start there. Mr. Kerr?

Mr. KERR. I was really rather hoping not to go first on this one.

Mr. BUCHANAN. Yeah.

Mr. KERR. In the main, of course, it is difficult to sit here and ever advocate for higher taxes in any sense. So I don't think that I am going to start doing so.

I certainly see the concerns and the interest in keeping the marginal rates the same, the 35 percent. It could be an environment to consider, well, is there a way to broaden the base and lower the rates on both sides? Now, obviously, that is an issue that is decided elsewhere, but I just want to throw that out for consideration. Otherwise, I don't really have anything to add to that.

Mr. BUCHANAN. Okay.

Anybody else want to add a comment on that?

Mr. KLAHSEN. Mr. Kerr referred to the broadening of the base and potentially lowering the rates. I think we need to be careful of the end result of that. And I believe that is perhaps where you were going, Mr. Buchanan.

There is a great appeal to the sound of reducing a tax rate from 35 to 30 percent. But if the result of that is that a great number of things are taken out of the tax code in terms of deductions or potential benefits and ultimately the tax burden increases, that is the burden that the small-business owners feel. They don't attach so much to what is the rate; it is, what am I paying.

Mr. BUCHANAN. I guess what I was trying to get at, I have just seen over the years, someone makes $500,000 and they always say, well where is my liquidity? Where is my cash? Well, they have paid out a third in taxes. They have made some additional investments in equipment that they write off over 5 years, that is gone. They have added some additional inventory. Before you know it, they have made $500,000 in a sense on their tax return, but they have $50,000 in the bank. That is what happens, I have seen over the years.

Mr. Shinn, do you want to comment any more on that?

Mr. SHINN. Yes. I think where you are headed with the bonus depreciation and the increase in the 179 deduction is a great start. But some of the opportunities for more installment sales on sale inventory, things like that, would allow them that opportunity where the cash flow and the payment of the taxes are more in sync.

Mr. BUCHANAN. Okay.

I want to shift over to the other thing on the S Corp and the LLC. It just seems like there is—I know there are benefits on both sides, and I haven't paid as much attention on the S Corp, because it seems like everything I have done in the last 8, 10 years, we have been pushed—everything has been LLC, because of I think the flexibility.

But what is the biggest difference? Is the S Corp, is there any sense that that could be obsoleted? Or is it because of the shareholder's ability to raise capital? You know, it just seems like the LLC, everybody I am talking to—now, maybe it is because there are only two, three owners—everybody is moving to LLC. That is just what my tax attorneys and tax people have been pushing me to, and I hear a lot of my friends are moving to that. They own businesses. I would be interested to see what the S Corp was 10 years ago, the numbers, and then what it is today. And maybe it is because of business, in general, it is up.

But, Byron, what is your feeling? What is the big difference? What do you find with small business from the S Corp and the LLC? Because everybody used to do the S Corp; now everybody, it looks like, is in the LLC.

Mr. SHINN. Once the States have had some litigation and people see how the safety of that corporate insulation, they have gotten comfortable with it. And you see more and more people going with they are operating companies that way. If they are in LLLPs or LPs, they still might do a LLC that is going to be the general partner and they will elect S as the general partner. So there are still opportunities for S as a managing partner of a large, limited-liability partnership or an LLC that is, for tax purposes, being treated as a partnership so the managing member might end up being an S Corp.

The other thing that really stands out with that, small businesses usually lose money when they first start out, and losing money cash-flow-wise. That is the investment you talk about of the assets and the loans and the inability to deduct those losses. And the IRS has time and again held true to S Corps. They don't want to allow guaranteed debt as basis. They don't want to have co-makers. So if Byron signs a loan, Byron Shinn and Shinn & Company, it is not allowed. They want me to borrow the money individually and then put it into the business. It has to be that refined.

And there has been so much case law on this. It is abusive from a standpoint of really hamstringing those S Corporate owners. So why do they go to the LLCs? Just because of that.

Mr. BUCHANAN. Mr. Anderson, any comment? Just in term of your thought on S Corps and LLCs, I am sure they have a different role, but is the shift in general for small businesses and entities with three, four, five, 10 shareholders, are they doing more of an LLC? Or does it just depend?

Mr. ANDERSON. Well, I think the advice that we give to our clients really depends upon whether we are talking about an existing entity or a newly formed entity.

From my perspective, although I love S Corporations, I am the first to acknowledge that an LLC taxed as a partnership is probably the most flexible vehicle for a newly formed entity.

But when you are converting an existing C Corporation, I think the S Corporation is the only game in town, quite frankly, for the reasons that I mentioned this in my testimony. And that is that when you convert a C Corporation to an S Corporation, there are no immediate—and I emphasize immediate—tax consequences. But if you were to convert an existing C Corporation to an LLC taxed as a partnership, the consequences could be disastrous.

And so we preserve the C Corporation attributes by converting to S Corporation status.

Mr. BUCHANAN. Is that something that should be looked at? I mean, should a C Corp have the same opportunities as an LLC? I mean, in terms of that conversion? I mean, you can move to an S Corp but you can't move to an LLC. Is that something that makes any sense?

Mr. ANDERSON. Well, I think that there had been proposals floated over the past several years that would go either way. For example, some proposals would say if you are going to make an S Corporation conversion, a C to S conversion, and you are of a particular size, we will tax that as a fully taxable liquidation. Great for simplicity but terrible for the business itself, if you happen to be the one converting.

On the other hand, there have been proposals that would cause a C to S conversion to be treated as a nonrecognition event. There are partnership provisions that would be built into those provisions that would preserve the gains at the entity level so that they are ultimately taxed somewhere.

But I have to submit that those are very, very complex. There is nothing really more complex than the partnership gain and loss allocation provisions. And, again, do we want complexity? Do we want it to be simple? We are really caught here, because we have lots of history and just, quite frankly, no way to go. It would be tremendously complex, I think, to allow conversions from C to S status and give them the equivalent of partnership status.

Mr. BUCHANAN. Mr. Klahsen, let me just ask you your thought. You are the S Corporation Association. What is happening with the trend lines? Because I still have probably some of the old S Corps, but are people, new entities, are they moving more to the LLC?

Mr. KLAHSEN. Actually, the numbers are quite interesting. The number of S Corporations continue to increase, as Mr. Anderson points out. A number of those are conversions of C Corporations. But, as I recall the most recent numbers, the annual increase in S Corporations are about evenly split between newly created S Corporations and those that have converted from C Corporation status.

And the reasons are varied. I think Mr. Anderson touched on a number of them why certainly that conversion, that is the way to go if you are currently a C Corporation. There are other instances where S Corporations provide a simplicity and a clarity. And I know that is a little bit contrary to what we have been talking about today. But if your alternative is partnership, things can become very, very complex very, very quickly. And so for some entities, the creation of an S Corporation, as opposed to an LLC or specifically a partnership, is still an appealing way to go.

Mr. KLAHSEN. Mr. Kerr, I want to just touch real quick on the bookkeeping, the IRS. How does the IRS treat, you know, a Sub-S over another entity, in terms of auditing? Is there a difference from your standpoint? Just out of curiosity.

Mr. ANDERSON. I don't think our members see a difference when IRS selects an entity for audit, whether it be a partnership or whether it be an S Corp. As an aside, I think it is interesting--

Mr. BUCHANAN. I am thinking, like, a sole proprietor or just a small partnership or an S Corp. Do they treat an S Corp differently?

Mr. ANDERSON. Oh, okay. I was looking at the selection criteria.

Mr. BUCHANAN. I am not looking so much at the C Corp, comparing that. I am just curious, an S Corp, how that compares to a—

Mr. ANDERSON. I don't think so. Because, at the end of the day, many of the tax code provisions apply regardless of the entity that you have chosen. And IRS tends to be interested in those provisions, and they apply without respect to the structure of your company.

As an aside, the other interesting thing is that IRS is in the process of what they call an NRP, a national research project, in which they are focussing on S Corps. And they have selected 2 years of returns, I think, with 2002-2003. And I would expect that those results are coming out imminently. And I think that it may be interesting for those of us in this room to pay attention to what IRS has found in its rather detailed audits of about 5,000 S Corps.

Mr. BUCHANAN. Let me, just in my last question in general, is just the attraction, will a lot of companies, S Corps, be able to attract capital. You know, this is something we set up 50 years ago now today. There is probably opportunities, a lot of opportunities for foreign companies or foreign investors into S Corps, which I think is not allowed, I guess, from my understanding.

You know, what is your thought on that? Is that something that you think we have to consider and give them more capability, like a C Corp, to look at foreign investors and S Corps, in terms of them having access to capital?

Do you want to comment, Mr. Klahsen?

Mr. KLAHSEN. I would. I certainly would encourage consideration of measures that would increase the access to capital for S Corporations. And it can be done through a variety of ways. Increasing the number of share holders is certainly a possibility. Implementing procedures or changes to allow certain types of other equity investments, so-called quality. A qualified preferred stock would be another option.

Certainly, you know, going back to some earlier comments, some built-in gains and the implications of that, when those assets are subject to tax for 10 years, it causes the S Corp owners to hold those assets for an extended period of time and causes even greater complications in terms of their access to capital. In many respects, S Corporations are left with very vanilla means of accessing capital. And any provisions that could expand upon that I think would be certainly appreciated by the S Corp community. RPTS MERCHANTDCMN HOFSTAD[11:05 a.m.]

Mr. BUCHANAN. Any other comments on that that you want to add.

Mr. Shinn, I just wanted to ask one last question about passive losses. And I was interested, I know that Florida and I am sure Vegas and parts of California have been devastated about the whole concept, in terms of real estate values falling, the idea that a lot of people probably have passive losses they can't use, which would be helpful if we are able to free them up.

Give me your thoughts on passive loss in terms of S Corps. You know, would it make a big difference?

Mr. SHINN. Just like the one example I gave you where a business owns their building and they are renting out part of building, that particular loss is trapped in 469 part of the code. And I think that either allowing it to be part of—if the business is in the building, give them a break.

The other thing is with 469, as we sit here and we watch—that is because of the section for passive losses—we have really destroyed the opportunity for people to take the cash-flow losses that they have on their rental property. And let's say the person has their tile business and they lay tile in houses and commercial property, and so they decide to buy a couple of rental houses. Well, they have huge losses now, and some of those houses are maybe going to go back to the lenders. Instead, maybe give them the opportunity to take more of the loss. There is a $25,000 limit right now for low-income people. Maybe increase that amount.

But I think that our passive loss rules have created a real tax blunder, so that now we are faced with this real estate issue. Now, how does it spin with the small businesses? I have tried to give you some examples of two situations where small businesses—of a doctor office, they bought a bigger building, they only needed a quarter of it, but they put up the capital for the full building. And as they try to find tenants and the tenants can't pay and they are 2 months slow, they are incurring losses. And those losses aren't allowed to be deducted against their other income because of the passive loss rules.

Mr. BUCHANAN. Thank you.

I yield back.

Chairwoman BEAN. Thank you.

I would like to recognize the gentleman from Indiana, Mr. Ellsworth.

Mr. ELLSWORTH. Thank you, Madam Chair.

Just a couple questions. What do we know? We hear, in this Committee and the other Committees, about cash flow for small businesses. And I was wondering, Mr. Anderson and anybody else that wants to comment, if you have specific changes that might allow for more cash flow for small businesses and changes to the S Corp rules that would better help corporations, small businesses. And anybody can comment, but if you have specifics please.

Mr. ANDERSON. Well, I think we have alluded to some of those provisions before, but I will be the first to acknowledge that the things I would talk about are not unique to the S Corporation area. These are issues that are common to partnerships and also to C Corporations.

The examples that went back and forth between Mr. Buchanan and Mr. Shinn dealt with an entity that has to invest, make capital expenditures to grow its business. Those capital expenditures are not deductible for tax purposes but must be depreciated. And the two relief provisions are the bonus depreciation for 2008 only and the first-year expensing, which also has limitations.

Those are two provisions that more closely tie a corporation's taxable income to its cash flow. And it seems to me that if there is an interest in those provisions, perhaps they ought to be expanded, increased, in the case of the bonus depreciation made permanent, subject to revenue constraints and other similar considerations.

Chairwoman BEAN. Could you repeat the last part? You said expanded, increased?

