Congressional Testimony

Tax Incentives for Businesses in Response to a Minimum Wage Increase

Testimony Before
United States Senate Committee on Finance

Testimony of Matthew F. Kadish. Esq.
Vice President of Legislation, Small Business Council of America

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The Small Business Council of America (SBCA) is a national nonprofit organization which represents the interests of privately-held and family-owned businesses on federal tax, health care and employee benefit matters. The SBCA, through its members, represents well over 20,000 enterprises in retail, manufacturing and service industries, virtually all of which provide health insurance and retirement plans for their employees. The SBCA is proud and fortunate to have the leading small business advisors in the country on its Advisory Boards.

The SBCA has identified the following seven legislative priorities, which would be of immediate help to small businesses. Each is discussed more fully below:

- Estate tax – need immediate certainty and reform;
- Deferred compensation – limit §409A to public companies;
- §179 expensing – make permanent at higher levels, and increase amount;
- Create SIMPLE cafeteria plans;
- Repeal the AMT;
- Expand the allowable use of the cash method of accounting by small businesses; and
- Eliminate unfair tax treatment of professional service organizations.

Need For Certainty and Reform in the Estate Tax Area

Small businesses, their owners, and many other taxpayers need certainty in the estate tax area as soon as possible. The law yearns for certainty, and in that regard, estate planning has operated under a cloud since 2001. Since then, the law in this area has failed one of its basic functions – to provide taxpayers with the opportunity to predict, with reasonable certainty, the likely outcome of their choices.

In order to immediately exempt small businesses from the federal estate tax, the estate tax exemption should be increased to the $3.5 million dollar level this year – not in 2009. The SBCA is in favor of reforming the existing estate tax system and is not in favor of the repeal of the estate tax law in 2010 and beyond, because repeal would hurt many small business owners.

Furthermore, the SBCA believes that the time for certainty in this area is <u>now</u> – the estate tax and various related provisions are currently set for repeal in 2010 – less than three years away, only to reappear at a $1 million exemption amount in 2011. This "Cinderella-at-midnight scenario" is making it increasingly difficult for small business owners and many others to do estate planning with any level of confidence.

Accordingly, the SBCA urges Congress to do the following as soon as possible:

- Increase the exemption amount immediately to $3.5 million and then increase it gradually over a number of years until it reaches at least $5 million and thereafter have it increase by COLA

- Preserve the step-up in basis at death for simplicity and fairness

- Rejoin the estate and gift tax systems immediately for simplicity

- Exempt retirement plan assets from the estate tax in an amount up to an additional $1 million as an additional incentive for people to save for their retirement

- Create a true small business exemption - *any* ownership interest owned by the decedent in a "real" small business or family business if left to a family member would be exempt from estate tax or if this is not feasible, reduce the estate tax rates to 15%, on any small business or family owned business that is part of the estate

By implementing these steps, small business owners who have worked a lifetime to build their company will be helped immensely. Additionally, by implementing these proposals, many small business owners will find themselves in a better tax position than they would if the proposed repeal were to take place as scheduled in 2010. This is because total repeal would be accompanied with a loss of the step-up in basis and the continued decoupling of the gift tax from bequests made at death. We saw what happened when the basis step up was dropped from the law in 1976. The enormous difficulties faced by taxpayers caused Congress to re-establish it in 1980. Further, enactment of our proposal exempting a certain portion of retirement plan assets from the estate tax would promote retirement plan savings at a time when it is essential for Congress to incentivize such savings in order to assist our country in dealing with the future health care and retirement income burdens which will be imposed on the country by the baby boomer generation.

Under our proposal, the only estates that will be left paying any tax will be those which are comprised of huge amounts of wealth not due to an active family or closely held business. Most Americans, if they truly understood this issue, would probably feel that it is not a prudent thing for the country to allow a very few people to amass great wealth and to be able to establish dynasties of this great wealth by passing it down tax free from generation to generation. From the viewpoint of keeping our democracy strong, it makes sense for our country to tax at least some portion of this huge build up of wealth. In fact, the estate tax historically was imposed only on the very, very rich of this country as a way to avoid the problems that occur when a very small elite of the country is able to amass great wealth and pass this wealth down to the next generation; it was never intended to reduce the estates of working Americans who had built up a family business or a small business based on their own hard work.

Unfortunately, many small businesses will actually end up paying more taxes under the repeal in 2010 and beyond than they would with the increased exemption proposed to be in effect in 2009. This is because a majority of small businesses actually do better under our current system of estate tax with the increased exemption ($3.5 million or more) than they would under repeal because of the loss of the step up in basis.

To understand our pro-small business proposal and why it is preferable to repeal, there are a few basic concepts to our estate tax system that need to be explained.

First, today any assets that a person receives from another person's estate receive a "step-up" in basis - this means that the person receiving them gets them at fair market value as of date of death. Thus, when the person decides to sell the property, he would be taxed on the difference between the sales price and the date of death fair market value (this would generally be subject to capital gains tax).

