POSITION PAPER

Recommendations for Tax Law Changes to Reflect How Small Businesses Operate in the Modern World

The Tax Cuts and Jobs Act (P.L. 115-97; 12/22/17 (TCJA)) included significant simplification for small businesses such as favorable accounting methods and an exception from the new interest expense limitation. These changes highlight the need for related changes to make these simplified rules more consistent in application. For example, while a small business may use the cash method and expense up to $1 million of qualified assets under section 179, that business might be required to amortize start-up expenditures over 15 years even though it has not used the entire $1 million of expensing and is using the simple cash method.

The number of small businesses continues to grow[1] as technology makes it easier to create a business and reach customers throughout the world. Our federal tax laws do not fully reflect the ways many of these businesses operate. Many do not need significant office space, have no employees,[2] and can operate out of the owner's home. Yet, despite incurring costs of operating that office, the business owner is unlikely to qualify for a home office deduction.

The predominant entity form is the sole proprietorship, mainly due to ease of formation and operation. Yet, sole proprietors do not obtain the same tax benefits as corporations with respect to state and local tax deductions, dealing with the alternative minimum tax (AMT), and a few other tax rules. In addition, sole proprietors face complexity and other challenges in creating their retirement plans.

The AICPA Tax Executive Committee identified 13 changes to further simplify tax rules for small businesses, bring greater equity among business types, and cause the tax law to better reflect the realities of how small businesses operate today. Our recommendations are explained here.[3]

1. **Expand section 179 to also include intangible assets**

   A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization.

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[1] Per the Small Business Administration (SBA), there were 28.4 million small businesses in 2012 and 30.2 million in 2015. See data reported in 2015 (https://www.sba.gov/sites/default/files/advocacy/US_0_0.pdf) and 2018 (https://www.sba.gov/sites/default/files/advocacy/2018-Small-Business-Profiles-US.pdf).

[2] Per SBA data, in 2015, 80% of small businesses had no employees; https://www.sba.gov/sites/default/files/advocacy/Frequently-Asked-Questions-Small-Business-2018.pdf.

[3] The recommendations of this position paper were drafted and approved by the AICPA Tax Executive Committee with input from the Tax Division 's Technical Resource Panels. The recommendations are numbered for reference, not to indicate prioritization.

Section 179 provides an election for small businesses to expense the cost of qualifying property, which is generally limited to tangible personal property, certain real property, and off-the-shelf software. Small businesses benefit from the simplicity and acceleration of tax deductions afforded by this provision. Lawmakers could improve the provision by expanding qualified property that can be expensed by small businesses to include intangibles that are required to be capitalized under section 263(a) (section 197 intangibles, prepaid expenses and contract rights outside the 12-month rule and facilitative costs), start-up costs under section 195 and organizational costs under sections 248 and 709. These provisions are complex for small businesses to administer and the objective of section 179 would be furthered by expanding its scope to include intangible property. Such expansion would better reflect today's business activities that often involve acquisition of domain names, customer lists, and intellectual property.

Recommendation: Modify section 179 to allow expensing of both tangible and intangible assets.

2. **Further simplify accounting method rules for small businesses**

The TCJA provided simplified methods of accounting for small businesses with average annual gross receipts in the prior 3-year period of $25 million or less, adjusted annually for inflation (defined at section 448(c)). Under these provisions, these businesses are eligible to use the cash method of accounting. In addition, they are exempt from the requirement to keep inventories under section 471, to apply the uniform capitalization rules under section 263A, and to use the percentage of completion method under section 460(e) for certain construction contracts. These simplified methods provide much needed relief for small businesses. However, small businesses grapple with many other accounting method provisions that create undue complexity. These provisions include capitalization requirements for intangibles under section 263(a), the requirement to capitalize start-up costs under section 195 and organizational costs under sections 248 and 709.

Recommendation: Small businesses as defined under section 448(c) should be excepted from sections 263(a) (for both tangible and intangible property), 195, 248 and 709 and other accounting methods under Subchapter E of Chapter 1 of the Internal Revenue Code that are contrary to simple use of the cash method by small businesses (such as section 460).[4] The AMT accounting methods should conform to those allowed for regular tax purposes to ensure simplified accounting methods exist for all tax purposes. For further simplification though, repeal the AMT for all taxpayers (see Recommendation 6).