Mr. ANDERSON. The point about the bonus depreciation is that it was enacted as stimulus only for 2008, and it will expire for property that is acquired after the end of 2008. It was part of the 2008 stimulus package. So, next year, a business making capital expenditures will have the first-year expensing under Section 179 but will not have the bonus depreciation under current law.

Mr. KERR. And then the 179 also is not permanent, so then you still have the problem of not knowing from year to year, which is frustrating and difficult for a small business or for any taxpayer to plan, if you don't know what the tax law is going to be.

Mr. ANDERSON. Well, the provision is permanent, but the dollar amounts will go up and down.

Mr. KERR. Yes, I am sorry. Yes, that is right.

Mr. SHINN. I would like to add that I concur that the bonus depreciation needs to be more than just a one shot, 1 year or 2 years, because, as Representative Buchanan made reference to, the businesses, you want them to reinvest to grow the business. That brings jobs. And, as we know, that is a big part of our GNP here.

I would like to point out, though, that, during those periods when you make large improvements to your business, you will incur a loss. And right now the 179 rules prevents you from creating a loss. I think you need to take that off. If they are going to make the investment, the bank is behind them, they are not going to make the loan right now, especially today, unless you have plenty of equity and you are signing on it personally.

That is why I come back to say, in an S Corp world, you need to allow that to be a basis and you need to take off the income cap limit for 179.

Mr. ELLSWORTH. Thank you.

It is my understanding that in S Corp they are only allowed one class of stock. Is that a problem? If it is a problem, what are the problems, and what can we do to rectify that?

And, Mr. Shinn, you are shaking your head. I will give you the first—

Mr. SHINN. Oh, absolutely. Right now you can have just voting and nonvoting. And when you look for a passive investor to infuse capital, let's say the banks just aren't there—and I have a situation right now with a marine business. The banks are scared to death of the marine business, and it is a big part of our business community. And so we are looking at equity to come in in a passive investment.

They want preferred guaranteed returns. They want convertibility of the debt to equity. And either of those cases would create a taxable event. That is why I am saying maybe it would be nice for them to bridge into an LLC or release those limitations so they walk and talk more similar to an LLC partnership environment.

So giving them the opportunity for preferred stock and allowing them to have disproportionate distributions. That is the terminology you will see in the court cases. Because right now it is just pro rata. If you are a 30 percent owner, you have to get 30 percent of the dividend.

Mr. ELLSWORTH. Ms. Blankenship?

Ms. BLANKENSHIP. Yes, for community banks this is critically important, because I heard today 2,400 banks in the Nation are sub-S. But when they want to go out and raise capital, they either have to dilute their current ownership, which sometimes would threaten their independence and the Main Street presence, you know, on Main Street America, in the community, or they have to sell out.

You know, because you have to give banks the ability to raise capital, because the more capital they can grow, the more they can infuse back into the community, of course.

And so, by extending that, by allowing a preferred stock or the conversion to the limited-liability charter in a tax-free transaction, particularly for community banks, would be very beneficial to the economy of Main Street.

Mr. ANDERSON. Mr. Ellsworth, I would just add that an S Corporation, even under current law, is not limited to simply issuing either common stock or plain vanilla debt, if you will. The current regulations promulgated by the Internal Revenue Service permit S Corporations to have a variety of, what I might call, equity-flavored instruments. There are some lenders who will lend if they can get options or warrants to acquire stock of the company. Obviously, if those warrants were ever exercised, there might be a terminating event for the S Corporation.

But lenders can participate in the upside potential of a company through acquiring some of these equity-flavored securities or instruments that do not violate current regulations. Employees can be incentivized through stock appreciation rights or stock options, and they are generally not considered to be shareholders and so don't violate any of the requirements applicable to S Corporations.

Mr. KLAHSEN. I would offer that while I agree with Mr. Anderson's comments, that there are certainly other things other than simply voting or nonvoting stock and access to equity in some respects in that manner, the introduction of an opportunity for investors to invest in preferred stock would greatly expand that capital access pool.

The opportunity to use some of the instruments that Mr. Anderson mentioned are honestly quite limited, and some of them do have the potential for terminating the S election, as he referred to. So the introduction of a preferred equity instrument greatly expands the investment community and improves the access to capital for S Corporations.

Mr. ELLSWORTH. Thank you.

Thank you all.

Madam Chair, I yield back.

Chairwoman BEAN. Thank you for your questions and your testimony.

I had a last question for Mr. Anderson. Under current law, certain shareholders of an S Corporation, as we heard many of you talk about, are taxed on their fringe benefits, while larger corporate entities, both for employees and owners, those are nontaxable benefits.

What do you think this does to the ability of those smaller S Corps to provide such benefits?

Mr. ANDERSON. Let me try to articulate what I think are the rules that apply to S Corporation shareholder employees. These are rules that apply to shareholder employees who have 2 percent or more of a company's stock, and they are simply treated as partners for fringe benefit purposes.

The biggest fringe benefit that most companies seem to provide to their employees would be health insurance. And under current law at least, there is, quite frankly, no significant distinction between the treatment of S Corporation shareholder employees and the treatment of C Corporation employees. While the fringe benefit is taxable to the shareholder employee, there is also an offsetting deduction that the individuals are entitled to claim. So, at the bottom line, if you will, there is probably no net impact to the shareholder employees.

The same cannot be said of the other type of fringe benefits that are provided. They are less significant, I think, in the mainstream than health insurance. And they would apply to such things as group term life insurance, disability insurance, some de minimis fringe benefits.

Beyond that, I don't think I can really comment. I don't see that S Corporations are coming to me, at least, or our firm and saying, this is a tremendous burden or a disincentive to conversion.

Mr. BUCHANAN. Just one question. I wanted to ask Ms. Blankenship, you had mentioned on behalf of the Independent Community Bankers that it is important or you would like to have considered going from 100 shareholders to 150 shareholders. I think I understand where you are going with it, but why don't you explain to myself and everybody else your thought there.

Ms. BLANKENSHIP. Well, I think I stated it in my testimony, but typically when community banks go out to raise capital, they go out into their communities, and they raise capital from a large number of shareholders in the community. Because they are not going to a broker on Wall Street. They are going to be partners with those people in the community. The community invests in the bank, and the bank invests, in turn, in the community.

And, you know, 100 shareholders typically is—it would take more than 100 shareholders in a typical community bank capital-raising transaction. So it just allows the viability of that Main Street community bank to be able to continue to partner in their community. And that is why it is so important for us to have the expanded number, expanded types of shareholders, because our own bank couldn't convert for 10 years because of those very restrictions.

Mr. BUCHANAN. I was just curious why you picked 150 and not 300 or 200? Is there any particular reason?

Ms. BLANKENSHIP. We would take 300.

Mr. BUCHANAN. Yeah, okay. Okay.

Ms. BLANKENSHIP. No, there is not a particular reason. You know, we were trying to be respectful about the limits and realistic. Other small businesses may not need that number because of the types of investors, but for community banks it is a little different animal.

Mr. BUCHANAN. We have in our area, and I am sure around the country, but in Florida it just seems like we have a new community bank a week opening up. And they do raise the capital, most of it, in the community.

Mr. BLANKENSHIP. Yes.

Mr. BUCHANAN. Thanks for your comment.

Ms. BLANKENSHIP. Thank you.

Chairwoman BEAN. Well, I want to thank you all for your testimony today. I think it provokes further questions, but we will probably have to ponder a little before we come up with those, and hope to follow up with some of you in the future.

I ask unanimous consent that members will have 5 days to submit statements and supporting materials for the record.

Without objection, so ordered.

And this hearing is now adjourned. Thank you.

[Whereupon, at 11:15 a.m., the Subcommittee was adjourned.]

MELISSA L. BEAN, ILLINOIS
CHAIRWOMAN

VERN BUCHANAN, FLORIDA
RANKING MEMBER

Congress of the United States
U.S. House of Representatives
Committee on Small Business
Subcommittee on Finance and Tax
2361 Rayburn House Office Building
Washington, DC 20515-6315

STATEMENT
of the
The Honorable Melissa Bean, Chairwoman
Subcommittee on Finance and Tax
"S-corps: Ensuring Parity, Growth and Development for Small Businesses"
Wednesday, June 18, 2008

Entrepreneurs face many challenges when starting their businesses. Small business owners must secure capital, develop their products and services, identify markets, and secure a workforce. One of the most important decisions they will make is how to structure or incorporate their company.

In the Small Business Committee we've explored business concerns about scarce capital, rising health insurance and gas costs. But what sometimes gets overlooked is how disparities in the tax rules for different types of company entities can have long term impacts on a business and its owners. Today's hearing will examine one of the most common business classifications in the tax code – the S corporation – and review suggestions for potential reforms that might better reflect the intentions of our tax code and more effectively support a growth economy.

In 1958, Congress created a corporate structure, known as the S corporation, to promote the growth of small businesses. As the S corporation has evolved, it has become a cornerstone of the small business community. Currently, there are approximately 4 million S corporations nationwide – up from 500,000 in 1985. These companies range from local community banks, to home businesses, to manufacturing firms.

Despite the growth in the number of S corps, there are concerns that certain requirements are either unnecessarily burdensome or create obstacles to expansion. Many of these provisions were written almost 60 years ago, and it is important that Congress revisit these measures to see that they are still best serving our nation's economic objectives.

One of the challenges for S corps—as with many small businesses—is raising capital. For instance, S corporations have limitations on eligible shareholders and investors. These regulations provide little flexibility in obtaining equity financing.

Small businesses also face challenges in offering health and retirement benefits. Currently, the tax code provides C corporations tax advantages unavailable to S corps when it comes to these types of programs. Would providing equal tax treatment improve the ability of small businesses to offer health insurance coverage and reduce the number of Americans without health insurance? Or should S corps change their corporate structure?

Today, we will hear testimony to examine these questions, and explore where changes might be advantageous. With our economy facing serious difficulties, it is more important than ever to ensure that our tax policy does not unnecessarily impede small firms' growth potential.

I'd like to thank our witnesses for coming here to share their experience and perspective on the issue of tax code disparities, and look forward to your testimony. I would now yield to Ranking Member Buchanan for his opening statement.

U.S. House of Representatives

SMALL BUSINESS COMMITTEE

Subcommittee on Finance and Tax

Wednesday, June 18, 2008

Opening Statement of Ranking Member Vern Buchanan

S-corps: Recommended Reforms that Promote Parity, Growth and Development for Small Businesses

I want to thank the chair for calling this important hearing to examine the challenges and possibilities facing S corporations as they strive to compete in the modern and global marketplace. I would also like to extend my thanks to our witnesses who have taken time out of their schedules to provide this subcommittee with the benefit of their experience and testimony today.

Today, we meet on the 50th anniversary of the passage of legislation permitting the formation of S corporations. For the past half century, S corporations have offered small business owners across the nation the ability to benefit from limited liability protection.

But as everybody knows, the times are changing. And what was right and proper fifty years ago doesn't always add up to what is right and proper today.

Back then it probably seemed good enough to make possible a business framework where the few owners would be able to prosper directly from their investment and avoid having their enterprises doubly-taxed by the federal government. Yet as we explore potential reforms that promote parity, growth and development for S corporations, I believe the following questions should be examined:

- First, should S corporations be given expanded legal protections?
- Second, should the number of owners permitted in S corporations be expanded from the current number (100 – a figure that frankly puzzles me) to one more relevant in the 21st century?
- Third, in a global economy where so much of American business is financed by foreign investors, should S corporations have the same ability to raise the needed resources abroad as C corporations do?

I don't think we're talking about a matter that requires complete overhauling. It seems to me that we can achieve greater fairness, safety, and opportunity by simply bringing the existing system into the modern age.

Again, I thank the chairwoman for holding this hearing and am looking forward to hearing the testimony. I yield back.

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U.S. House of Representatives

SMALL BUSINESS COMMITTEE

Subcommittee on Finance and Tax

Wednesday, June 18, 2008

Opening Statement of Full Committee Ranking Member Steve Chabot

S-corps: Recommended Reforms that Promote Parity, Growth and Development for Small Businesses

Madam Chairwoman and Ranking Member Buchanan, thank you for holding this hearing on reforming the rules that govern S corporations. I also want to thank our witnesses for being here today.

S corporations operate in virtually every business sector in almost every state. According to the U.S. Chamber of Commerce, more than 55 percent of all corporations file taxes as S corporations. The vast majority of those corporations are small businesses.