A step-up in basis is contrasted to a "carry-over" in basis where the heirs receive the assets with the same basis that the deceased owner had. For example, assume a father bought a house for $20,000 and did not improve it in any way and that 35 years later at his death, the house is valued at $750,000. If the son received the house with a "carry-over" basis, his basis in the house would be $20,000. If the son then sold the house for $750,000, he would have $730,000 of gain which would be subject to capital gains taxes. If instead the son received the house with a stepped- up basis, his basis in the house would be $750,000 and there would be no gain subject to tax when he sold the house for $750,000.

Second, any assets that a person owns up to the exemption level - $2 million this year, can be given away at death, free of estate taxes. This is referred to as the exemption or exclusion amount and it is scheduled to increase to $3.5 million in the year 2009. This means with basic estate planning in the year 2009, a couple could leave $7 million to their heirs without the imposition of estate tax and with a step-up in basis on the entire $7 million of assets.

Third, assuming a couple has assets in excess of $7 million in 2009, the excess would be subject to the maximum rate of 45%. (This assumes that the couple has already sheltered $3.5 million at the earlier death of the first spouse).

After the full repeal of the estate tax in 2010, the current rule providing for a fair market value basis in property acquired from a decedent (i.e., the step-up in basis) is repealed. In lieu of this rule, the recipient of property acquired from a decedent will have basis in such property equal to the lesser of the decedent's adjusted basis in the property or the property's fair market value at the time of the decedent's death. However, recipients of property from a decedent will be entitled to an aggregate basis increase of $1.3 million (adjusted for inflation after 2010). In addition, the decedent's surviving spouse will be entitled to an additional aggregate basis increase of $3 million (adjusted for inflation after 2010). Accordingly, if a decedent is survived by the decedent's spouse and the value of the decedent's estate is $4.3 million, the full amount of the estate will pass to the spouse free of any estate tax and the surviving spouse will have a stepped-up basis for the entire estate. If there is no surviving spouse, then only $1.3 million of assets will receive the step-up in basis.

Assume there is a small business owner who has $3.5 million of assets and no surviving spouse. He (or rather his heirs) are better off under the 2009 law rather than total repeal because of the loss in the step up in basis. This is how this works:

Under total repeal: $1.3 million of the assets receive a step-up in basis to the fair market value of those assets at date of death. The remaining $2.2 million have the basis that the decedent had in those assets. (As an aside, imagine if the decedent were an 85 year old man who acquired many of these assets more than 40 years ago... how anyone is even going to be able to figure out the carry over basis of those assets is beyond us. The step-up in basis was repealed back in 1976 and was then reinstated in 1980, though the carry-over rules never became applicable during that period, because Congress learned from attorneys and accountants who handled the probate process that it was almost impossible to determine the carry-over basis for many assets.)

Now when the heirs of this decedent sell this $2.2 million of assets, they will be subject to capital gains tax on the difference between the then market value of the assets and the decedent's basis in those assets. For example, let's assume that the carry-over basis in the assets is $1 million - then the heirs will be taxed on $1.2 million of capital gain (assuming the fair market value of the assets was still $2.2 million).

Under the $3.5 million exemption - 2009 law: All $3.5 million of assets receive a step-up in basis to the $3.5 million level (this is the fair market value of his assets as of his passing). Now when the heirs sell any of these assets - there is no capital gains and no estate tax.

Basically, a single person with assets greater than $1.3 million up to $3.5 million is better off without total repeal of the estate tax and is in a better tax situation under the estate law as it stands in 2009. Similarly, a decedent who is married with assets greater than $4.3 million up to $7 million does better under the law as it would stand in 2009 than he would under total repeal. This covers a significant amount of taxpayers based on the data that illustrates how many taxpayers drop off of the estate tax rolls as the exemption amount increases. Based on data set forth in a March 16, 2005, issue paper from the Center on Budget and Policy Priorities[1] on this topic, if the estate tax exemption were $1 million in 2011, then 53,800 estates would be subject to the estate tax (this represents about 2% of the 2.6 million people expected to die in that year). Of the 53,800 estates that would be taxable, nearly half (46%) would have assets of less than $2 million and nearly three fourths would be valued at less than $3.5 million. If the exemption level in 2011 were $2 million instead of $1 million, then the number of taxable estates would shrink to 21,000. This is a reduction of 61% in the number of estates that would face the estate tax. If the exemption amount in 2011 were $3.5 million instead of $2 million, then the number of taxable

[1] This paper is entitled, "Estate Tax Reform Could Raise Much-Needed Revenue: Some Reform Options with Low Tax Rates Raise Very Little Revenue" by Joel Friedman and Ruth Carlitz

estates would drop to 8,500 (84% of the estates would be exempt compared to the number that would have been subject to estate tax if the exemption amount were to be $1 million in 2011). This amount represents about 0.3% of all the people who are expected to die in 2011. These numbers clearly show how many small business owners would be worse off under total repeal than if the law were frozen at 2009 (with the $3.5 million exemption and the step-up in basis).

