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Chairman Hatch, Ranking Member Wyden, and members of the committee: thank you for inviting me to discuss this important topic. My name is Sanford Zinman, and I am the Vice President and Tax Policy Chair of the National Conference of CPA Practitioners - NCCPAP. NCCPAP is the country's second largest CPA organization, comprised mostly of small CPA firms. NCCPAP members serve more than one million business and individual clients. NCCPAP has long advocated for tax simplification and tax equality. When taxpayers understand the laws they are more accepting of the rules.

My testimony today will address the current business tax structure in the U.S. and its impact on the small and "micro" businesses. My 35 years as a CPA sole practitioner involves working with and advising a variety of these businesses. My clients include grocery stores operating as cooperative corporations, building contractors and home builders, medical professionals, attorneys and everything in between.

Small Business and Micro Business – An Overview

What's already known is that small businesses make up an overwhelming majority of the number of businesses in our country. According to a GAO report published in June of 2015, small businesses, as defined by less than $10 million in total revenue, make up roughly 99 percent of all businesses. That same report states that 69 percent of those small businesses are individual taxpayers while 31 percent come from partnerships or corporations. The report also indicates that 20 percent of the small business population hire at least one employee and produce about 71 percent of total small business income. The small business community is vital to America. It's vital to our economy and it's vital to keeping alive the American dream for all. Today, small business deals with massive hurdles brought on by the burden of dealing with tax compliance related activities. These compliances vary depending on the type of business entity, industry type, number of employees, asset size, to name a few. Without going into the overwhelming number of separate items which would necessitate the conversation for sweeping tax reform, we need to now resolve the tremendous cost burden that the small business owners must endure.

Many Mom and Pop businesses, which l call "micro" businesses, operate the same way they did 50 years ago. Many are sole proprietors or Subchapter S corporations. The life of a business often begins when the owner seeks advice from his or her attorney. Just as often, the attorney recommends that the owner gets the opinion of a qualified tax advisor - usually a CPA. The form of organization is often irrelevant to the business owners. They just want to get out there and make some money.

What do these "micro" business owners want? They want to better their lives and keep as much of their profits as they legitimately can for themselves. It's safe to say that this is the American way. When these individuals come to me and want to start a business, the first thing they want to know is what is the simplest type of business to open that will protect their existing assets while costing them the least amount of tax. Of course, this is never a standard "C" corporation.

Life was simpler 50 or 60 years ago, but we aren't there anymore. New types of business organizations have been created. Each one has potential benefits and potential pitfalls. CPA's will explain the nuanced differences between a corporation, an S corporation, a partnership and an LLC. Ultimately, the differences are not extremely significant in the big picture. However, these differences can cause unnecessary complications in the decision making process.

The interview process requires the CPA to determine a business owner's sophistication regarding the tax law and tax regulations. Do they understand the payroll process along with the filing and paying of payroll taxes? Are they responsible to pay their own quarterly estimated taxes? What are their medical insurance needs? Only after these conversations can a CPA provide meaningful guidance. Yet the issues raised do not necessarily help the business owner in achieving his or her true objective: to put food on the table. Additionally, although the form of business entity chosen may meet the current needs of the owner, these needs may change over time. Then the organizational structure, which was originally correct, may no longer be the proper one. Over the years I have met with business owners believing that their lawyer or CPA caused problems because they set things up wrong. After some prodding I find that the nature of the business changed and what was correct before no longer is.

We try to help our clients choose a business structure that is right for them. The similarities and differences among business entities often make the choice a difficult one. There can be a simpler common taxation approach to the various business entities.

Types of Business Entities – An Overview

(Sources: Internal Revenue Service and Small Business Administration)

This section is not meant to be a complete review of all types of business entities or the related taxes.

C Corporations

In forming a corporation, prospective shareholders exchange money, property, or both, for the corporation's capital stock. A corporation generally takes the same deductions as a sole proprietorship to figure its taxable income. A corporation can also take special deductions. For federal income tax purposes, a C corporation is recognized as a separate taxpaying entity. A corporation conducts business, realizes net income or loss, pays taxes and distributes profits to shareholders. The profit of a corporation is taxed to the corporation when earned, and then is taxed to the shareholders when distributed as dividends. This creates a double tax. The corporation does not get a tax deduction when it distributes dividends to shareholders. Shareholders cannot deduct any loss of the corporation.

S Corporations

S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations are responsible for tax on certain built-in gains and passive income at the entity level.

All states do not tax S corps equally. Most recognize them similarly to the federal government and tax the shareholders accordingly. However, some states (like Massachusetts) tax S corps on profits above a specified limit. Other states don't recognize the S corporation election and treat the business as a C corporation with all of the tax ramifications. Some states (like New York and New Jersey) tax both the S corps profits and the shareholder's proportional shares of the profits. The corporation must file the Form 2553 to elect "S" status within two months and 15 days after the beginning of the tax year or any time before the tax year for the status to be in effect.