By choosing to organize as an S corporation, a small business owner receives the limited liability protection of a corporate shareholder, and an advantageous federal income tax structure, where the corporation does not pay income tax, but its profits are "passed through" to the owners, who report them on their individual tax returns.

The rules governing S corporations have not been significantly updated for several years. I am pleased that today we will hear testimony from witnesses who can identify reforms to help small companies compete better in our global economy. We look forward to hearing your ideas.

Again, Madam Chairwoman, thank you for holding this hearing.

Note: This statement was submitted for the record

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INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

Testimony of

Cynthia Blankenship
Vice Chairman/COO, Bank of the West

On behalf of the
Independent Community Bankers of America

Before the

Congress of the United States
House of Representatives
Committee on Small Business
Subcommittee on Finance and Tax

Hearing on
"S-Corps: Recommended Reforms That Promote Parity, Growth and Development for Small Businesses"

June 18, 2008
Washington, D.C.

Madam Chairwoman, Ranking Member Buchanan and members of the committee, I am Cynthia Blankenship, Vice-chairman and Chief Operating Officer of Bank of the West in Irving Texas. I am also Chairman of the Independent Community Bankers of America.[1] I am pleased to have this opportunity to present the views of the nation's community bankers on S corporation reforms and promoting the growth of small businesses. Community banks are small businesses, are independently owned and operated and are characterized by personal attention to customer service and lending to small business.

ICBA represents 5,000 community banks throughout the country. Bank of the West is part of a two-bank holding company with assets of $250 million. We have eight locations in the Dallas/Fort Worth metroplex. The other institution in the holding company is the Bank of Vernon with assets of $30 million located in Vernon, Texas which is an agricultural community. We serve the small business community with a strong focus on SBA lending and real estate.

Bank of the West itself is a Subchapter S entity. Many of our small business customers are Subchapter S businesses as well. Subchapter S businesses are found on Main Street, not Wall Street. Subchapter S status is an important part of the community banking landscape nationwide. There are more than 2,500 S corporation banks across the U.S. representing nearly one-third of the entire banking industry. My home state of Texas alone has 291 Subchapter S banks or 44% of all banks in Texas. Madam Chair, your home state of Illinois has 237 Subchapter S banks or 35% of all the banks in the State. Subchapter S continues to offer an important business structure option for small businesses and especially for community banks.

The FDIC's latest *Quarterly Banking Profile* reported that 82 banks converted to an S corporation in the first quarter of 2008 representing combined assets of $13.1 billion.[2] And Subchapter S banks pay their fair share of taxes. Taxes on S corporation income must be paid by the shareholders on their individual income tax returns regardless of whether the bank's income is distributed to the shareholders or not. For every dollar of Subchapter S bank income, shareholders pay on average 26 cents in federal income tax, plus additional state-level taxes.

Summary of Testimony

Subchapter S status is a vitally important business form across the small business landscape in America. S corporations represent the most common corporate entity in the U.S. More than 3.6 million small businesses choose to be S corporations and pay taxes at the individual shareholder level. Community banks are small businesses too and often elect to be S corporations. In fact, since banks were first allowed to elect Subchapter S status in tax year 1997, more than 2,500 banks have become S corporations. This represents nearly one-third of all banks nationwide.

The Independent Community Bankers of America has worked very hard over the years to ensure Subchapter S status is an available and efficient business form for community banks and their small business customers. While some obstacles facing community banks' ability to elect Subchapter S have been addressed by Congress in recent years, many onerous obstructions still exist. Small business development and growth is more important to America's economy than ever before.

Therefore, we must ensure our tax code is simple and does not unnecessarily impair small business vitality and opportunities. ICBA urges additional Subchapter S reforms be enacted to keep pace with the growing small business sector in America.

ICBA Recommended Subchapter S Reforms Include:

- **Increasing the maximum number of allowable Subchapter S shareholders to 150 from 100;**
- **Allowing new Individual Retirement Account (IRA) shares to be invested in Subchapter S entities;**
- **Allowing Subchapter S businesses to issue preferred stock;**
- **Reducing and reforming the Built-in-Gains (BIG) tax;**
- **Preserving the current 35% top marginal income tax rate on Subchapter S income and keeping the S corporation and C corporation top income tax rate in parity;**
- **Allowing community banks that are national banks to organize as limited liability companies (LLC); and**
- **Preventing unwarranted new Subchapter S threats from regulation to expand "TEFRA" and payroll tax burdens.**

ICBA strongly supports several important bipartisan bills in the 110th Congress that would help small businesses by reforming onerous S corporation rules and restrictions. These include:

- **The "Communities First Act" (H.R. 1869 / S. 1405);**
- **The "S Corporation Modernization Act" (H.R. 4840 / S. 3063); and**
- **The "Small Business Growth and Opportunity Act" (H.R. 3874).**

ICBA greatly appreciates the opportunity to contribute recommendations for Subchapter S simplification and reform. Small businesses are more important to our U.S. economy than ever before. ICBA believes additional S corporation reforms will improve the viability of more small businesses and community-based banks.

ICBA has conducted a comprehensive examination of needed simplifications measures and potential reforms in an ICBA/Grant Thornton LLP tax study that focused on restrictive S corporation rules.[3] ICBA is pleased that many of these simplification measures have been adopted by Congress over the years, and we continue to advance additional reforms. ICBA applauds the Small Business Committee's efforts to examining how reforms to restrictive Subchapter S corporation rules can allow more small businesses to benefit from a more user-friendly and pro-growth tax code.

Subchapter S Background

For decades, community banks were completely shut out of electing S corporation status. In 1996, Congress passed the Small Business Job Protection Act that allowed small banks to be eligible to elect S corporation status for the first time starting in tax year 1997.[4] Unfortunately, many community banks have been obstructed from converting to S corporations and benefiting from Congress's intended relief because of technical rules and community-bank specific regulations that could be addressed with tax simplification measures. This conclusion was further supported by a comprehensive General Accounting Office study in June, 2000.[5]

Notably, an additional 16 percent of all the small banks surveyed indicated that they were interested in making the S corporation election pending resolutions of the various Subchapters S glitches that prohibit using this tax status.[6]

Currently, before making the S corporation election community banks must first overcome some difficult obstacles not faced by other corporate tax structures such as Limited Liability Corporations (LLCs) while attempting to avoid disrupting their operations or disenfranchising many of their existing shareholders.[6] The obstacles most often facing community banks include:

- Restrictions on the types of shareholders;
- Restrictions on the number of shareholders;
- Limitations on the options for raising capital (e.g., inability to issue preferred stock);
- Complex and restrictive treatment of IRA shareholders; and
- Burden of the Built-in-Gains tax.

Addressing obstacles in the current tax law would enhance the ability of community banks and many other small businesses to utilize S corporation status as intended by Congress.

ICBA Recommended Subchapter S Reforms

- **Increase the maximum number of S corporation shareholders to 150.**

For all small businesses, raising capital is critical to the start-up, survival, and growth of the business. Arbitrary and restrictive limits on the number of allowable Subchapter S shareholders can jeopardize the ability of S corporations to raise capital. Notably, other business forms such as LLCs and partnerships have no restrictions on the number of shareholders. When the S corporation rules were first enacted, the maximum number of shareholders was 10.[7] Throughout the period 1976-1982 Congress increased the number to 35. The Small Business Job Protection Act increased the maximum number of eligible S corporation shareholders from 35 to 75 for tax years beginning after December 31, 1996.[8] The American Jobs Creation Act of 2004 increased the number of eligible shareholders from 75 to 100.[9] However, similar pass-through tax structures have no shareholder limits at all. Today, the rigid Subchapter S shareholder limits are still out of sync with the modern capital and operating needs of small businesses.

Reflecting their nature, many community banks were created by involving a large number of shareholders in a community to raise capital. This helps assure that the institutions are widely owned by members of the local communities they serve. The provision of the S corporation rules limiting the number of shareholders to no more than 100 often forces community banks that wish to become an S corporation to disenfranchise shareholders, severely limit ownership and its ability to raise capital in the future. Additionally, other corporate structures such as a LLP or LLC do not have any limitation on the number of shareholders.

Unfortunately, community banks with more than 100 shareholders that decide that making the S corporation election is beneficial often are forced to eliminate shareholders - even when they would prefer to be more broadly held. A community bank's effort to reduce the number of existing shareholders is generally a very thorny and expensive undertaking.

ICBA recommends increasing the maximum number of allowable S corporation shareholders to 150. ICBA believes that increasing the number of allowable shareholders will permit more community banks to make the S corporation election and, at the same time, continue to be widely owned by members of their communities. ICBA supports the bipartisan "Communities First Act" (H.R. 1869 / S. 1405), introduced by Small Business Committee Chairwoman Nydia Velazquez (D-NY) in the House and Senator Sam Brownback (R-KS) in the Senate.[10] This pro-small business legislation advances an important increase in the Subchapter S shareholder limitation to 150 from 100. ICBA applauded the enactment of two important Subchapter S tax reforms from the "Communities First Act."[11] A summary of the tax titles of the Communities First Act are attached to this testimony.

- **Allow new IRAs as eligible S corporation shareholders.**

Current law restricts the types of individuals or entities that may own S corporation stock.[12] S corporation community banks seeking to raise capital may not allow new IRA shareholders. Traditional and Roth IRA stock are permitted only to the extent that that IRA stock was held on or before October 22, 2004. Again, Subchapter S community banks are put at a disadvantage relative to other less restrictive business forms in their ability to attract capital due to the rigid IRA shareholder restriction.

ICBA recommends that new IRA investments in a Subchapter S bank be allowed regardless of timing. ICBA supports the bipartisan "S Corporation Modernization Act of 2008," (H.R. 4840 / S. 3063) introduced by Rep. Kind (D-WI) in the House and Sens. Lincoln (D-AR), Hatch (R-UT) in the Senate. This legislation would liberalize the existing IRA shareholder investment restriction by allowing new IRA shareholders to participate in Subchapter S corporations. ICBA believes this reform will grant more community banks the needed flexibility in attracting IRA shareholder capital.

- **Allow community bank S corporations to issue certain preferred stock.**

Current law only allows S corporations to have one class of stock outstanding.[13] C corporations that want to make the S corporation election must eliminate any second class of stock prior to the effective date of the S corporation election. Likewise, issuing a second stock class by an S corporation terminates its S corporation status. Community banks must maintain certain minimum capital ratios to be considered a well-capitalized institution for regulatory purposes. As a community bank grows in size, its earnings alone may not provide sufficient capital to fund its growth. Banks needing more capital can raise additional capital by issuing common stock, preferred stock, or, in some cases, trust-preferred securities.

Many community banks avoid issuing additional common stock to fund growth so that they can protect their status as an independent community bank and serve their local community lending needs. Instead, they frequently use preferred stock to fund growth and retain control. However, S corporation banks are not allowed to issue commonly used preferred stock because preferred stock is considered a second class of stock. This prevents small community banks from having access to an important source of capital vital to the economic health and stability of the bank and the community it serves.

ICBA recommends exempting convertible or "plain vanilla" preferred stock from the "second class of stock" definition used for S corporation purposes. This would help more community banks become eligible to make the S corporation election as well as help those that currently are S corporations seeking to raise additional capital. Allowing community bank S corporations to issue preferred stock would allow them to reduce the burden of double taxation like other pass-through entities and, at the same time, fund future growth. To provide community banks one more important option in attracting capital to fund business operations and serve their communities, ICBA strongly recommends passage of the provision in the "Communities First Act," which would allow the use of preferred stock by S corporation banks.[14]

- **Reform the punitive built-in-gains (BIG) tax.**

Eligible small businesses including community banks are often unwilling and unable to convert from a C corporation to an S corporation due to the punitive built-in-gains (BIG) tax that would be applied. If a C corporation converts to an S corporation, present law retains the C corporation tax on the "built-in" gain from certain sales of assets that were appreciated as of the conversion date.

For the first ten years after a corporation converts from a C to and S corporation, certain built-in capital gains of the corporation attributable to C corporation years are subject to the tax at the corporate level.[15] The BIG tax does not apply to a corporation that has always been an S corporation. Banks were only allowed to elect Subchapter S status for the first time in tax year 1997. A corporation that elected S status while owning appreciated property must hold the asset for 10 years after election to avoid the punitive BIG tax upon sale or distribution to its shareholders. This punitive tax either deters businesses from converting to an S corporation or locks-up available assets and resources that may be put to greater use in the business.