The SBCA believes that the reason why most small businesses owners (particularly where they have assets which under repeal will have a carry over basis versus a stepped up basis if the $3.5 million exemption were in effect) do not understand that they are worse off under repeal, is because they do not understand the impact of the carry over basis and the ultimate imposition of capital gains tax on those assets.

If Congress wants to protect small business owners then it could do so by not only increasing the exemption amount immediately up to $3.5 million, retaining the step-up in basis, rejoining the gift and estate tax system, but also by putting into place a real exemption for small business owners. Such an exemption would not bear any resemblance to the Qualified Family Owned Business Interest (QFOBI) exemption that came into law a few years back. This rule was not only complicated, but suffered from the most severe planning defect - a business owner would not be able to know if he qualified for the exemption until death occurred. The exemption that the SBCA would endorse would be a very simple exemption - *any* business interests owned by a decedent in an active family or small business that was passed on to a family member would be exempt from the estate tax (again for simplicity, the interests should be passed on to the heirs with a step-up in basis).

The SBCA also believes that giving an exemption for up to $1 million in retirement plan assets that are left to a surviving spouse and up to $500,000 for retirement plan assets that are left to others would go a long way towards promoting retirement plan savings by small business owners and others. Right now the incentives towards locking up money in a retirement plan are being diminished by the lower tax rates on capital gains and dividends that do not apply to funds coming out of a retirement plan.

In conclusion, the 2001 Tax Act has created a legal landscape that makes it impossible for small business owners and other taxpayers to plan their estates with any predictability. This uncertainty is preventing taxpayers from making transfers and undertaking necessary planning. Uncertainty also undermines taxpayer confidence in the tax system. The SBCA urges Congress to act as soon as possible to provide estate tax certainty by way of an increase in the exemption amount, retaining the step-up in basis, reunifying the estate and gift tax, and taking the other steps outlined above.

Provide Certainty, Simplification and Fairness
Limit Application of Nonqualified Deferred Compensation – Code §409A

In 2004, Congress acted in response to perceived abuses committed by corporate executives at companies like Enron and WorldCom by enacting new Section 409A of the Internal Revenue Code. For publicly traded companies, the goals of §409A were, and still are, valid and important. However, its application to small businesses is unnecessary and unduly burdensome. In addition, the burden of failing §409A is borne by employees. Small businesses are often uninformed, and §409A has become a trap for the unwary. **Section 409A should be revised so as to exempt businesses that are not publicly traded from its application**.

Section 409A serves no purpose for nonpublic companies and costs small businesses money in unnecessary legal and accounting expense. In addition, section 409A prevents common sense economic arrangements that are sensible for the employees and businesses and pose no opportunity for abuse. Unlike public companies and the well known problems of excessive executive and sometimes director deferred compensation at the expense of the shareholders, there is no abuse in private businesses by executives at the expense of shareholders due to the close identity of the owners and the executives in private businesses, which is totally different than public companies, when those controlling the business (executives and directors) are often owners of a small percentage of the outstanding stock.

Background

In general, whether compensation is taxed currently or on a deferred basis is determined under several long-standing statutory provisions and judicial doctrines. These include Code Section 83 (relating to property received for the performance of services), the doctrine of constructive receipt, the economic benefit doctrine, and others. In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, and the payments are subject to a risk of forfeiture (meaning that creditors of the employer have priority over the potential recipient of the nonqualified deferred compensation), the compensation is includable in income when it is actually or constructively received. Correspondingly, the employer gets a deduction only when nonqualified deferred compensation is actually paid, not earlier when the commitment to pay it is made. If the arrangement is funded, then income is taxed to the recipient for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture, whether or not it is paid later.[2]

Overlaying those rules, Section 409A requires that all amounts deferred under a nonqualified deferred compensation plan (including arrangements set up by the employer unilaterally with no employee involvement or choice) after December 31, 2004 comply with very complex new rules. If these rules are violated, the amounts are currently included in the employee's income and also are subject to an additional 20% income tax. In addition, the employee is required to pay interest at the IRS underpayment rate plus 1% on the underpayment that would have occurred if the amounts had been included in income when first deferred or, if later, when they were not subject to a substantial risk of forfeiture.[3]

Section 409A defines a "nonqualified deferred compensation plan" as any plan that

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2 See House Committee Report, H.R. Rep. No. 108-548, pt. 1.