3. **Increase the deduction thresholds under sections 195, 248 and 709 and adjust them for inflation**

Generally, start-up and organizational expenditures are amortized over 15 years under sections 195, 248 or 709. However, a business can deduct up to $5,000 in the year business begins if total expenditures under the particular provision are $55,000 or less (with a phase

[4] Alternatively, taxpayers should be allowed to treat section 195, 248, 263(a) and 709 expenditures as eligible for the section 179 election to allow a simpler expensing in the year the business starts operations; see Recommendation 1.

down between $50,000 and $55,000 of such expenditures). These figures are not adjusted for inflation. These amounts should be increased for the effects of inflation since these figures were added in 2004 and thereafter adjusted annually for inflation.[5]

Recommendation: Increase the dollar amounts in sections 195, 248 and 709 and adjust them for inflation. This change should be made in addition to Recommendation 1 that would allow a taxpayer to elect to expense these expenditures under section 179.

4. Simplify retirement plan options and rules for self-employed individuals

The commonly used retirement plans available to self-employed individuals and small businesses retirement plans are the SEP / IRA and the solo 401(k). The contribution limits for these plans differ though. Also, the solo 401(k) must be established before year end while a SEP may be created after year end. In addition, the solo 401(k) requires filing of Form 5500 once the account exceeds a certain limit resulting in increased compliance and administration costs for the business owner.

Recommendation: Retirement plans available to self-employed individuals should be simplified. Any choice of plans should have similar contribution and compliance requirements.

5. Modernize the definition of tax shelter

The TCJA allows favorable accounting methods for small businesses and excepts them from the complex interest expense limitation added at section 163(j). However, if a small business meets the definition of a tax shelter,[6] these favorable rules do not apply, even though the business has no tax avoidance or evasion purpose. The definition of tax shelter used by the TCJA is the same one added to the law in 1986 and goes well beyond an entity formed for tax avoidance or evasion purposes which is how most people would define a tax shelter. The old definition, given broader significance by the TCJA, includes a syndicate where over 35 percent of losses for a tax year are allocable to owners who do not actively participate in management of the entity (not uncommon for a small business operating as a limited liability company (LLC) with multiple owners). The concerns of 1986 do not exist today particularly because the passive activity loss limitation rules of section 469, enacted in 1986, prevent passive owners from deducting entity losses unless the owner also has passive activity income. In addition, in 1986, use of the limited liability company (LLC) entity was rare as most states did not even have LLC laws.[7] If a tax shelter

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[5] H.R. 6756 (115th Congress), the American Innovation Act, would modify section 195 to increase the $5,000 deduction amount to $20,000 and the start of the phase-out of $50,000 to $120,000, adjust for inflation, and include certain organizational expenditures. This bill passed in the House on 9/27/18.

[6] Section 448(d)(3) defines tax shelter per section 461(i)(3) which includes three definitions of a tax shelter: (A) any enterprise (other than a C corporation) if at any time its interest are offered in a sale required to be registered with any federal or state agency; (B) a syndicate as defined at section 1256(e)(3)(B), and (C) any tax shelter as defined at section 6662(d)(2)(C)(ii).

[7] In 1977, Wyoming became the first state to allow for LLCs. Delaware recognized this form in 1991, and other states followed. Today, an LLC is the predominant partnership form (see Joint Committee on Taxation, *Choice Of Business*

limitation is needed, the definition of tax shelter at section 6662(d)(2)(C) of an entity with a significant purpose of avoidance or evasion of federal income tax is the more appropriate definition today given other loss limitation rules already in the law and the reality that LLCs are a favored entity form for small businesses. In addition, the broader definition harms entities with inactive owners who often provide needed financing, yet the entity was not formed for tax avoidance or evasion.

Recommendation: Modernize the definition of tax shelter to simplify the tax system for many small businesses and provide equity among business entity forms.