ICBA recommends the built-in-gains tax burden be reduced, and at a minimum, the 10-year period after converting from a C corporation to an S corporation where the BIG tax would imposed be shortened. ICBA strongly supports the "S Corporation Modernization Act" (H.R. 4840 / S. 3063) that would allow the BIG tax application period to be shortened from ten years to seven.[16] ICBA also strongly supports the "Small Business Growth and Opportunity Act" (H.R. 3874) that would also reduce the recognition period for the BIG tax from ten years to seven.[17]

Currently the BIG tax forces S corporations to be taxed twice on assets they sell within 10 years of converting to this tax status. This makes the sale and reinvestment of these assets prohibitively expensive and hinders growth and job creation. In some states, the double-tax burden can reach as high as 70 percent.

ICBA believes forcing S corporations to hold on to often unproductive and inefficient assets for 10 years limits cash flow and the use of available resources. Therefore, allowing S corporations to liquidate assets if they choose after seven years – a more realistic business cycle – would free up capital to be used to grow the small business and create new jobs.

- **Allow a national bank limited liability company (LLC) charter.**

Community banks are small businesses yet are often unable to use preferred business forms available to other small businesses such as a limited liability corporation (LLC). Additionally, even as some S corporation rules and restrictions have been addressed in recent years to enable greater use of this structure, current restrictions still make Subchapter S unworkable for many community banks. ICBA recommends the limited liability company charter available to small businesses be available to community banks nationwide.

ICBA strongly supports the "Communities First Act" (H.R. 1869 / S. 1405) provision that would allow a bank, or savings association to convert to an LLC charter in a tax-free transaction.[18] The U.S. banking regulators ruled favorably that State banks chartered as LLCs would be eligible for federal deposit insurance.[19] ICBA believes allowing a community banks the flexibility to use the LLC structure available to other small businesses would help overcome the many obstacles preventing a similar Subchapter S election.

Unlike Subchapter S, LLC status does not have the stifling limits on the number of shareholders, types of shareholders, or class of stock restrictions that unfairly prevent community banks from electing a pass-through tax structure. LLC-chartered banks could continue to be widely owned and not be forced to restrict or limit ownership as in an S corporation. An LLC-chartered bank would also find it easier to preserve independence and pass on ownership to subsequent generations without fear of the adverse consequences related to too many owners. To preserve their ongoing viability and to serve their local areas, community banks must have options for generating new sources of capital without setting themselves up to become takeover targets. Allowing banks to form as LLCs would go a long way in supporting the viability of community banks and the communities they serve.

- **Preserve 35% top marginal tax rate on Subchapter S income.**

Small businesses are facing difficult economic times. A troubled credit market combined with a slowdown in U.S. economic growth, high energy prices, and sharp inflationary costs across-the-board for inputs are crimping small business profits and viability. Maintaining cash flow is vital to the ongoing survival of any small business and taxes are typically the second highest expense for a business after labor costs. As pass-through tax entities, Subchapter S taxes are paid at the individual income tax level. Marginal income tax rates do play a critical role in a small business' viability, entrepreneurial activity, and choice of business form. Today more than half of all business income earned in the United States is earned by pass-through entities such as S corporations and limited liability corporations.

The top corporate income tax rate and individual income tax rate are currently set at 35%. Much discussion has been given to addressing the corporate tax rate for international competitiveness concerns and raising the individual income tax rate. ICBA believes significant shifts in the existing marginal tax rates and parity between corporate and individual tax rate can trigger unwanted and costly shifts in business forms. ICBA believes it is important to consider maintaining parity between the top corporate and individual income tax rates in the Code. Additionally, during this difficult economic period, at a minimum, the current top tax rate of 35% should be preserved on both small business Subchapter S income and C corporation income, not increased.

- **Prevent new threats to Subchapter S status from the "TEFRA" disallowance and encroaching payroll taxes.**

ICBA also wants to highlight to the Committee two additional S corporation issues that greatly threaten the ability of small businesses to effectively use Subchapter S status.

First, a new proposed IRS rule would reverse long-standing tax treatment and precedent on the use of bank qualified bonds.[20] These bank qualified tax-exempt bonds were allowed in order to help cities and towns served by community banks finance needed local project s such as schools, water treatment plants, firehouses and hospitals in an affordable way.

Unfortunately, the IRS proposed a new regulation that would contradict an existing statute. The community banking industry has in good faith relied on this statute and informal IRS guidance in applying the so-called "TEFRA disallowance" for Subchapter S banks for the past seven tax years or more. The existing practice by S corporation banks, that the 20% TEFRA disallowance terminates three years after the S election, is soundly based on existing law. The IRS should not have the authority to override a statute with a regulation.[21] The ICBA believes this proposed regulation is unwarranted, and if further advanced, would be tremendously damaging to Subchapter S banks, their taxpaying shareholders and the communities they serve. The ICBA strongly opposes the proposed regulation and has respectfully urged the IRS to promptly withdraw it.

Second, new pressure is building to apply payroll taxes to capital income generated by S corporations rather than levied only on salaries and wages. The Joint Committee on Taxation (JCT) advanced a proposal to broadly extend payroll taxes on the net income of all Subchapter S corporations.[22] ICBA wants to ensure application of payroll taxes are applied fairly on *wage* income but not inappropriately on Subchapter S corporate income from *capital* investments and capital returns. S corporation shareholders that work in the business already are legally obligated to receive reasonable compensation and pay all applicable payroll taxes on that compensation. In fact, the IRS already has the power to apply a "reasonable compensation" standard to S corporation shareholders and require shareholders to pay themselves the market rate for their service to the business. ICBA believes subjecting an increased share of non-wage earnings of S corporations to the payroll tax, regardless of whether they are distributed to the owners of the firm or represent a return on their personal labor, would violate the long-standing principle that payroll taxes be applied to wage compensation only.

ICBA believes these recommendations would go a long way in helping more small businesses and community banks stay strong and competitive. They would allow small businesses to more fairly and efficiently choose the corporate structure that would best suit the need of their businesses, customers and communities they serve.

Conclusion

Small businesses are critical to the U.S. economy and are facing difficult economic times. Reforms to outdated and onerous Subchapter S laws would provide a needed boost to many small businesses at a critical time. Community banks are small businesses and should be allowed the flexibility and choice afforded other small businesses to select a business form that best suits the need of the business and community. Additional tax code reform and simplification in the S corporation area would go a long way in allowing community-based banks to convert to S corporation status as Congress intended in 1996. Many community banks and small businesses find that current technical barriers to making the conversion from a C corporation to an S corporation are too great to overcome. Current restrictions and complicated rules for S corporation status make the conversion from a C corporation unattainable for many community banks, thwarting Congress's intended relief from punitive double taxation of small businesses. ICBA believes reforming and simplifying onerous Subchapter S corporation rules will create a tax code that is small-business friendly and improve community banks' ability to meet the lending needs in their local communities.

If enacted, the ICBA-recommended Subchapter S corporation rule changes would greatly simplify the ability for community banks to elect Subchapter S status as Congress intended. These include, increasing the allowable number of S corporation shareholders to 150, allowing new IRA shareholders, permitting the issuance of preferred stock, reforming the built-in-gains tax, and preserving the top 35% marginal income tax rate. Additionally providing the flexibility of a limited liability corporation (LLC) bank charter would grant greater flexibility in business form choice available to other small businesses.

The ICBA is delighted to see the House Small Business Committee's Subcommittee on Tax and Finance examining Subchapter S reform options. Many solid reform ideas have already advanced in bipartisan legislation including the "Communities First Act" (H.R. 1869 / S. 1405) and the S Corporation Modernization Act (H.R. 4840 / S 3063) in the 110[th] Congress. ICBA enthusiastically support these bipartisan Subchapter S reform bills.

Thank you Madam Chairwoman for the opportunity to appear before the Committee today. ICBA looks forward to working with you and the Committee to ensure the enactment of beneficial S corporation reforms.

Summary of Tax Titles in the Communities First Act (H.R. 1869 / S. 1405)

Title III

Tax Relief for Bank Depositors, Rural Banks, Municipalities, Banks Organized and Limited Liability Companies, Individual Savers, and Small Businesses

Section 301. Long-Term CDs: Reduces tax rate and defers income on long-term certificates of deposit. Defers tax recognition of individual interest income on long-term CDs (term of 12 months or more) until maturity and reduces the tax rate to long-term capital gains tax rate.

Section 302. Enhanced Rural Lending: Excludes from taxable income of a bank or savings association, income earned on agricultural real estate loans and mortgage loans in communities of 2,500 or less population. This mirrors exclusion available to the Farm Credit System.

Section 303. Update Tax-Exempt Bond Limits: Increases to $30 million the current $10 million annual issuance limitation for tax-exempt obligations. Cap would be indexed.

Section 304. LLCs: Allows bank, bank holding company, savings association or savings association holding company to be treated for tax purposes as a limited liability company and allows privately-held financial institutions to convert their state or federal charters to an LLC charter in a tax-free transaction.

Section 305. Individual AMT Repeal: Repeals the punitive individual alternative minimum tax.

Section 306. Young Savers Accounts: Permits a Roth IRA account for children under age 25 to encourage early savings.

Section 307. Permanent Section 179 Small Business Expensing: Makes permanent increased limits on small business expensing for equipment.

Title IV

Targeted Tax Relief for Community Banks and Holding Companies

Section 401. Limited Community Bank Credit: Allows banks, bank holding companies, savings associations and savings association holding companies with up to $5 billion in assets that are taxed as C corporations to take a 20% credit against their taxable income up to a cap of $250,000. Shareholders of financial institutions that are S corporations would be able to exclude 20% of the distributable income from the financial institution up to an aggregate cap of $1,250,000. Also creates a 50% tax credit for financial institutions with up to $5 billion in assets that are operating in distressed communities and/or designated enterprise or empowerment zones, or qualifying New Market Tax Credit Census tracts not to exceed $500,000. Financial institutions that are operating in these areas and that are S corporations would be able to exclude 50% of distributable income not to exceed $2.5 million of income.

Section 402. Community Bank AMT Relief: Repeals the alternative minimum tax for banks, bank holding companies, savings associations and savings association holding companies with assets of $5 billion or less.

Title V
Small Business Subchapter S Reforms

Section 501. Shareholder Limit: Increase shareholder limit for S corporations to 150 from 100.

Section 502. Qualifying Directors Shares: A banks' qualifying directors' shares not included in the shares counted toward the S corporation shareholder limit. (Note: Enacted 5/25/2007)

Section 503. Bad Debt Reserve: Provides option to recapture bad debt reserves in first S corporation year or in last C corporation year. (Note: Enacted 5/25/2007)

Section 504. Preferred Stock: Allows the use of preferred stock for S corporation bank.

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[1] The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 268,000 Americans, ICBA members hold more than $908 billion in assets, $726 billion in deposits, and more than $619 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

[2] Federal Deposit Insurance Corporation, "Quarterly Banking Profile," March 31, 2008.
[3] "Community Bank Tax Relief and Simplification Options," A study prepared for the Independent Community Bankers of America by Grant Thornton LLP, 2003.
[4] Public Law 104-188.
[5] U. S. General Accounting Office, "Banking Taxation, Implications of Proposed Revisions Governing S-Corporations on Community Banks," June 2000. (GAO/GGD-00-159).
[6] Grant Thornton LLP, Ninth Annual Survey of Community Bank Executives.
[7] Former Internal Revenue Code §1371(a)(1), as in effect for taxable years starting before January 1, 1977.
[8] Internal Revenue Code §136(b)(1)(A).
[9] Public Law 108-357, 10-22-04.
[10] "Community Banks Serving Their Communities First Act," H.R. 1869 and S. 1405, 110th Congress.
[11] Public Law 110-28. President Bush signed on May 25, 2007 the "Small Business and Work Opportunity Tax Act of 2007," which was part of the larger "U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability

Appropriations Act of 2007," (H.R. 2206) and contained S-Corp. items from "Communities First Act" Title IV (H.R. 1869 / S. 1405).

[12] Internal Revenue Code §1361(b)(1).

[13] Internal Revenue Code §1361(b)(1)(D).