3 Explanation from comments of American Bar Association: "The Application of Section 409A to Transactions Involving Partnerships," submitted to Mark W. Everson, Commissioner of the Internal Revenue Service on May 20, 2005.

provides for the deferral of compensation (other than certain enumerated exceptions). It includes plans where the employee has no election to defer. A plan generally provides for the deferral of compensation if it gives a service provider a legally binding right during a taxable year to compensation that (i) has not been "actually or constructively received and included in gross income" and (ii) pursuant to the terms of the plan (a) is payable to (or on behalf of) the service provider in a later year and (b) is not required to be "actually or constructively received" by the employee within 2½ months after the end of the tax year of the employee in which it is no longer subject to a substantial risk of forfeiture (or if later, 2½ months after the end of the tax year of the service-recipient in which it is no longer subject to a substantial risk of forfeiture.) Prop. Regs. §409A-1(b)(1), (4)(i).

Section 409A imposes three restrictions on (i) distributions; (ii) acceleration of payments; and (iii) the employee's election of payment. The provisions must be satisfied both in form and operation. **The scope of 409A spans much farther than many originally expected or is warranted. It not only encompasses traditional nonqualified deferred compensation arrangements (such as so-called rabbi trusts and secular trusts), but as interpreted by the IRS and Treasury, extends to any agreement which has the effect of deferring compensation. Thus, owners of closely-held business continue to scramble to review, among other things, their employment agreements, buy-sell or other purchase agreements (to the extent purchase obligations are measured by productivity or contain severance pay), stock options, restricted stock arrangements, partnership agreements, limited liability company operating agreements, and numerous other standard business arrangements, to determine whether they contain any potential exposure to premature taxation (before receipt of the funds) and the severe penalties imposed by §409A for nonconforming deferrals of compensation. What a waste of time and effort for small business!**

The enactment of Section 409A, due to its complexity and wide reach, has spawned an industry, both on the government side and in private practice, as clients and their advisors (and the IRS, for that matter) struggle to understand and define the scope and relevant operating rules. The IRS and Treasury have issued several rounds of guidance, and are continuing to receive comments and requests for further guidance in this far-reaching and difficult area. However, Treasury has not provided any exceptions for private businesses (where no abuses like those in public companies can occur). Despite this guidance, many tax experts continue to struggle in providing clear answers on the scope and applicability of §409A to many real-world situations.

The justification for the enactment of §409A was to protect investors (including employees' ownership of stock in the employer's retirement plans) in publicly traded companies as a response to the abuses seen in the Enron, WorldCom and similar scenarios. In those and similar cases, corporate executives had, or created, large nonqualified deferred compensation accounts, and withdrew their balances shortly before the corporation declared bankruptcy, depleting company funds to the detriment of shareholders and creditors. As large public companies, the corporations' shareholdings were very broad, and the shareholders had no direct input or control over corporate activities, learning too late of the draining of the nonqualified deferred compensation accounts and the collapse of the corporation's financial position.

It appears that IRS believes that §409A was enacted to provide uniform and specific rules on when income deferral should be allowed in nonqualified compensation arrangements, but the rules were already well defined for tax purposes. Funded arrangements, as discussed above, were taxed to employees when they vested, even if they had not received any payments. Unfunded arrangements were taxed when payments were received, and only then could the employer take a deduction. Thus, the rules made sense and there were no abuses of the tax system because the rules made that impossible.

Small (not publicly traded) businesses and their advisors are experiencing significant uncertainty and burdens as a result of the new provisions, and the burdens far outweigh any possible public benefit. In fact, we see no public benefit and know of no abuses where private companies are concerned because the owners, not the executives (if they are also not owners) are in control.

For one thing, unlike in tax-qualified retirement plans, <u>no real income deferral results from nonqualified deferred compensation arrangements</u>. The employer (or its owners, in the case of a flow-through entity) pays taxes on the income as earned. It receives no deduction for deferred compensation paid unless and until the amounts are includible in income by the employee (or independent contractor). Accordingly, the perceived need for specific tests when nonqualified deferred compensation arrangements in fact defer income is misleading – the issue is essentially when the incidence of taxation shifts from the employer to the employee. For the reasons noted earlier in this paragraph, it is expected that there would be little or no revenue impact from restricting the application of §409A to publicly traded companies. **Overall, we submit that in the small business context, the level of complexity and risks imposed by §409A are harmful, burdensome, and completely inappropriate.**

In addition, unlike in Enron and other public companies, in a small closely-held business, the interests (and often identity) of the shareholders and executives are closely aligned. Even where the shareholders are not in fact themselves the executives, they generally exercise direct supervision over their activities and compensation arrangements. Accordingly, there are inherent safeguards present in the small business model that were not present to protect the shareholders in Enron and similar cases.

