



American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

December 21, 2016

The Honorable Kevin Brady, Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

RE: The House Republican's Tax Reform Task Force Blueprint

Dear Chairman Brady:

The American Institute of CPAs (AICPA) appreciates the opportunity to provide input on the House Republican's Tax Reform Task Force blueprint¹ ("A Better Way" plan), released on June 24, 2016. Our profession has long-advocated for simplification to the tax system² because we are convinced such actions will reduce taxpayers' compliance costs, encourage voluntary compliance through an understanding of the rules and greater respect for the system, and improve enforcement actions. Our comments in this letter focus on areas of interest to professional service businesses. We expect to provide additional comments on the plan after draft legislative language is available.

The AICPA is the world's largest member association representing the accounting profession, with more than 418,000 members in 143 countries and a history of serving the public interest since 1877. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium size businesses, as well as America's largest businesses.

Cash Method of Accounting

The AICPA recognizes that the blueprint does not limit the use of the long-standing cash method of accounting for businesses that are currently entitled to use it. The cash method of accounting is simpler in application, has fewer compliance costs and does not require taxpayers to pay tax before receiving the associated income. The cash method of accounting is particularly appropriate in the service sector since revenues earned for services – including work in process and billed, uncollected receivables – are particularly difficult to estimate until they are ultimately collected. The cash basis of accounting in these business sectors significantly reduces the cost of collection in tax administration and the cost of uncertainty to taxpayers. We will continue to oppose any new limitations on the use of the cash method of accounting.

¹ House Republican's Tax Reform Task Force, A Better Way: Our Vision for a Confident America, June 24, 2016; <http://abetterway.speaker.gov/assets/pdf/ABetterWay-Tax-PolicyPaper.pdf>.

² AICPA, Guiding Principles for Good Tax Policy: Framework for Evaluating Tax Proposals, 2001; <http://www.aicpa.org/taxreform>.

Tax Rate for “Active Business Income”

In your efforts to reduce income tax rates, we appreciate the recognition that a rate reduction only for C corporations is inappropriate. Discouragement of the formation of pass-through entities should not happen because such entities provide for the flexibility desired by many business owners.

We assume that use of the term “active business income” is to distinguish business from investment income. A distinction between active business income and passive investment income presently exists by virtue of the definition of passive income in section 1362(d) of the Internal Revenue Code. We suggest the use of this definition for this purpose as well.

Distinguishing Compensation Income

The AICPA recognizes that providing a reduced rate for active business income of pass-through entities will place additional pressure on the distinction between the profits of the business and the compensation of owner-operators. The plan states (page 23) that: “Under this new approach for taxing small businesses, sole proprietorships and pass-through businesses will pay or be treated as having paid reasonable compensation to their owner-operators. Such compensation will be deductible by the business and will be subject to tax at the graduated rates for families and individuals.”

We recommend determining compensation income by using traditional definitions of reasonable compensation supplemented, if necessary, by additional guidance from the Secretary of the Treasury. We believe that changes to existing payroll tax rules to require partnerships and proprietorships to charge reasonable compensation for owners’ services and to withhold and pay the related income and other taxes will also facilitate compliance in this area.

We encourage Congress to consider existing guidance on “reasonable compensation” that reflects the type of business (for example, labor versus capital intensive), the time spent by owners in operating the business, owner expertise and experience, and the existence of income-generating assets in the business (such as other employees and owners, capital and intangibles). There is substantial law developed by regulations and judicial decisions relating to reasonable compensation. Congress should leverage the existing law in this context.

We acknowledge that “reasonable compensation” has been the subject of controversy and litigation (hence, the numerous court decisions helping to define it). Therefore, we would suggest that the Internal Revenue Service (IRS) take additional steps to improve compliance and administration in this area. For example, the creation of a new tax form (or preferably, modification of an existing form, such as Form 1125-E Compensation of Officers) would allow businesses to indicate the factors considered in determining compensation in a consistent manner.

For example, the potential factors may include: (1) approximate average hours per week worked by all owners; (2) approximate average hours worked per week by non-owner employees; (3) the owner’s years of experience; (4) guidance used to help determine reasonable compensation for the

geographic area and years of experience (such as, wage data guides provided by the U.S. Bureau of Labor Statistics); and (5) book value and estimated fair market value of assets that generate income for the business.

To accommodate the change within the current tax system and to facilitate administration, changes are also necessary to existing payroll tax rules to require partnerships and proprietorships to charge reasonable compensation for owners' services and to withhold and pay the related income and other taxes. The partners and proprietors are not treated as "employees," but rather owners subject to withholding – a new category of taxpayer – similar to a partner with a guaranteed payment for services.³ Rules requiring reasonable compensation currently exist in connection with S corporations. The broader inclusion of partners and proprietors in these rules should facilitate and enhance the development of reasonable regulations and enforcement in this area.

The AICPA believes there are advantages of this reasonable compensation approach for owners of all business types. These advantages include:

- Fairness that respects the differences among business types;
- A reduced reliance by both taxpayers and the IRS on quarterly estimated tax payments for timely matching of the earning process and tax collection;
- Diminished reliance on the self-employment tax system (since businesses would include payroll taxes withheld from owners and paid for owners); and
- Simplification from uniformity of collection of employment tax from business entities, and an ability to rely on a deep foundation of case law (in the S corporation, personal service corporation, and accumulated earnings tax areas) to provide regulatory and judicial guidance in a broad variety of situations.