To qualify for S corporation status, the corporation must meet the following requirements:

- Be a domestic corporation
- Have only allowable shareholders
  - May be individuals, certain trusts, and estates and
  - May not be partnerships, corporations or non-resident alien shareholders
- Have no more than 100 shareholders
- Have only one class of stock
- Not be an ineligible corporation (i.e. certain financial institutions, insurance companies, and domestic international sales corporations).

An S corporation is created through an IRS tax election. An eligible domestic corporation can avoid double taxation (once to the corporation and again to the shareholders) by electing to be treated as an S corporation.

What makes the S corporation different from a traditional corporation (C corporation) is that profits and losses pass through to the shareholder's personal tax return. Consequently, the business is not taxed itself. The corporation must furnish copies of Schedule K-1 (Form 1120S) to the partners by the date Form 1120 is required to be filed, including extensions. There is an important caveat, however: any shareholder who works for the company must pay him or herself "reasonable compensation." Basically, the shareholder must be paid fair market value, or the IRS might reclassify any additional corporate earnings as "wages."

Advantages of an S Corporation

- **Tax Savings.** One of the best features of the S Corp is the tax savings for the owners and the business. While members of an LLC are subject to employment tax on the entire net income of the business, only the wages of the S Corp shareholder who is an employee are subject to employment tax. The remaining income is paid to the owner as a "distribution," which is taxed at a lower rate, if at all.
- **Business Expense Tax Credits.** Some expenses that shareholder/employees incur can be written off as business expenses. Nevertheless, if such an employee owns 2% or more shares, then benefits like health and life insurance are deemed taxable income.
- **Independent Life.** An S corp designation also allows a business to have an independent life, separate from its shareholders. If a shareholder leaves the company, or sells his or her shares, the S corp can continue doing business relatively undisturbed. Maintaining the business as a distinct corporate entity defines clear lines between the shareholders and the business that improve the protection of the shareholders.

Disadvantages of an S Corporation

- **Stricter Operational Processes.** As a separate structure, S corps require scheduled director and shareholder meetings, minutes from those meetings, adoption and updates to by-laws, stock transfers and records maintenance.

- **Shareholder Compensation Requirements.** A shareholder must receive reasonable compensation. The IRS takes notice of shareholder red flags like low salary/high distribution combinations, and may reclassify distributions as wages. An owner could pay a higher employment tax because of an audit with these results.

Partnerships

A partnership is the relationship existing between two or more persons who join to carry on a trade or business. Each person contributes money, property, labor or skill, and expects to share in the profits and losses of the business. A partnership must file an annual information return to report the income, deductions, gains, losses, etc., from its operations, but it does not pay income tax. Instead, any profits or losses pass through to its partners. Each partner includes his or her share of the partnership's income or loss on his or her tax return. Partners are not employees and should not be issued a Form W-2. The partnership must furnish copies of Schedule K-1 (Form 1065) to the partners by the date Form 1065 is required to be filed, including extensions. Because partnerships entail more than one person in the decision-making process, it’s important to discuss a wide variety of issues up front and develop a legal partnership agreement. This agreement should document how future business decisions will be made, including how the partners will divide profits, resolve disputes, change ownership (bring in new partners or buy out current partners) and how to dissolve the partnership. Although partnership agreements are not legally required, they are strongly recommended and it is considered extremely risky to operate without one.

Types of Partnerships

There are three general types of partnership arrangements:

- **General Partnerships** assume that profits, liability and management duties are divided equally among partners. If partners opt for an unequal distribution, the percentages assigned to each partner must be documented in the partnership agreement.

- **Limited Partnerships** (also known as a partnership with limited liability) are more complex than general partnerships. Limited partnerships allow partners to have limited liability as well as limited input with management decisions. These limits depend on the extent of each partner's investment percentage. Limited partnerships are attractive to investors of short-term projects.

- **Joint Ventures** act as general partnership, but for only a limited period of time or for a single project. Partners in a joint venture can be recognized as an ongoing partnership if they continue the venture, but they must file as such.

To form a partnership, the partners register the business with resident state, a process generally done through the Secretary of State's office. A business name must be established. The legal name is the name given in the partnership agreement or the last names of the partners or a fictitious name (also known as an assumed name, trade name, or DBA name, short for "doing business as").

Most businesses will need to register with the IRS, register with state and local revenue agencies, and obtain a tax ID number or permit. A partnership must file an "annual information return" to report the income, deductions, gains and losses from the business's operations, but the business itself does not pay income tax.

Partnership taxes generally include:

- Annual Return of Income
- Employment Taxes
- Excise Taxes

Partners in the partnership are responsible for several additional taxes, including:

- Income Tax
- Self-Employment Tax
- Estimated Tax

Advantages of a Partnership

- **Easy and Inexpensive.** Partnerships are generally an inexpensive and easily formed business structure. The majority of time spent starting a partnership often focuses on developing the partnership agreement.
- **Shared Financial Commitment.** In a partnership, each partner is equally invested in the success of the business. Partnerships have the advantage of pooling resources to obtain capital. This could be beneficial in terms of securing credit, or by simply doubling seed money.
- **Complementary Skills.** A good partnership should reap the benefits of being able to utilize the strengths, resources and expertise of each partner.
- **Partnership Incentives for Employees.** Partnerships have an employment advantage over other entities if they offer employees the opportunity to become a partner. Partnership incentives often attract highly motivated and qualified employees.