For example, assume Small Corp. has two shareholders and 30 employees. The shareholders are 59 and 62, and have invested in their company over the years. The company is now valued at about $2.5 to $3 million. However, the company is very entrepreneurial, dependent on the vision and leadership of its two shareholder-employees, and no outside buyers appear interested in buying it if the shareholders do not continue to be directly involved in guiding the company's future. The shareholders want to convert their business capital into retirement cash for the owners. A proposal is made to offer two current key management employees an option to buy the company at a relatively low price, provided it meets certain income goals at the end of five years, and subject to ongoing payment of extra income to the two shareholder-employees, which will be taxed to them as ordinary income, taxed at a much higher rate (35%) than would the same payments if treated as a part of the sale of their stock (15%) while they phase out of the business. The company's tax advisor tells the shareholders that the proposed arrangement is a nonqualified deferred compensation arrangement under §409A. The shareholders cannot understand why there is anything wrong with this arrangement.

Employers frequently prefer to pay deferred bonuses or allow employees to defer payment, but the employer wants cash flow protection, providing that payment is deferred if the company fails to meet an objective financial criteria (such as minimum sales, EBITDA, or gross profit), but these standards are not permitted as exceptions under §409A.

Section 409A also inhibits negotiation of severance pay agreements where it is in the business interest of the employer to accelerate payments in exchange for a reduction in the amount due. There can sometimes be a substantial savings in interest costs and a reduction in amount payable, particularly where the employee perceives a credit risk in collecting the full amount. There may also be valid business reasons for an employer to pay off a deferred compensation obligation earlier, such as when it has excess cash, or to reduce a later obligation for credit purposes. This is usually done by paying bonuses during employment. This would currently violate both the rule against acceleration and the rule that precludes payments except on termination of employment or change of control. It is also a problem that the current severance pay exception is only for involuntary terminations, where in the real world most involuntary terminations are characterized as resignations. (The irony here is that in this instance, the Government would actually receive taxes earlier but for this code section that the IRS has been interpreting in the broadest possible way.)

Small employers often prefer to issue stock options at low values as an added incentive to employees. Unlike public companies (where values can be established based on the stock's traded value), the valuation of any given closely-held company is often open to debate, even among valuation experts. If the exercise price of the stock option is below fair market value as of grant, §409A applies. Unfortunately, the uncertain value of closely-held business interests presents a huge risk to a closely-held business considering issuing stock options, as the IRS can challenge the value (even if supported by an independent appraisal), thus exposing the transaction to penalties, interest and additional taxes under §409A.

The misplaced application of §409A is particularly evident in the personal service organization arena (accountants, architects, dentists, lawyers, nurses, physicians, psychologists, social workers, etc.), where essentially all of the practice's income is derived from personal services. In such a case, any non-immediate payments to shareholders as compensation or severance pay are subject to scrutiny and immediate tax and 20% penalty if §409A is violated. Such violations are often inadvertent and cause no harm.

For example, suppose Medical Practice has several family practice doctors, and one, Dr. Senior, wants to be able to slow down but not fully retire. Medical Practice values Dr. Senior, who is a valuable resource for the community, and would like him to stay on, but economically needs to limit his pay based on productivity. By contrast, Dr. Senior would like to supplement that income. As an incentive to encourage Dr. Senior, Medical Practice would like to propose to allow him to begin receiving his severance pay, which was to be funded by the collection of his accounts receivable after he retired, when his billings drop below a certain level, but while he was still employed. Medical Practice is advised by its tax advisor that the proposed arrangement would violate §409A, as it is not permissible without the imposition of current tax and a 20% penalty to Dr. Senior on money that he would be paid later (but taxed earlier when he was paid unlike the original arrangement, when he would be taxed when paid after retirement). Clearly, section 409A makes no sense in this situation, as Dr. Senior would be taxed when he received the money.

Section 409A complicates planning for partnerships and other entities (such as limited liability companies treated as partnerships for tax purposes), as the IRS has not yet determined how to address partnership deferrals, due to the conflict between Code sections 409A and 736.

There is also a high degree of complexity in determining whether a plan is grandfathered out of the application of §409A, or even if so, which part is grandfathered where, for example: (a) there is uncertainty about whether amounts were legally binding; (b) not all amounts are vested; and (c) one of the participants was a controlling owner.

In summary, it would be a tremendous help to small businesses to limit the application of §409A to publicly traded companies. As noted above, existing statutory and judicial provisions provide sufficient rules to cover nonqualified deferred compensation plans for private business, where Enron-type abuses do not occur. Small businesses would be better served if could they could take the money they currently have to spend on tax advisors to cope with §409A, and could instead invest more money in making their businesses profitable

<u>Section 179 (Expensing) – Make it Permanent and Increase the Dollar Limitations</u>

Section 179 of the Internal Revenue Code allows businesses to expense (fully deduct from taxable income) a limited amount of the cost of new business equipment acquired that year. This tax benefit is limited by a provision of the law which stipulates that the expensing amount is phased out dollar for dollar for any amount of investment above a certain limit in a given year. Under current law, businesses can expense up to $100,000 and the phase-out threshold level begins at $400,000 for equipment in service in taxable years 2004 through 2007, but those limits revert back to $25,000 and $200,000, respectively, in 2010, if the current provision is not made permanent.