In Chairman Camp's 2014 discussion draft, a proposal was included to treat 70 percent of pass-through income of an owner-employee as employment income. While this proposal would be a simple method of determining the compensation component, we believe that it would result in an inaccurate and inequitable result in too many situations.

In particular, it fails to take into account the relative contribution of capital, investment and employee labor from the contribution made by the labor of the owners. Enterprise value and capital invested in land, buildings and equipment for a farmer is a greater contributor to profits than the farmer's labor, despite the amount of labor that farming involves. Profits from a law practice with no employees is more likely attributable primarily to the labor of the owners rather than the business assets. In contrast, a law firm with 10 practicing attorneys and 50 non-owner employees would have a material percentage of the income attributable to non-owners, invested capital and business goodwill.

³ In order to avoid the generation of net operating losses, a "true-up payment" or payroll adjustment after the end of any calendar year to adjust reasonable compensation based on the actual profits of the enterprise in any calendar year is recommended.

Definition of “Compensation”

The blueprint states (page 20): “businesses will deduct compensation paid to their employees and workers. Generally, the tax system should use the same definition for taxable compensation of employees as it does for compensation employers may deduct.”

We are concerned about any reduction in an employer’s deduction for compensation paid to employees, whether in the form of wages or fringe benefits (health and life insurance, disability benefits, deferred compensation, etc.). We are similarly concerned about an expansion of the taxable income for employees. Such changes in our Tax Code would have a negative impact on small and labor-intensive businesses’ ability to retain a competitive workforce.

Limitation on Interest Expense Deduction

A limitation of the deduction for interest expense (to the extent of interest income) would effectively eliminate the deduction of a valid business expense for many small businesses, as well as many professional service firms. If, as some have suggested, this intended change is paired with the blueprint’s proposal to allow a deduction for otherwise depreciable property, it is important to recognize that combination would adversely affect service providers and small businesses while offering larger manufacturers, retailers and other asset-intensive businesses a further benefit.

Currently, small businesses can expense up to \$500,000 of acquisitions per year under section 179 (\$510,000 for 2017) and deduct any associated interest expense. The new proposal would eliminate the benefit of the interest expense while allowing immediate expensing of the full cost of new equipment in the first year. However, since small businesses do not generally purchase large amounts of new assets, the proposal does not provide any new benefit for smaller businesses. Instead, it only takes away an important deduction for many small businesses who rely on debt to cover their operating and expansion costs.

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

Retirement Savings

We encourage Congress to simplify retirement savings for both individual plans, employer-provided plans, and those plans for self-employed individuals. When a small business grows and explores options for establishing a retirement plan, it encounters numerous alternatives subject to various rules that can become overwhelming. It is valuable to provide simple and equitable options encouraging both employers and their employees to fund retirement savings. We encourage Congress to maintain these incentives. The AICPA would support consolidation and simplification in this area. We also suggest that any changes to retirement plans reflect today’s

longer life expectancies with the increased need for all individuals to have adequate retirement savings.

Tax Administration

We appreciate your interest in the “New Tax Administration for New Tax Code.” Our profession is committed to improving the taxpayer and tax preparer experience when interacting with the agency. The AICPA Council passed a resolution regarding tax administration⁴ and fully supports rebuilding the IRS into a modern and efficient 21st century administrator of the nation’s tax system.

In order to achieve a streamlined structure, we think it is crucial for taxpayers and practitioners to have access, both timely and meaningful access, to the IRS. We have urged the agency to focus on (1) utilizing modern and secure technology, (2) developing and continuing to hire and train knowledgeable employees, and (3) regularly seeking and utilizing stakeholder engagement. By focusing on these factors, the IRS will become a “Service First” agency.

Finally, we recommend that you consider various options for easing compliance burdens on taxpayers and maximizing their access to professional advisors. For example, permitting certain flow-through entities to choose fiscal year ends consistent with their normal operating cycle year-ends while allowing advisers to spread out their workloads during the year would help ease burdens on both taxpayers and advisors. The AICPA looks forward to working with Congress to identify these types of issues.

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We appreciate the opportunity to provide comments and look forward to working with you on the development of tax reform proposals. Our members have direct knowledge of what works, and what does not work, in our existing system and how changes can affect individuals, businesses and non-profit entities of all sizes. We are committed to sharing our expertise and insights with you. Please feel free to contact me at (408) 924-3508 or Annette.Nellen@sjsu.edu; or Melissa M. Labant, Director – AICPA Tax Policy & Advocacy, at (202) 434-9234 or mlabant@aicpa.org.

Respectfully submitted,



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Chair, AICPA Tax Executive Committee

cc: The Honorable Sander M. Levin, Ranking Member, House Committee on Ways & Means
The Honorable Orrin G. Hatch, Chairman, Senate Committee on Finance
The Honorable Ronald L. Wyden, Ranking Member, Senate Committee on Finance
Members of Committee on Ways & Means

⁴ AICPA Council Resolution Regarding Tax Administration, May 17, 2015; <https://www.aicpa.org/Advocacy/Tax/downloadabledocuments/council-resolution-on-tax-administration.pdf>.