Disadvantages of a Partnership

- **Joint and Individual Liability.** Similar to sole proprietorships, partnerships retain full, shared liability among the owners. Partners are not only liable for their own actions, but also for the business debts and decisions made by other partners. In addition, the personal assets of all partners can be used to satisfy the partnership’s debt.
- **Disagreements Among Partners.** With multiple partners, there are bound to be disagreements Partners should consult each other on all decisions, make compromises, and resolve disputes as amicably as possible.
- **Shared Profits.** Because partnerships are jointly owned, each partner must share the successes and profits of their business with the other partners. An unequal contribution of time, effort, or resources can cause discord among partners.

LLC’s

A limited liability company is a hybrid type of legal structure that provides the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. The "owners" of an LLC are referred to as "members." A Limited Liability Company (LLC) is a business structure allowed by state statute. Each state may use different regulations. Depending on the state, the members can consist of a single individual (one owner), two or more individuals, corporations or other LLCs. Unlike shareholders in a corporation, LLCs are not taxed as a separate business entity. Instead, all profits and losses are "passed through" the business to each member of the LLC. LLC members report profits and losses on their personal federal tax returns, just like the owners of a partnership would.

A few types of businesses generally cannot be LLCs, such as banks and insurance companies. There are special rules for foreign LLCs. Depending on elections made by the LLC and the number of members, the IRS will treat an LLC as either a corporation, partnership, or as part of the LLC's owner's tax return (a "disregarded entity"). Specifically, a domestic LLC with at least two members is classified as a partnership for federal income tax purposes unless it files Form 8832 and affirmatively elects to be treated as a corporation. And an LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes (but as a separate entity for purposes of employment tax and certain excise taxes), unless it files Form 8832 or Form 2553 and affirmatively elects to be treated as a corporation. An LLC that does not want to accept its default federal tax classification, or that wishes to   its classification, uses Form 8832, Entity Classification Election, to elect how it will be classified for federal tax purposes. Generally, an election specifying an LLC's classification cannot take effect more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date the election is filed. An LLC may be eligible for late election relief in certain circumstances.

In the eyes of the federal government, an LLC is not a separate tax entity, so the business itself is not taxed. This is similar to an S Corporation or a partnership. Instead, all federal income taxes are passed on to the LLC's members and are paid through their personal income tax. While the federal government does not tax income on an LLC, some states do. Since the federal government does not recognize an LLC as a business entity for taxation purposes, all LLCs must file as a corporation, partnership, or sole proprietorship tax return. As noted above, LLCs that are not automatically classified as a corporation can choose their business entity classification. To elect a classification, an LLC must file Form 8832. This form is also used if an LLC wishes to change its classification status.

There is always the possibility of requesting S-Corp status for an LLC by making a special election with the IRS to have the LLC taxed as an S-Corp using Form 2553. The LLC remains a limited liability company from a legal standpoint, but for tax purposes it can be treated as an S-Corp.

Advantages of an LLC

- **Limited Liability.** Members are protected from personal liability for business decisions or actions of the LLC. This means that if the LLC incurs debt or is sued, members' personal assets are usually exempt. This is similar to the liability protections afforded to shareholders of a corporation.
- **Less Recordkeeping.** An LLC's operational ease is one of its greatest advantages. Compared to an S-Corporation, there is less registration paperwork and there are smaller start-up costs.
- **Sharing of Profits.** There are fewer restrictions on profit sharing within an LLC, as members distribute profits as they see fit. Members might contribute different proportions of capital and sweat equity. Consequently, it's up to the members themselves to decide who has earned what percentage of the profits or losses.

Disadvantages of an LLC

- **Limited Life.** In many states, when a member leaves an LLC, the business is dissolved and the members must fulfill all remaining legal and business obligations to close the business. The remaining members can decide if they want to start a new LLC or part ways. However, the operating agreement can include provisions to prolong the life of the LLC if a member decides to leave the business.

- **Self-Employment Taxes.** Members of an LLC are considered self-employed and must pay the self-employment tax contributions towards Medicare and Social Security. The entire net income of the LLC is subject to this tax.

Thank you again for allowing me to address this Committee today. My primary focus today was about business taxation for small business. We know that Congress cannot stop people from coming up with clever new forms of business organizations. But Congress can insure a level playing field in business taxation. There are unnecessary inequities and complexities in our current system of business taxation which affect all business both small and large. A simpler, equitable tax structure would allow business owners to better understand potential tax liabilities and make better business decisions. To do this, the effect of income tax on the overall profitability of a business must be taken out of the equation. Allowing for a single level of tax for all business sizes will provide an understandable equity.

Thank you for the opportunity to present today and I welcome your questions.