[14] Title V "Small Business Subchapter S Reforms." "Community Banks Serving Their Communities First Act," H.R. 1869 and S. 1405, 110th Congress.

[15] Internal Revenue Code §1374.

[16] The "S corporation Modernization Act," H.R 4840 and S. 3063, 110th Congress.

[17] The "Small Business Growth and Opportunity Act," HR 4840, 110th Congress.

[18] Title III "Targeted Tax Relief for Bank Depositors, Rural Banks, Municipalities, Banks Organized as LLCs, Individual Savers, and Small Businesses." "Community Banks Serving Their Communities First Act," H.R. 1869 and S. 1405, 110th Congress.

[19] FDIC Adopts Final Rule on Federal Deposit Insurance Eligibility for State Banks Chartered as Limited Liability Companies (Part 303 of FDIC's Rules and Regulations). Federal Register Vol. 68, No. 30, Thursday, Feb. 13, 2003. A new amendment to Part 303 of the FDIC's Rules and Regulations clarifies that a state bank that is chartered as a limited liability company could be considered "incorporated" for the purposes of being eligible for federal deposit insurance.

[20] IRS Proposed Regulation §1.1363-1(b) (IRS-REG-158677-05).

[21] Manhattan Gen. Equip. Co. v. Comm'r, 297 U.S. 129 (1936).

[22] Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05, January 27, 2005, p.95, and updated Aug. 3, 2006.

S-CORP

THE S CORPORATION ASSOCIATION OF AMERICA

"Defending America's Small and Family-Owned Businesses"

Statement of Rick L. Klahsen
for the
S Corporation Association

House Committee on Small Business Subcommittee on Finance and Tax
"S-corps: Recommended Reforms that Promote Parity, Growth and Development for Small Businesses"

June 18, 2008

Chairwoman Bean, Ranking Member Buchanan and other members of the Subcommittee, thank you for the opportunity to testify today.

My name is Rick Klahsen. I am a Managing Director in the National Tax department of RSM McGladrey, Inc., and the National Service Line Leader for Tax Advisory & Compliance.

RSM McGladrey, when combined with McGladrey & Pullen, is the fifth largest business consulting, accounting, and tax firm that focuses on mid-sized companies. With over 100 offices nationwide, we offer business and tax consulting, wealth management, retirement resources, payroll services and corporate finance to our clients.

I also serve on the Board of Advisors for the S Corporation Association and submit my testimony today on its behalf. The S Corporation Association is the only organization in Washington D.C. exclusively devoted to promoting and protecting the interests of America's 4.2 million S corporation owners. The Association focuses on ensuring that America's most popular corporate structure remains competitive in the Twenty-First Century.

I want to thank you for holding this hearing to consider reforms that would promote equality and development for S Corporations. It is especially fitting given that this year the S corporation celebrates its 50th birthday.

History of the S Corporation

Before Congress created S corporations, entrepreneurs had two basic choices when starting a business. They could form a regular C corporation, and enjoy liability protection but face two layers of federal tax at the corporate and individual level. Or they could form a partnership or operate as a sole proprietorship, and enjoy a single layer of taxation at the individual level but sacrifice the umbrella of liability protection.

Neither choice was optimal for small and family-owned businesses. In 1946, the Department of Treasury suggested a third option—merging a single layer of federal tax with comprehensive liability protection. President Dwight Eisenhower joined the cause, and promoted the passage of legislation to encourage small business growth and entrepreneurship.

In 1958, Congress acted on President Eisenhower's recommendation, creating subchapter S of the tax code. In exchange for enjoying a single layer of tax, entrepreneurs electing S corporation status agreed to the following limitations:

- They were required to be a domestic enterprise;
- They were required to have a limited number of shareholders;
- They were limited by who those shareholders could be; and
- They could have just one class of stock.

How significant was the creation of subchapter S? Consider that in 1958, the top income tax rate was 52 percent for corporations and 91 percent for individuals. Dividends paid by a C corporation to a high-income shareholder faced an effective tax rate of 96 percent! Even a shareholder with median family income faced an effective federal tax of more than 60 percent. Creation of the S corporation was a huge step forward in eliminating a devastating double tax and encouraging small and family business creation in the United States.

Nearly a half century later, S corporations are the most popular corporate structure in America, with twice as many firms as C corporations.

Growth of Pass-Through Businesses

An important trend over the past three decades is the dramatic growth in the number of S corporations and partnerships, including limited liability companies.

The number of S corporation returns has increased from less than 500,000 in 1978 to more than 4 million today. Partnerships have seen similar growth, increasing from 1.2 million in 1978 to about 3 million today.

At the same time, the number of regular C corporations peaked in 1986 at 2.6 million and has declined steadily since then. The overall contribution of C corporations to tax receipts is declining as well. When S corporations were created in 1958, C corporations paid a quarter of all federal tax receipts. In the last five years, their contribution has ranged between 7 and 15 percent.

The growth of pass-through businesses coupled with the decline of the traditional C corporation has had the effect of shifting an increasing amount of business income from the corporate tax code to the individual tax code.

This means that tax policy for businesses is increasingly affected by changes to the individual tax code. As Treasury reported earlier this year, more than a third of those taxpayers paying taxes in the top two rates have business income that exceeds 30 percent of their total income. Much of this income can be attributed to partnerships and S corporations. We believe policymakers in Washington need to be acutely aware of the dynamic between individual tax rates and business income as they consider broad-based tax reform.

S Corporation Reform

The history of S corporations, the growth of limited liability companies as a competing business structure, and the need to update rules dating back five decades all combine to make S corporation reform an important part of any effort to update the tax code. Over the years, the S Corporation Association has worked with policymakers in Congress as well as allied trade associations to develop a list of critical reforms Congress should consider. These reforms include:

Built-In Gains Tax Relief: Businesses converting to S corporation must hold on to any appreciated assets for 10 years following their conversion or face a business level tax imposed on the built-in gain at the highest corporate rate of 35 percent. We support decreasing the holding period of assets subject to the built-in gains tax from 10 years to 7 years.

Repeal of excessive passive investment income as a termination event: We support repealing the rule that an S corporation would lose its S corporation status if it has excess passive income for three consecutive years.

Modifications to passive income rules: We support increasing the threshold for taxing excess passive income from 25 percent to 60 percent (consistent with a Joint Tax Committee recommendation on simplification measures). In addition, we advocate removing gains from the sales or exchanges of stock or securities from the definition of passive investment income for purposes of the sting tax.

Nonresident Aliens as Shareholders: We support permitting nonresident aliens to be S corporation shareholders. To assure collection of the appropriate amount of tax, we would like to require S corporations to withhold and pay a tax on effectively connected income allocable to its nonresident alien shareholders. Additionally, we advocate enhancing an S corporation's ability to expand into international markets and expanding an S corporation's access to capital.

IRAs as Shareholders: Congress has previously allowed IRAs to hold stock in a bank that is an S corporation "only to the extent of bank stock held by the IRA on the date of enactment." We support extending this provision to allow IRAs to hold stock in all S corporations.

Permit Issuance of Preferred Stock: We support permitting S corporations to issue qualified preferred stock. To qualify, the stock would not be entitled to vote, would be limited and preferred as to dividends, would not participate in corporate growth to any significant extent, and would have redemption and liquidation rights which do not exceed the issue price of such stock. This reform increases access to capital from investors who insist on having a preferential return and facilitates family succession by permitting the older generation of shareholders to relinquish control of the corporation but maintain an equity interest.

Safe Harbor Expanded to Include Convertible Debt: We support permitting S corporations to issue debt that may be converted into stock of the corporation provided that the terms of the debt are substantially the same as the terms that could have been obtained from an unrelated party. This reform would also expand the current law safe harbor debt provision to permit nonresident aliens as creditors.

S Corporation Certainty: We support providing reasonable certainty to S-corporations and their shareholders as to the entity's tax status as an S corporation by adding language to Section 1362(f) that would allow an S corporation, without IRS consent, to rectify an ineffective election or a terminating event, if such event occurred in a year in which the statute of limitations for claiming a credit or refund has expired. As long as the S corporation corrects the item and its shareholders report information consistent with S corporation rules in all years for which a claim for credit or refund has not expired, the corporation's status as an S corporation will be respected.

In this Congress, the S Corporation Association has been fortunate to enjoy the support of senior members of both the Ways and Means Committee in the House and the Finance Committee in the Senate. Legislation introduced in both bodies would advance the rules governing S corporations dramatically. These legislative initiatives include:

S Corporation Modernization Act of 2007: Introduced by Ways and Means members Congressmen Ron Kind (D-WI) and Jim Ramstad (R-MN) on December 19, 2007, the "S Corporation Modernization Act" is designed to simplify the rules under which S corporations operate. Original cosponsors of H.R. 4840 represent Districts across the country, including Representatives Stephanie Tubbs-Jones (D-OH), Phil English (R-PA), Allyson Schwartz (D-PA), Sam Johnson (R-TX), and Steve Kagen (D-WI).

The bill is endorsed by an impressive group of business associations and includes reforms important to keeping S corporations competitive both here at home and abroad, including:

- Modernizing the rules that apply to firms that have selected S corporation status;
- Increasing the ability of S corporations to access needed capital; and
- Encouraging S corporations to support charity through small business trusts.

With the number of Ways and Means members supporting these important reforms, we are hopeful that Congress will take up this legislation this year.

Small Business Growth and Opportunity Act: The "Small Business Growth and

Opportunity Act" was introduced by Congressman Steve Kagen (D-WI) and Ways and Means members Congressmen Jim Ramstad (R-MN), Ron Kind (D-WI) and Phil English (R-PA) on October 17, 2007.

The bill would reduce from ten to seven years the period that a business must hold onto appreciated property before it can be sold. Under current rules, S corporations that sell their appreciated assets prior to the 10-year waiting period are subject to the punitive built-in gains tax.

Other H.R. 3874 cosponsors include representatives from across the country, including Congressmen Richard Baker (R-LA), Jerry McNerney (D-CA), Michael Conaway (R-TX) and House Financial Services Committee member Congressman Dennis Moore (D-KS).

S Corporation Modernization Act of 2008: Introduced by Finance Members and long time S corporation champions Senator Blanche Lincoln (D-AR) and Orin Hatch (R-UT) on May 23, 2008, "The S Corporation Modernization Act of 2008 " is the companion bill to H.R. 4840 and is designed to simplify the rules under which S corporations operate. Current cosponsors of S. 3063 include Senators Ben Cardin (D-MD), Gordon Smith (R-OR) and Olympia Snowe (R-ME).

Like H.R. 4840, the bill has been endorsed by an impressive group of business associations and the S Corporation Association has great expectations that the provisions of S. 3063 will become law in the near future.

S Corporations and Economic Stimulus

Another area where S corporation reform can help is with capital investment and economic growth. As Congress examines what provisions should be included in a possible second stimulus package, we believe policymakers should consider relief from the built-in gains tax (BIG) as a means of freeing up much needed capital.

BIG applies to any appreciated assets that are held by a firm converting to S corporation. Under BIG, these firms are required to hold these assets for at least ten years or be subject to a punitive level of tax—first the BIG corporate tax rate of 35 percent and then all the other applicable federal, state and local tax rates.

According to government statistics, hundreds of thousands of S corporations nationwide may be sitting on "locked-up" capital that they cannot access or redeploy due to the prohibitive tax implications of BIG. This "lock-in effect" is widespread and results in these businesses being unable to access billions of dollars in assets that could be used to grow the business and hire new employees.

The inability to access this capital is particularly harmful to S corporations. As closely-held businesses with limited access to the public markets, they have fewer options for raising capital than many of their competitors.

In an economy where a one or two percent change in growth can mean the difference between a recession and moderate growth, eliminating that lock-in effect and allowing those assets to become fully productive could be significant.

C Corp Rate Reduction and S Corporations

Another potential challenge to the S corporation community is the proposed reduction in the tax rate applying to C corporations. While this proposal is pro-growth and a benefit to the entire American economy, the manner in which it is carried out may have significant adverse effects on pass-through businesses.

In the past year, both the Secretary of Treasury and the Chairman of the House Ways and Means Committee have proposed to reduce the tax rate on C corporations while eliminating certain tax benefits that they currently enjoy, including the recently enacted Section 199 deduction, LIFO accounting rules and other targeted tax benefits.