In 2003, Congress passed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). The measure included a temporary increase that raised the direct expensing allowance for business from $25,000 to $100,000 for 2003, 2004, and 2005. The provision's phase-out threshold was increased from $200,000 to $400,000 over the same time period. In 2004, the American Jobs Creation Act of 2004 extended for two years, through 2007, the increases in the direct expensing allowances and the phase out threshold. The Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) extended the changes in the allowance made by JGTRRA through 2009.

In his fiscal year 2007 budget, President Bush proposed an increase in the allowance to $200,000 and an increase in the asset cap to $800,000. Last year, Senator Olympia Snowe introduced the Small Business Expensing Permanency Act of 2006, which would codify the President's proposal and make this benefit permanent.

These past efforts to increase both the expensing limit and the phase-out threshold have had the dual effect of simplifying the tax code for small businesses and freeing up more capital so small businesses can invest in themselves and create new jobs. **The SBCA believes that increasing the amount a small business can expense, as well as the amount of money that can be invested before the expense is phased out, will allow companies to invest more freely without fear of being hit by higher taxes. Furthermore, making these benefits permanent will eliminate uncertainty and allow these companies to better make long-term plans and invest with confidence.**

Allow Small Businesses to Have Cafeteria Plans -- Give Small Business a Level Playing Field!

The SBCA strongly endorses the concept of a SIMPLE cafeteria plan which would allow small businesses to sponsor cafeteria plans. We strongly endorses the SIMPLE Cafeteria Plan Act of 2005[4], introduced by Senator Olympia Snowe, and co-sponsored by Senators Kit Bond and Jeff Bingaman. We applaud the efforts of these Senators to bring health insurance to small business employees through this vehicle which is valued by employees. We agree with Senator Snowe's comment with respect to this essential legislation, "Establishing a SIMPLE Cafeteria Plan for small businesses will help them offer the same health insurance and savings options currently available to employees of large companies and government agencies."

Even though it seems beyond belief, as the law stands today, sole proprietors, partners and S-corporation stockholders who own more than 2% of the stock as well as other small business owners are not eligible to participate in a cafeteria plan. It is essential that the tax code be amended so that owners of small businesses who are set up in any business form other than a C corporation would be allowed to participate in a cafeteria plan. There is simply no rationale for this type of discrimination against small business owners.

It is important for small businesses to have a SIMPLE cafeteria plan which would be easy for small businesses to sponsor and administer. This would enable them and their employees to be able to purchase employer-provided health insurance with pretax dollars.

Modeled after the effective Savings Incentive Match Plan for Employees (SIMPLE) pension plan enacted in 1996, the new SIMPLE cafeteria plan would allow most small businesses who are not currently able to satisfy the existing anti-discrimination cafeteria plan rules due to their size, to sponsor these plans that are highly valued by their employees, in exchange for making a contribution to the plan for their employees' employee benefits, particularly health insurance.

4 S.723 (2005).

It is important that cafeteria plans be allowed to offer long term care insurance as an optional benefit for the employees to select.

The "use it or lose it" rule which causes employees to actually have their own salary revert back to their employer if they do not spend as much money on medical care as they had anticipated, is long overdue to be thrown out. In effect, instead of being rewarded for being healthy (as is true with the HSAs), this rule, created by the IRS, stands common sense on its head and causes employees to forfeit their own dollars to their employers because they did not need to spend those dollars on health care.

Legislation that would make it easier for small business employees to be covered by a cafeteria plan will allow the small business employees to be able to select the benefits that can be offered by a cafeteria plan that they need most, the same way that employees for mid and large businesses are currently able to do so. Even more important, by giving the small business owners an incentive to sponsor cafeteria plans, this legislation will go a long way in helping small business employees to afford health insurance.

- **Employees of big businesses, mid-size businesses and the Federal government appreciate the valuable benefits provided by cafeteria plans. Cafeteria plans allow workers to obtain and choose employee benefits that are tailored to their needs in a tax advantaged manner**. Cafeteria plans can allow employees to pay their portion of health insurance on a pre-tax basis. They can allow employees to have deductions taken from their paychecks to pay for braces, eyeglasses, and other health care items that insurance will not pay for, dependent care, disability insurance and life insurance. Workers are able to select the benefits that they need most and are able to save for these expenses by having funds removed from their paychecks. It is clear that this is the easiest way for workers to save for these necessary expenditures - the dramatic success of employees saving for their retirement in 401(k) plans but not in IRAs attests to the importance of payroll deduction for effective savings. **It is clear that cafeteria plans offer a successful approach to encourage employee participation in healthcare costs.**

- **Employees of small businesses are seldom offered this valuable benefit because small business owners are effectively precluded from participating in a cafeteria plan. As mentioned above, small business owners who operate in any entity other than a C Corp (or those that own less than 2% in a Sub-S corp) are basically not allowed to be covered by a cafeteria plan.** When small business owners cannot take advantage of the benefits offered by a cafeteria plan, they seldom have any interest in sponsoring such a plan. Even if the owners are allowed to participate (e.g., a less than 2% stockholder in an S Corp or an owner in a C Corp), the existing non-discrimination rules effectively preclude the owners from being able to use the plan except for de minimus amounts. Again, if the owners of a small business cannot benefit from the plan to a meaningful degree, it is not likely to be offered.