6. Repeal the individual and estate and trust AMT

An AMT is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the tax year. Prior to 2018, there was also a corporate AMT, but it was repealed by the TCJA. Small businesses that operate in passthrough form continue to be encumbered by a complex dual tax system that businesses operating in corporate form are no longer subject to. Many of the AMT preferences and adjustments affect taxation of business items taxable to individuals, estates and trusts. For example, AMT timing differences for depreciation, long-term contracts, amortization, magazine circulation expenditures, research and experimentation expenditures, now apply differently to non-corporate businesses than for corporations. These items create undue complexity for non-corporate businesses and inequity in that the AMT only applies to non-corporate taxpayers.

Recommendation: Repeal the AMT in its entirety. Alternatively, the AMT should be simplified and made more equitable among business entity types by repealing AMT preference and adjustment items that pertain to businesses.

7. Relax the exclusive use requirement for a home office deduction

A growing number of individuals are self-employed. Often, they have no need to own or rent office or distribution space because they have few or no employees and limited space may be needed if the business primarily ships goods or deals in digital goods or services. Such a business may operate out of the owner's home (rented or owned). Given that the space needs may be small and business activities can operate on a 24/7 schedule, the home space often does not generate a business deduction because the exclusive use requirement is not met. This requirement is too strict today when people run many aspects of their personal and working lives from a laptop computer and smartphone. But such combined use prohibits deduction for any space where that computer or phone are used.

Recommendation: Modernize the home office rules to remove the exclusive use requirement and allow all businesses to report taxable income that reflects all operational costs.

Entity: Present Law And Data Relating To C Corporations, Partnerships, And S Corporations, JCX-71-15 (4/10/15), Table 6 and Figure 3).

8. **Allow a deduction for health insurance of self-employed individuals in computing self-employment tax**

   Deductions allowable in determining a tax should remain consistent among all taxpayers subject to that tax. The Self-Employment Contributions Act (SECA) imposes tax on the net earnings from self-employment. The tax is composed of two parts: old-age, survivors and disability insurance (OASDI) tax and hospital insurance (HI) tax. Section 162(l)(4) provides that self-employed individuals are not allowed to deduct their health insurance costs from net earnings from self-employment (within the meaning of section 1402) in determining tax under section 1401(a) and section 1401(b) for OASDI. However, pursuant to section 3121(a)(2), health insurance costs are excluded from an employee's wages in determining tax under section 3101(a) and 3101(b) for OASDI and HI taxes.

   Recommendation: Allow self-employed individuals to reduce self-employment income by their self-employed health insurance costs of section 162(l).[8]

9. **Increase the current, longstanding $400 self-employment earnings threshold**

   For a few decades, the threshold of self-employment income for when self-employment tax is owed is $400 and not adjusted for inflation.[9] Lawmakers should increase the amount to better reflect the effects of inflation over the years. The amount should also exceed what might be earned in one week or less.

   One possible threshold that would be adjusted annually by the Social Security Administration is to use "the amount required under section 213(d) of the Social Security Act for a quarter of coverage for the calendar year in which such taxable year began."[10] For 2019, this amount is $1,360.[11]

   Recommendation: Increase the statutory threshold ($400) to a higher amount such as the amount specified annually under section 213(d) of the Social Security Act.

10. **Provide similar treatment for all businesses with respect to deducting state and local income taxes**

    All businesses should be allowed to deduct the taxes imposed upon them. Under current law, all businesses may deduct taxes imposed directly on the business, such as property taxes. However, only corporations can deduct state and local income taxes on their business income. For individuals, this deduction is only allowed if the individual itemizes deductions and then only if the income taxes, along with other taxes owed by the individual do not exceed $10,000.

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[8] This is a longstanding recommendation of the AICPA (see for example, 2017 AICPA Legislative Compendium of Tax Legislative Proposals, page 31). It is also a recommendation of H.R. 593, Small Business Owners' Tax Simplification Act of 2019 (H.R. 3717 (115th Congress)).

[9] Section 1402(b).

[10] This proposal is included in H.R. 593, Small Business Owners' Tax Simplification Act of 2019 (H.R. 3717 (115th Congress)).

[11] SSA, Quarter of Coverage information; https://www.ssa.gov/oact/cola/QC.html.