The overall goal of the two proposals was to reduce marginal tax rates on corporations while broadening the tax base. With the federal tax on corporate income the second highest in the world, reducing the tax would significantly increase the ability of U.S. corporations to compete in global markets.

The challenge for the Treasury and the Ways and Means Committee is that many of the businesses that use Section 199 and the other business tax benefits eliminated as part of the base broadening are not C corporations. In other words, the effort to cut the marginal tax on C corporations would have also significantly raised taxes on S corporations and partnerships.

The S Corporation Association has met with the tax staffs at Treasury and the Ways and Means Committee to discuss this adverse outcome for pass-through businesses and we believe this is an appropriate issue for the Small Business Committee to take on as Congress considers major reforms to the tax code next year. Lower rates for C corporations would likely benefit the economy and job creation, but only if these reductions do not come at the expense of S corporations and partnerships.

S Corporations and the Payroll Tax

A final important issue to the S corporation community is how to appropriately tax income earned by S corporation shareholders who actively work at their business.

When Congress created the S corporation in 1958, the IRS ruled that only S corporation shareholders who are active in their business should be subject to payroll taxes only on amounts received for their labor. While the payroll tax has grown dramatically in the past fifty years, the application of payroll taxes has always applied to labor income, not capital income. In recent years, however, several proposals have been put forward that would alter this historic relationship and increase the application of payroll taxes on S corporations.

In January of 2005, the Joint Committee on Taxation (JCT) recommended that Congress apply payroll taxes to all S corporation income where the shareholder works at the business as part of a broader set of proposals to raise revenue. The JCT estimated its proposal would raise $57.4 billion over ten years.

In May of 2005, the Treasury Inspector General for Tax Administration (TIGTA) issued a memorandum recommending a similar payroll tax increase on S corporations, arguing that all income from S corporations more than 50 percent owned by a single shareholder should be subject to payroll taxes.

More recently, the JCT modified its original proposal so that it would apply payroll taxes to S corporation income where the S corporation is a service business. While more targeted than their original proposal, this JCT proposal suffers from similar flaws. It changes the nature of payroll taxes and raises taxes on small and mid-sized businesses.

Finally, in October of 2007, Ways and Means Chairman Charles Rangel introduced legislation that, among other items, would impose payroll taxes funding Social Security and Medicare on S corporations with service-related income. Under the bill, the tax increase would be limited to the income from service business only. Under the Rangel bill, S corporations with income primarily from the service sector of the economy would see payroll taxes applied to the entirety of their service income, rather than just the portion paid out as wages.

The S Corporation Association appreciates the concern that certain taxpayers are paying less than their fair share of payroll taxes. However, the IRS already has the tools necessary to identify these taxpayers and force them to pay the correct level of tax. While applying these tools may be time-intensive and costly, alternative proposals risk raising payroll taxes on small and family-owned businesses that are fully complying with the law and paying all the taxes they owe.

Getting the solution to this challenge right is important, and the S Corporation Association looks forward to working with the Ways and Means and Small Business Committees to ensure whatever reform is enacted does not adversely impact law-abiding business owners.

Conclusion

Chairwoman Bean, the S Corporation Association and I greatly appreciate the opportunity to testify today and to highlight various issues of concern to the S corporation community. I thank you for this opportunity and I am happy to answer any questions you may have.

Oral Testimony of Robert Kerr
Senior Director, Government Relations
National Association of Enrolled Agents
before the House Small Business Committee
Subcommittee on Finance and Tax
June 18, 2008

Thank you, Madam Chair and members of the Subcommittee, for the opportunity to testify before you today. My name is Bob Kerr and I am the head of government relations at the National Association of Enrolled Agents (NAEA).

Enrolled agents are the only tax practitioners for whom IRS directly attests to their competence and ethical behavior. NAEA represents the interests of some 46,000 enrolled agents across the country. Our members usually work with those on the smaller end of small businesses and more typically see gross incomes in the tens of thousands rather than the tens of millions.

I will discuss two issues today—reasonable compensation and recordkeeping—and provide several approaches that would help S-corps, and to some extent all small businesses, operate more easily.

Reasonable Compensation

One of the advantages of an S-corp is that shareholder employees can receive both wages and profit distributions, both of which are subject to the shareholder's personal income tax rate, but only the wages are subject to payroll taxes. Not surprisingly, the tax advantage for distributions leads to challenges for the corporation, namely in determining what constitutes the "reasonable compensation" required by IRS. In the absence of clear guidance, people disagree on what constitutes reasonable and many EAs find themselves enmeshed in or refereeing 'spirited' discussions with their S-corp clients as a result. Meanwhile, other small S-corps are completely unaware of the reasonable compensation requirements, which can, my members assure me, lead to a very unpleasant surprise during an audit.

With respect to reasonable comp, EAs and others are in a quandary when asked what is reasonable or when raising the issue to a client. I know there are those who believe that treating S-corp and partnership income similarly would solve the problem. I'm not at all certain that we would buy into that solution. In the near term we suggest practitioners and S-corps could be helped by practical IRS guidance—perhaps in the form of an audit technique guide—in determining what is reasonable compensation.

Recordkeeping

As to my second point, I can't imagine that I am the first person to come before this committee stating that recordkeeping is the bane of a small businessman's (or woman's) existence. Recordkeeping is burdensome and the Code requires small businesses to keep a myriad of records. For instance, Section 274(d) requires stringent documentation for deductions for both business cell phone use and business use of an automobile. Section 280A requires in-home offices to be used solely for business activity and for deductions to be made as a proportion of the entire home. Further, there is no *de minimis* amount for expensing rather than depreciating business assets.

At the end of the day, small business owners are not tax experts, though the complexity of our tax code really does dictate that small businesses retain tax experts to advise them of their obligations and to help them take advantage of tax code provisions, such as §179 expensing or the business provisions of the recently-passed stimulus bill.

NAEA has advocated for years for simplification wherever possible in the tax code. To that end, we applaud and encourage the conversations recently underway with respect to a safe harbor for in-home offices, and particularly note Chairwoman Velazquez's bill. Further, Chairman Rangel (in HR 5719) recently proposed removing cellular phones from §274(d) listed property, a move that would dramatically lower recordkeeping requirements. We enthusiastically support such provisions.

If I may be so bold, S-corps and small businesses would be greatly assisted if Congress measured complexity and gave it weight when considering various tax law changes.

Further, both IRS and tax professionals are well placed to provide information to S-corps and to small businesses as they organize. EAs far too often find these businesses in tax trouble not because of malice aforethought but because of sheer ignorance—or bad advice from unqualified preparers.

Congress could act to improve competence in the tax preparation industry by enacting HR 5716, the Taxpayer Bill of Rights Act of 2008, introduced by Rep. Becerra. We believe greater competency leads to better advice and better compliance.

For its part, IRS has in recent years made decided efforts to educate small businesses and should be supported and encouraged as it moves forward and as it continues to balance its compliance obligations with its assistance obligations.

This concludes my testimony and I will be happy to answer questions.

Testimony

Kevin D. Anderson*
BDO Seidman, LLP

Before the
Committee on Small Business
Subcommittee on Finance and Tax
United States House of Representatives

S-corps: Recommended Reforms that Promote Parity, Growth and Development for Small Business

June 18, 2008

*Partner, BDO Seidman, LLP. Employment is shown for identification purposes only. The views expressed do not necessarily represent those of BDO Seidman, LLP, or its partners.

I. Introduction

Good morning. Madam Chair, Ranking Member Buchanan, and members of the subcommittee, I am Kevin Anderson, a partner of BDO Seidman, LLP, a firm that provides tax, audit, financial advisory, and consulting services to clients across the country. I am pleased to have this opportunity to present my views on potential S corporation reform and expansion. I wish to emphasize that I am here to offer my own personal views based on many years of accounting, law firm, and government experience in this area, and not to advance the interests of any particular client or those of my firm.

The other panel members have adequately covered proposed legislative changes in the S corporation area that would, if enacted, promote the goals of parity, growth, and development. I will generally refrain from supporting or opposing any of the specific proposals discussed by the other panelists. Instead, in the time that I have, I would like to address some of the policies that have motivated the development of the S corporation form in the 50 years since its origin. I will then discuss some of the policy considerations that might govern the analysis of the proposals being discussed here.

II. The S Corporation—Straddling Two Worlds

The S corporation has always had some features in common with both partnerships and C corporations. Partnerships are always taxed only once on their income, while C corporations incur potential double taxation on distributed profits and are also subject to a variety of other tax provisions unique to corporations. Like a partnership, an S corporation is generally not taxed directly on its income, but its shareholders are required to include their share of the income in their own returns, and may deduct their share of the losses of the corporation, subject to applicable limitations.[1] When an S corporation makes distributions to its shareholders, the income is not taxed a second time, but the distribution is considered as a return or recovery of the shareholders' previously taxed profits.

On the other hand, a C corporation is directly subject to tax on its profits, while its losses may only be used to offset its own income or the income of other members of a group of corporations with which it files a consolidated

[1] IRC Sections 1366 through 1368 set forth the general "flow-through" rules applicable to S corporations and their shareholders.

return. A corporation may be organized and reorganized under provisions of subchapter C of the Internal Revenue Code that apply only to corporations. Similarly, a corporation may be recapitalized, divided, liquidated, purchased, or sold under provisions uniquely applicable to corporations. Like a C corporation, an S corporation is subject to most of these subchapter C provisions for its extraordinary transactions.[2]

Because an S corporation has income tax features that are common to both partnerships and taxable corporations, it is sometimes difficult to determine whether a particular provision should be modified to bring the treatment of S corporations closer to that of partnerships or to that of other corporations. I submit that some of the proposals being discussed today would, if enacted, bring the S corporation more in line with C corporations, while other proposals would bring S corporations closer to partnerships. There is little that these proposals have in common other than that they make the S corporation form more widely available and more tax efficient.

III. Policy Considerations for Further Reform and Expansion

To the extent that parity is a goal of S corporation reform, it is therefore appropriate to ask whether parity is an achievable goal and, if it is, parity with what? Do we seek parity with the tax treatment of business income generally, regardless of the type of entity employed? Parity with partnerships? Parity with C corporations? Parity with the taxation of individuals? In view of the scheduled expiration of the individual income tax rate reductions after 2010, and the proposals of the major-party presidential candidates for modifications to the individual and/or corporate tax rates, the question of parity will loom ever larger.

It is also appropriate to recognize that changes to reduce the level of taxation of S corporation income, or to make S corporation status more readily available, will have revenue implications. When the Joint Committee on Taxation scored the S corporation expansion and relief provisions that were enacted in 1996,[3] 2004,[4] and 2007,[5] these provisions were estimated to

[2] IRC Section 1371(a) provides that, except as otherwise provided in the Code, and except to the extent inconsistent with subchapter S, the provisions of subchapter C shall apply to an S corporation and its shareholders.
[3] Small Business Job Protection Act of 1996, Pub. L. No. 104-188.
[4] American Jobs Creation Act of 2004, Pub. L. No. 108-357.
[5] Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28.

reduce revenues over the applicable window. I expect that the same would be true of many of the provisions being advocated here today.

Despite recent increases in the number of permissible shareholders of an S corporation, the policies underlying the statutory structure of S corporation taxation have been grounded in a desire for simplicity. The most obvious means that Congress has used to date in order to achieve simplicity is the single-class-of-stock requirement for S corporations.[6] Under this requirement, although differences in voting rights among various classes of stock are permitted, all outstanding shares must have the same "economic" rights, *i.e.*, the rights to regular distributions and liquidation proceeds.[7] At the end of the year, the profits and losses are allocated to shareholders simply on the basis of the number of shares owned by each shareholder, with adjustments only for those shareholders whose stock interests varied throughout the year.[8]

Shareholder limitations—both quantitative and qualitative—also promote the objective of keeping S corporations small. After all, the Internal Revenue Code refers to them as "small business corporations."[9] However, there is no limitation on the size of an S corporation based on revenues, assets, profits, employees, or similar measures. Indeed, even with the current limitations, there are a few S corporation banks or bank holding companies with several billions of dollars of assets.[10] Measures that increase the number and type of permitted shareholders will inevitably result in further increases in the size of S corporations. As the size of S corporations increases, complexity may also increase.