- **Small businesses are at a double disadvantage when it comes to offering health care and other employee benefits to their employees. Health care insurance premiums are higher because small businesses lack the bargaining power of larger businesses. Because most small businesses do not offer cafeteria plans, small business employees are not able to pay for their health care and other benefit expenditures on a pre-tax basis. The health care**

playing field needs to be leveled for small businesses and its employees.

● **Small business needs a safe-harbor cafeteria plan that would be modeled after the SIMPLE retirement plan that has been very successful with small businesses.** For example, in a SIMPLE cafeteria plan, if the small business contributes a safe harbor contribution of 2% or matches employee contributions up to 3% of the employee's compensation, then in exchange for this required contribution, none of the discrimination tests applicable to cafeteria plans and dependent care plans would apply. **Providing a SIMPLE cafeteria plan would provide small business employees access to this important cost savings employee benefit vehicle.** Small businesses have demonstrated that they are willing to absorb some additional cost for employees in the way of mandated contributions in exchange for relief from complex administration and discrimination tests with the widespread acceptance of the SIMPLE plan in the retirement plan area. It is anticipated that the safe-harbor cafeteria plan patterned on the SIMPLE retirement plan would also be accepted and adopted by small business. **If this is correct, then literally millions of small business employees would be likely to have health care insurance with some portion of the premium paid for by the employer and the remainder being paid for by the employee. Small business employees would also be able to select from other benefits those that are most needed.**

Congress has already decided that the SIMPLE plan provides sufficient benefits for the non-owner employees to justify the contributions for the owners – this SIMPLE cafeteria plan is patterned on the SIMPLE model and if it works it will bring access to valuable employee benefits, most importantly health insurance to small business employees.

● **Cafeteria plans should be able to provide employees with long term care insurance.** Presently this valuable employee benefit is not allowed to be offered by a cafeteria plan. By allowing employees to purchase this valuable benefit on a pre-tax basis and by payroll deduction, it is far more likely that employees will elect to be covered by long term care. It is also more likely that they will select long term care when the policy has been "pre-selected" by the employer for them. **This change would encourage more employees to finance their own long term care. It is desirable to shift as much of the burden of providing for the long term care needs of the baby boomer generation over to them rather than having to be taken care of by the government. The more we can incentivize individuals to purchase long term care insurance on their own the better.**

● **It is time for the unpopular and unfair "use it or lose it" policy now applicable to flexible health care accounts to be eliminated.** This policy basically means that if an employee has over estimated the amount of health care expenditures that he or she will have to pay during the year (over and above those paid by health insurance) then the excess amount is forfeited to the employer. Employers are prohibited from bonusing this amount back to the employee who forfeited his or her own money. Some employers apply these forfeited amounts to benefits for all the employees in the following year, but there is no requirement that they do so. Theoretically, the policy behind this unpopular rule created by the IRS was to make the flexible health care account be more like an insurance policy. Though the absurdity of this argument is easy to see – it's hard to imagine any insurance policy being purchased where the risk is limited to the amount of "premiums" paid and the "insureds" forfeit their own money if they can't come up with enough expenses. Thus, comparing the "use-it-or-lose-it" rule of a medical reimbursement account under a flexible spending arrangement to health insurance (or any other kind of insurance) is ridiculous. Regardless of where this idea came from it is a bad idea and it is time for the flexible health care account to be treated like its sister benefit - the dependent care flexible account. The use it or lose it concept is unfair to employees and runs counter to public policy inasmuch as employees generally will not save as much as they are able to pay for health care expenditures because they are fearful of forfeiting their own money (their savings for health care expenditures) to their employer.

The nature of the health care flexible spending account should be changed to that of a reimbursement account so that it is the same as the dependent care account. By capping the amount of the health cared flexible spending account similar to the way dependent care account is capped, there is no need to fear that the account could be subject to abuse.

These changes would encourage employees to select the appropriate amount required for health care expenditures rather than possibly choosing to estimate low so that they don't forfeit their own money to their employer. This would assist employees in dealing with rising health care costs and provide a vehicle for them to save for these expenditures in a tax free manner.