All state and local income taxes allocable to business income should be deductible *for* adjusted gross income (AGI) (existing AICPA position). One of the provisions of the TCJA was a substantive amendment to section 164. Congress imposed limits on the amount of state and local taxes an individual may deduct for regular federal income tax purposes, imposing a $10,000 limit for most individuals and a $5,000 limit on married individuals filing separately. There were no changes to the provision in section 164 that allows for the deduction for taxes paid by a trade or business that are imposed on the business directly, such as property taxes. The new limit on the deduction for state and local taxes has a disproportionately negative impact on business owners who are operating as sole proprietorships, disregarded entities, or pass-through entities. Under the TCJA, C corporations may continue to deduct state and local income taxes in determining their taxable income. The rationale for this different treatment is a 1944 law that added the concept of adjusted gross income.[12] This 1944 view does not adequately reflect today's tax system and the varied business forms utilized today.

Recommendation: Allow all businesses a deduction for state and local income taxes imposed on business income.

11. Limit section 461(l) and the 80% limitation on NOLs of section 172 for start-up businesses

Starting in 2018, excess business losses of noncorporate taxpayers are not allowed to the extent the loss exceeds specified thresholds ($500,000 married filing joint/$250,000 single) under section 461(l). NOLs generated in 2018 and afterward can only be used in any particular year to offset 80% of taxable income (section 172). These changes create hardships for start-up companies. The definition of start-up businesses ("qualified small business") of the section 41(h)(3) could be used for this purpose.

Recommendation: Provide an exception for start-up businesses from application of section 461(l) and the 80% limitation on NOLs.

12. Repeal section 465

Rules that limit losses for small business owners are onerous and complex, as a taxpayer has multiple sets of rules to consider with different purposes and definitions. A taxpayer's loss deductions from any activity cannot exceed the amount the taxpayer has "at risk" in each activity at the end of the tax year. Investors are at risk for an activity to the extent of cash and other property contributed, or for loans on which they are personally liable, or for qualified nonrecourse financing related to the activity of holding real estate.

The passive loss rules further limit deductions and credits from passive trade or business activities (*i.e.*, an activity where the taxpayer does not materially participate). Starting in

[12] See footnote 168 of the Conference Committee Report 115-166 (12/15/17) to H.R. 1 (P.L. 115-97) that refers to "Individual Income Tax Bill of 1944 (78th Cong., 2d. Sess.), reprinted at 19 C.B. 839 (1944)." This 1944 description provides that taxes directly imposed upon a business are deducted for AGI while those only remotely imposed (such as state income taxes for a sole proprietor or partner) are deducted from AGI.

2018, new section 461(l) limits excess business losses of noncorporate taxpayers to the extent the loss exceeds specified thresholds ($500,000 married filing joint/$250,000 single).

The at-risk rules under section 465 were enacted prior to the passive loss regime and the new excess business loss regime and the rules are complex and duplicative with the other regimes in several respects. For example, the activity of holding real estate is generally a passive activity, such that the losses are limited under the passive activity rules.

Recommendation: Repeal the at-risk rules for all taxpayers. Alternatively, they should be repealed for small businesses, or the loss limitation rules applicable to small businesses should be streamlined.

13. Require all estimated tax payments to be due on the 15th day after quarter end

Quarterly estimated tax payments for individuals (including business owners) are currently due April 15, June 15, September 15 and January 15. The spacing between these dates does not tie to normal quarters which can be confusing to self-employed individuals (and others) and even challenging to compute and timely pay. Changing the June 15 date to July 15 and the September date to October 15 would consistently schedule the dates to three months apart and tie to the normal quarter date (15 days after the quarter end).[13]

Recommendation: Change the due dates for the second and third quarter estimated tax payments to have all quarterly payments due 15 days after the end of the quarter.

[13] This proposal to change the estimated tax due dates to all be 15 days after the normal quarter end is included in H.R. 593, Small Business Owners' Tax Simplification Act of 2019 (116th Congress); (H.R. 3717 (115th Congress)). It was also recommended by the National Taxpayer Advocate in the 2018 Purple Book (item #13) and the 2019 Purple Book (Item #11).