There are also provisions to ensure that S corporation income is taxed currently to its shareholders, without significant potential for deferral. This policy forms the basis for applying the unrelated business income tax to tax-

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[6] IRC Section 1361(b)(1)(D).
[7] IRC Section 1361(c)(4); Treas. Reg. § 1.1361-1(*l*)(2)(i).
[8] IRC Section 1377(a)(1). In certain cases, the corporation and the affected shareholders are permitted to treat the two parts of the taxable year, *i.e.*, the portion preceding and the portion following the change in ownership of S corporation stock, as if it were two separate taxable years. Under this "closing of the books" election, the income or loss is allocated to the pre-change portion of the taxable year using the stock ownership during that period, and the income or loss is allocated to the post-change portion of the taxable year using the stock ownership during that period.
[9] IRC Section 1361(b)(1).
[10] Publicly-available information obtained from the Web site of the Federal Deposit Insurance Corporation (www.fdic.gov) indicates that, as of March 31, 2008, two S corporation banks had assets in excess of $10 billion each.

exempt shareholders, such as pension and profit-sharing plans, charitable organizations, and the small number of individual retirement accounts that currently are permitted to be shareholders.[11] The only exception to this rule exists for employee stock ownership plans, or ESOPs, that own stock in an S corporation.[12]

Finally, the built-in gains provisions, which currently require a ten-year holding period after conversion from C corporation to S corporation status, are the product of a fundamental decision that Congress made with the Tax Reform Act of 1986.[13] The repeal of the so-called *General Utilities* doctrine[14] solidified the policy decision to subject to tax all appreciation on assets held by C corporations regardless of how the asset is disposed of. Thus, whether an asset is sold to a third party, distributed to its shareholders as a dividend, or distributed to its shareholders in liquidation of the corporation, the corporation must recognize the gain as if the property had been sold for its fair market value.[15] In order to prevent S corporations from being used as a means to circumvent the repeal of the *General Utilities* doctrine, the built-in gains provisions impose a corporate level-tax on S corporations in much the same manner as a C corporation would be taxed.

IV. Specific Proposals

The proposals under consideration fare somewhat differently when compared measured against some of these historical policies. I hope to provide a few comments on some of the more frequently-considered provisions, again without either supporting or opposing them.

A. Increase in the Shareholder Limitations

An increase in the shareholder limitations from 100 to 150—the number most frequently used in current proposals—would increase the size and complexity of S corporations at the margins.[16] The current-law treatment of

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[11] IRC Section 512(e).
[12] IRC Section 512(e)(3).
[13] IRC Section 1374 (generally) and Section 1374(d)(7) (regarding definition of recognition period).
[14] The doctrine is named for the Supreme Court decision in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).
[15] IRC Sections 311(b) and 336(a).
[16] Despite prior increases in the number of permitted shareholders of an S corporation, the vast majority of S corporations have relatively few shareholders. The most recent IRS Statistics of Income (Spring 2008), based on 2003 tax returns (available at www.irs.gov/taxstats/bustaxstats/article/0,,id=96405,00.html), indicates that more than 99 percent of S corporations have ten or fewer shareholders.

family members as if they are one individual applies only for counting and qualification purposes.[17] Thus, an S corporation may currently have, for example, 200 shareholders to whom income must be allocated. The ability to have large numbers of shareholders imposes significant compliance burdens on S corporations, especially if the corporation has operations in several states. More to the point, if the Internal Revenue Service were to examine the S corporation return and adjust the income or loss of the corporation, the Service must also proceed against all 200 shareholders to collect any additional tax and interest. An increase in the number of shareholders could exacerbate the examination and collection issues that are currently faced by the Service.[18]

B. Permit Nonresident Aliens to be Shareholders

Because the Internal Revenue Code imposes a tax on the worldwide income of United States citizens and residents, the nonresident alien is the only category of individual on whom worldwide taxation is not imposed. Instead, the nonresident alien is taxed only on income that is considered to have a United States source. Historically, nonresident aliens have not been permitted to be shareholders in an S corporation because of the perceived difficulty of collecting taxes that would be imposed on their shares of S corporation income.[19] Any proposal that would permit such individuals as S corporation shareholders would have to address the requirements for collecting tax, and would most likely include a complex withholding regime and other filing requirements.[20]

[17] IRC Section 1361(c)(1).
[18] Congress had previously extended so-called "TEFRA" partnership provisions to S corporations. These provisions require most examinations to be resolved at the entity level rather than at the owner level. The partnership TEFRA provisions are set forth in IRC Sections 6221 through 6234. The S corporation provisions, which were set forth in former IRC Sections 6241 through 6245, were repealed by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, Section 1307(c)(1), and replaced with an obligation of consistency of treatment between the S corporation shareholder and its shareholders. *See* IRC Section 6037(c). If the shareholder does not report a "subchapter S item" consistently with the corporation's reporting of the same item, the Service must be notified of the inconsistency.
[19] IRC Section 1361(b)(1)(C) defines a "small business corporation" as a domestic corporation that does not have a nonresident alien as a shareholder.
[20] IRC Section 1446 requires a partnership to withhold tax on effectively connected taxable income allocable to a foreign partner. A comparable provision should be enacted if S corporations are permitted to have nonresident aliens as shareholders.

C. Permit Individual Retirement Accounts to Own S Corporation Stock

The limited provision under current law which permits certain individual retirement accounts to own stock in S corporation banks or bank holding companies is already coupled with a requirement that ensures current taxation of S corporation income.[21] An IRA holding stock in an S corporation must pay the unrelated business income tax, or UBIT, on its allocated share of S corporation income. In my experience, it is extremely unusual for an IRA to incur and pay a UBIT, and a wholesale expansion of S corporation availability for IRAs would also greatly increase the compliance burdens on such accounts and their custodians and beneficiaries.

D. Allow S Corporations to Issue Preferred Stock

The proposal to permit S corporations to issue preferred stock would most certainly increase their access to certain capital markets. There are clearly certain types of investors that will insist upon having a preferred claim against the assets of the corporation. Having provided the most recent capital needed to permit a corporation to survive or grow, such investors may not wish to place their capital at the same risk as that of the common stockholders. However, such investors may also desire to obtain some of the "upside" potential that is accorded to the holders of common stock. The desire to invest in preferred stock, convertible debt, or debt with detachable warrants is often driven by business considerations rather than by tax considerations. Under current law, the use of preferred stock is absolutely prohibited for S corporations,[22] while the use of debt with certain equity-like features raises questions about the single-class-of-stock requirements.[23]

As indicated above, the historical basis for the single-class-of-stock requirement is the need to make simple allocations of S corporation income or loss. In order to preserve this goal, the proposals under consideration would give preferred stock certain debt-like characteristics. That is, distributions on preferred stock would be treated as an expense of the corporation, and only the net income or loss remaining after deducting such

[21] IRC Section 1361(c)(2)(A)(vi) permits IRAs to be shareholders of an S corporation, subject to significant restrictions and limitations, and IRC Section 512(e)(1) specifically imposes the unrelated business income tax on an IRA that is permitted to hold stock in an S corporation.
[22] IRC Section 1361(b)(1)(D).
[23] IRC Section 1361(c)(5) (straight-debt safe harbor not available for convertible debt); Treas. Reg. § 1.1361-1(*l*)(4) (certain instruments, obligations, or arrangements treated as a second class of stock).

dividends would be allocated to holders of the common stock on a per-share basis. This approach is currently being used for "restricted bank director stock" issued by banks and bank holding companies,[24] and a further expansion of this approach would add even more complexity to subchapter S. Moreover, the Code tends to draw a careful line between the treatment of debt, on the one hand, and equity on the other. Such a proposal would further blur the distinction between debt and equity for tax purposes.

E. Decrease the Built-in Gains Tax Holding Period

As I indicated above, the built-in gains tax was originally imposed to prevent C corporations from converting to S corporation status and quickly making post-conversion sales of appreciated property, thus circumventing the repeal of the *General Utilities* doctrine. An S corporation was not permanently subject to this tax, but only if it sold an appreciated asset within ten years after converting from C corporation status.[25] Candidly, the ten-year period was arbitrary, no more or less so than the seven-year period being advocated by these proposals. A reduction of the recognition period from ten to seven years will necessarily have revenue implications, as it will permit S corporations to sell assets in the eighth, ninth, or tenth years of S corporation status without the imposition of a corporate-level tax.

As a footnote to this discussion, the Service has used the ten-year recognition period as a model for other situations in which a C corporation converts to a flow-through entity, such as a regulated investment company (mutual fund) or real estate investment trust.[26] Thus, a change in the S corporation recognition period will likely have implications for these other types of flow-through entities as well.

F. Increase Passive Investment Income Threshold from 25 Percent to 60 Percent

The origins of the section 1375 tax on excess net passive income are somewhat obscure. This tax applies only to those S corporations that have

[24] IRC Section 1361(f) provides that such stock is not taken into account as a class of outstanding stock for purposes of subchapter S, while IRC Section 1368(f) provides rules for the tax treatment of distributions with respect to such stock.
[25] IRC Section 1374(d)(7) defines the recognition period during which the tax is imposed as the ten-year period beginning with the first day of the first taxable year for which the corporation is an S corporation.
[26] Treas. Reg. § 1.337(d)-7(b).

"earnings and profits" accumulated in C corporation years.[27] Some have speculated that the tax deters the use of converted S corporations as "incorporated pocketbooks" that generate substantial amounts of passive income, such as rents, interest, dividends, or royalties.[28] In this regard, the tax serves much the same function as the personal holding company tax for C corporations.[29] The goal of the personal holding company tax is to encourage the prompt payment of dividends that result in an immediate second level of taxation of corporation earnings.

Although the terminology, classification, and statutory structure are different, a C corporation only becomes a personal holding company when its passive investment income exceeds 60 percent of the gross income of the corporation.[30] The proposal to modify the S corporation tax provisions, to increase the passive income threshold from 25 percent to 60 percent, is presumably based on the analogies to the personal holding company provisions, and would be a desirable change for many S corporations.

G. Repeal Excess Passive Investment Income as a Termination Event

If the origins of the section 1375 tax are somewhat obscure, the origins of the terminating event are even more obscure. Under current law, if the passive investment income of an S corporation exceeds the 25-percent gross receipts threshold for three consecutive years, and the S corporation has accumulated earnings and profits at the end of the third year, the corporation loses its status as an S corporation, and thus reverts to the status of a C corporation.[31] There is widespread support for this change, given that there is no analogous provision that applies to personal holding companies. In other words, a personal holding company may be subject to the tax for several consecutive years without any penalty other than the imposition of an additional corporate-level tax for those years. To impose the additional penalty of termination of its status does seem to be unwarranted.

These two proposals relating to the passive investment income of an S corporation are essentially independent of each other. The proponents of

[27] IRC Section 1375(a).
[28] IRC Section 1362(d)(3)(C) contains the applicable definition of "passive investment income" for purposes of the section 1375 tax. See IRC Section 1375(b)(3).
[29] *See* IRC Section 541 et seq.
[30] IRC Section 542(a)(1).
[31] IRC Section 1362(d)(3).

these proposals would likely desire to see both of them enacted, but might be almost as pleased with the enactment of either proposal.

H. Tax Rate Applicable to Built-in Gains Tax and the Tax on Passive Investment Income

None of the proposals being discussed in this hearing address this issue, but I wanted to raise one other issue that has not been recently addressed. Both of the corporate-level taxes imposed on S corporations, *i.e.*, the tax on recognized built-in gains and the tax on excess passive investment income, are designed to replicate the treatment of a C corporation that recognized an item of income, pays tax on that item, and distributes the after-tax amount to its shareholders promptly. This tax structure reasonably achieved this objective until the maximum individual rate on corporate dividends was reduced to 15 percent.[32] In some cases, depending on the type of income that produces the corporate-level tax for the S corporation, the corporation and its shareholders may be subject to a *greater* tax burden than would have applied if the corporation had remained a C corporation. Where the income or gain is subject to a 35-percent tax at both the corporate and shareholder levels, the tax burden is actually worse for the S corporation.[33] To the extent that the 15-percent tax rate remains as a feature of the individual income tax beyond its scheduled expiration of 2010, further consideration of the rates applicable to corporate-level taxes would be in order.

V. Conclusion

I applaud the subcommittee for giving thoughtful consideration to the proposed reform and expansion of the S corporation form. While not advocating any specific proposals, I hope that I have given the members some insights into the policy considerations that may guide the further development of these proposals. I would be pleased to answer any questions you may have.

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[32] IRC Section 1(h)(11).

[33] For example, if a C corporation has $100 of taxable income, and is subject to a 35-percent tax rate, the corporate-level income tax would be $35. The corporation would then distribute $65, the amount remaining after taxes, to the shareholders, and the $65 distribution would be subject to approximately $10 of shareholder-level tax at a 15-percent tax rate. The shareholder would be entitled to retain $55 after full payment of corporate- and shareholder-level taxes. In contrast, assume that an S corporation recognizes $100 of rent or interest income, or ordinary gain, that is subject to either of the two corporate-level taxes. The shareholder receives the same $65 after payment of corporate-level taxes, but is subject to a tax of approximately $23 (35% of $65). Thus, the shareholder of an S corporation retains only $42 after full payment of corporate- and shareholder-level taxes.

Testimony of

Byron E. Shinn, CPA
President,
Shinn & Company, P.A.

Before the

Congress of the United States
House of Representatives
Committee on Small Business
Finance and Tax Subcommittee

Hearing on
"S-Corps – Recommended Reforms that Promote Parity, Growth and Development for Small Business"

June 18, 2008
Washington, D.C.

Good Morning. My name is Byron E. Shinn, CPA and I am the President of Shinn & Company, P.A., a Florida licensed CPA firm located in Bradenton, Florida. Chairwoman Velazquez, Ranking Member Chabot, and members of the committee. I am honored to be testifying today as a CPA who prepares hundreds of Small Business S-Corporation tax returns each year.

I have worked in public accounting my entire career, spanning over 28 years and currently have a small business CPA firm providing tax, audit and accounting services to small businesses, non-profit organizations and governmental entities. We have been operating as an S Corporation since 1993.

I have been appointed to the Florida State Board of Accountancy and served as its chairman in 2001. I currently serve on the Probable Cause Panel of the Board which oversights licensees in Florida. I was on the National Ethics Committee of the National Association of State Boards of Accountancy (NASBA) immediately after Enron and WorldCom, which changed the independence rules for CPAs. I also serve on the University Of South Florida School Of Accountancy Advisory Board.

Summary of Testimony

The S Corporation tax rules are very complex and costly to administer. With the development and popularity of LLC usage, many of these state chartered corporations are choosing to be treated as partnerships to take advantage of the Federal partnership tax rules. It seems only fair and logical to converge the tax structure of these two types of returns into identical benefits and reduce administrative costs for small businesses.

With the current financial strain on small business and the banking industry, I would recommend the suspension or repeal of the Passive Loss limitations (IRC Section 469) which limit the current deduction of losses incurred by the taxpayer on rental real estate and other investments reported from pass-through entities such as S-Corporations and partnerships.

Observations

S-Corporation vs. Partnership - Recently, there has been a convergence of the S-Corporation tax rules toward the partnership rules in regard to the fringe benefit area. However, one of the biggest differences in the tax structure between the two types of entities deals with the calculation of tax basis available for the deductibility of tax losses passed through from the small business. Partnerships generally allow for entity debt to be included in the calculated tax basis, whereas, for an S Corporation, the direct shareholder loans are the only debt added to shareholder basis. That includes loans and other debt that the business has outstanding, including shareholder guaranteed debt. This just doesn't tie to the financial reality of the small business. The loans guaranteed by the owner are real and have a dramatic impact on the owner's credit scores and business planning.

Complexity and administrative costs - The complexity of S-Corporation reporting and filing continues to be more extreme and costly to administer. Some examples include IRC Section 199, Domestic Production Activities Deduction, and the use of an Installment Sale of Assets with the Liquidation of the business.

LLC - In the last decade many states have developed statutes which created the "LLC" or Limited Liability Corporations. This development has provided a general acceptance of the LLC structure as the preferred structure for legal protection while still having the maximum flexibility since they generally can be treated for federal tax purposes as a partnership or an S-Corporation.

Tax Abuses – The wide-spread abuse by taxpayers to avoid payroll taxes on earned income by the aggressive treatment of payments from an S-Corporation to the owners by recharacterizing the payments as a dividend distribution, avoiding the FICA and Medicare taxes due on the payments.

Financing – Generally, small business financing includes the owner's equity that exists in their home as added collateral for the financial institution in order to make the business loan. With the current residential real estate devaluation, many banks are limiting renewal and in many cases closing down the remaining line of credit balance which forces the small business to high interest funding sources such as credit cards. This is devastating, since the banks look at the business assets as having only a low liquidation value, reducing future borrowing power and hamstringing the future of the business.

SBA Loans – The SBA loan packages and documentation requirements take 60 to 90 days from start to completion, even though acceptance time may be less than 10 days after the completed package has been processed. The costs associated with the complexities of the SBA loan documentation are substantial and time consuming. It has been my experience that a non-real estate traditional bank loan, without SBA guarantee usually takes between 14 to 30 days.

S-Corporations versus C-Corporation – S-Corporations are very effective for the owners to avoid double taxation that exists with a "C" corporation. This is due to the double taxation on the dividend distributions.

Passive Loss Rules – The Passive Loss rules of IRC Section 469 have created a situation that generally has a taxpayer who incurs a real cash flow loss from taking a tax loss currently and treats it as a suspended tax loss. This has aggravated the residential real estate market since many middle income taxpayers have invested in real estate and the rules dramatically reduce or totally suspend these losses and prevents a current tax savings. This could go to helping save the property from foreclosure. This would also reduce the pressure on our financial institutions.

GAAP – Generally Accepted Accounting Principles in the US is converting to IFRS, International Financial Reporting Standards. In May of this year, The AICPA Council approved IFRS for non-public companies. This brings fundamental changes to financial accounting standards, including an emphasis on fair value rather than historical cost. Many accounting method changes will be requested with the IRS in the coming years and continue to increase administrative costs to the small business owner.

Qualified shareholders of S Corporations – Currently IRAs are not considered a qualified shareholder for S-Corporations.

Recommendations –

Passive Loss Rules - With the current real estate and foreclosure crisis, a repeal or a suspension of the passive loss rules would provide a significant tax relief for the property owners. This would give some immediate help to the owners of rental real property. I would still keep the passive loss rules in place for the publicly traded partnerships and other investments that are NOT real estate related. Many middle income Americans got caught up in the real estate boom and purchased several rental properties which they are now stuck with little chance for sale in the near future. Foreclosure becomes a real option since many of these homes have first and second mortgages that exceed their current market values. If the banks foreclose, the banks are likely to absorb a large part of the loss. If the taxpayer could receive a current tax benefit for the actual cash loss, they may try to hold on and this would reduce the financial impact on our financial markets and reduce the number of Americans impacted by this awful collapse of our real estate market.

Convergence of S-Corporation rules with Partnerships – Since both are generally treated as pass-through tax entities; immediate convergence of many of the differences in the tax law should be combined. A list of a few of the differences that should be adjusted immediately include –

-Tax Basis and the inclusion of Entity Debt – The S-Corporation currently can only include the shareholder loans made direct to the entity, whereas the partnership includes generally all the entity debt for determining tax basis. This calculation is used for tax loss deductibility in the tax year. This is a huge disparity and has dramatic repercussions to the owners.

-Built-In Gains Rule – This was to avoid double taxation and has a ten year waiting period while a partnership has a disguised sale rule which goes for 7 years. The waiting period needs to be the same at 7 years.

- Disproportionate Distributions – This is NOT allowed currently in S-Corporations which are very important to raise capital from investors when investors want a fixed minimum return and many times will require the debt to be converted into equity. In either case this would terminate the S-Corporation with the current rules. An immediate rule change is highly recommended due to the very restrictive lending which has recently evolved due to the real estate market collapse.

-IRA ownership – Currently S-Corporations can NOT be owned by an IRA, while a partnership can. This would provide an alternate source of funds for the small business and would provide parity with partnerships.

-Acquisition of interest step-up – IRC Section 754 allows for the additional step-up of asset values to the purchase price allowing for additional depreciation for the acquiring partner in a partnership, however, in an S-Corporation no such opportunity exists. This is a huge loss for raising capital and is a huge restraint on an S-Corporation.

-Tax on Liquidation or Transfer of Assets – Generally, the sale and/or distribution of assets from an S Corporation to a partnership creates a tax trap. In order to help existing S-Corporations convert to a partnership, I would recommend that if all the business assets of an S-Corporation are transferred to a new partnership, then a tax-free transfer should be allowed with a similar waiting period as the disguised sale rules that currently exist for property that is transferred into a partnership.

To Reduce Tax Abuses – As stated, I have observed over the years many S-Corporations that had a minimal or non-existent compensation for the managing shareholder and owner employees. This needs either identical treatment as a general partner in a partnership where all the payments are subject to FICA and Medicare, or that specific language is developed which provides better guidance, such as a reasonable rate of return on the investment along with a reasonable level of compensation for services provided to the company.

I have seen physicians with compensation as low as $ 12,000 along with dividend distributions of $ 250,000 or more and there is no more than $ 200,000 in net equity in the company. This is better than a 100% rate of return on the equity of the company along with a very understated salary for services provided to the business.

If the physicians had been in a partnership or an LLC that was treated as a partnership, then both distributions would generally have been subject to the payroll taxes. Parity is sorely needed in this area also.

Financing and SBA Loans – My experience has been that most small businesses do not have the internal resources to complete an SBA loan package, therefore, they are forced to spend time and money with outside professionals who are familiar with the forms and format requested. In addition, the time from start to finish and funding is excruciatingly long. A real review of the necessary forms and processes needs to occur to streamline this process. The SBA loan process needs to be no longer than 14 days for NON-real estate and no longer than 30 days for real estate loans. This would make it competitive with conventional financing. I believe that SBA guarantee support is imperative to maintain a viable source of financing as we move into these trying times before us with the banking situation that is occurring in 2008. The financial institution capital has been dramatically strained due to the foreclosure proceedings and business recession occurring in the marketplace today.

Accounting Method Changes to consider – Many of the small business accounting methods allowed are very basic and should be reviewed immediately. To name a few –

- **Bad debt expense** should be allowed based on the historic collection percentage of the business account receivable history. Currently, only specific receivables can be written off, unless the taxpayer is a bank or financial institution. Many businesses are forced by their bank to book an allowance for bad debt based on their historic trends however the tax rule is very outdated.

-**Inventory adjusted to lower of cost or market**-Inventory should be allowed to be adjusted downward automatically to lower of cost or market regardless of the method initially elected by the taxpayer, since this is also required by their bank and by GAAP. The current rule forces a taxpayer to request a change in accounting to take this change into account. An automatic provision would help speed up benefits and parity.

-**Repeal the rule which caps "Bonus Depreciation" to the current year profit**- The current tax law limits bonus depreciation and IRC Section 179 expense to the business income reported in the current year. If the company has made the qualified expenditures, then why prevent the tax benefit? DON'T we want to help motivate investment in US small businesses? I recommend the deletion of the income limitation for IRC Section179 expenses.

-**FICA Tip Credit**-Consider increasing the limitation on the usage of the FICA Tip Credit by restaurant owners. Most owners can not utilize the tip credit because the window for available usage is so small.

-**Installment Sale allowed for inventory sale**- Currently, if a business sells inventory and holds paper from the buyer, the seller is required to report all the income in the year of the sale. I have seen many instances with builders and mobile home park owners which sell manufactured homes and hold a note as the seller and they are not allowed to use the installment sale. They are forced to pay the tax well in advance. There is no argument of ordinary income versus capital gain. It is just timing. With the current real estate situation, this would help the small business stay afloat.

Conclusion

In conclusion, I have given you a detailed list of items that I have accumulated from discussions with various business owners that I have surveyed recently along with actual situations that I have encountered.

Probably the two most important items would be (1) the convergence of the S-Corporation rules over to the partnership arena, and (2) the suspension of the passive loss rules for rental real estate. This would maximize flexibility and would still have a 7 year look-back rule for abuse similar to the disguised sale rules currently in the partnership area. The passive loss suspension would help with the real estate situation that is impacting almost every American and financial institution.

All of these items listed have been noted from real situations that have come up in my involvement with small businesses over the past 28 years. I pray that your leadership will promote parity, growth and development for small business in the US.

Thank you again for the opportunity to share ideas with the committee.