- **The legislation would revise the discrimination tests applicable to the dependent care flexible spending account so that it is easier for all employees to use the benefit. The dollar amount would be increased to take into account today's cost of providing care for dependents.**

Some have argued that this legislation is too expensive to pass – however because good health care for our citizens is so vital, it is essential to incentivize individuals to undertake as much of the burden of providing for this health care as possible. Passing legislation similar to S. 723 will allow small business employees to join their counterparts in mid and large businesses and to save for health care and other employee benefits in a tax advantaged manner. Furthermore, it makes sense for all employees regardless of the size of the entity they work for to be able to have access to the same benefits under the tax code. Small business employees are in need of access to health care in a cost effective manner.

Repeal AMT

AMT is basically a second tax system that sits on top of our regular system and in effect the taxpayer has to end up paying the higher tax generated by each of the systems. Viewing this from a bare bones approach, it means that many of the deductions allowed by the regular tax system are rendered meaningless by the AMT. This particularly harms small business owners. This is another tax that was never designed to hit the working American but instead was designed to apply to a very few, very rich taxpayers who one way or another seemed to be able to dodge their tax bill every year under the regular tax code - they did it legitimately, but it did not sit right with Congress that the very richest taxpayers often paid the smallest amount of tax. Today, the AMT affects more and more Americans and it is time that it be rolled back entirely. A repeal of AMT will simplify our tax system and will make it more fair for the American worker and small business owner.

We are aware that AMT reform or repeal has major revenue implications. However, as has been increasingly well-publicized, the reach of the AMT appears to be growing exponentially, and along with it the cost of fighting back this out-of-control tax. We applaud the Senate leadership for bringing this matter to the legislative forefront now, and believe that it is a legitimate priority for small business owners, as well as all taxpayers.

Expand the Safe Use of the Cash Method by Small Businesses

Taxpayers generally are allowed to use the same accounting method for tax purposes that they use for book accounting purposes. Code §446(a). However, §448 prohibits certain entities from using the cash method (C corporations, partnerships with C corporation partners, and tax shelters). Certain limited exceptions apply, including small business exceptions. Code §448(b)(3) exempts taxpayers with average annual gross receipts of not over $5 million. Also, via Rev. Proc. 2001-10, 2001-2 IRB 272, the IRS has administratively exempted businesses with not more than $1 million of gross receipts from accounting for inventories and using the accrual method. The IRS supplemented Rev. Proc. 2001-10 with Rev. Proc. 2002-28, 2002-18 IRB 815, allowing relief for some taxpayers with average annual gross receipts of up to $10 million. However, Rev. Proc. 2002-28 relief is not available for taxpayers otherwise barred by §448 from using the cash method. In addition, entire industry segments are barred from Rev. Proc. 2002-28 relief, based on the codes assigned to them under the North American Industry Classification System (NAICS).

While the SBCA agrees with the approach in Rev. Proc. 2001-10, we urge Congress to expand that safe harbor to businesses with average gross receipts of up to $5-10 million (regardless of whether §448 applies, and regardless of NAICS codes). SBCA believes that raising the threshold more realistically reflects an appropriate small business cut-off point for this purpose, as shown in part by the existing §448(b)(3).

As noted above, taxpayers are generally allowed to use the same accounting method for tax purposes that they use for book accounting purposes. However, Code §446(b) gives the IRS the discretion to force taxpayers to change that method if it does not clearly reflect income, and the IRS generally prefers the accrual method. Small business taxpayers often prefer the cash method, which they can understand, and which is much less costly to comply with. In many cases, there is considerable room for debate (and which sometime consumes significant amounts of taxpayer and Government time and money) over what method(s) clearly reflect income.

When a taxpayer switches from cash to accrual method, an adjustment generally needs to be made to the taxpayer's income under §481(a) to reflect mismatched timing due to the old method. Depending on the case and amount of time involved, §481(a) adjustments can be very large. Although some rules provide for limited mitigation, a huge §481(a) adjustment can pose an immediate, and potentially fatal, threat to the continuing economic viability of a small business. Small businesses often do not have sufficient cash reserves or borrowing power to withstand large unanticipated liabilities.

The IRS treats taxpayer conversions from cash method to accrual in one of two ways. If the taxpayer voluntarily changes, it is given a four year period over which to spread the impact of the §481(a) adjustment. (See Rev. Proc. 97-27.) If the IRS discovers and forces the change, it does not give the spread-out period. (See Rev. Proc. 2002-13). By this "carrot and stick" approach, the IRS attempts to force taxpayers to switch to the accrual method, to avoid a sudden §481(a) adjustment from occurring at a time beyond the taxpayer's control.

The SBCA believes that small business taxpayers should be allowed to use the cash method without the fear of a sudden and disastrous audit and §481(a) adjustment. The area is too unclear for many taxpayers to understand, and the use of the accrual method is too complex and burdensome for taxpayers to simply capitulate and use. Accordingly, we ask that Congress change §481 to provide that the type of 4-year spread-out of a §481(a) adjustment be allowed for any conversion from cash to accrual method, whether or not voluntary.

Eliminating Unnecessary Complexity & Burdens For Personal Service Corporations

The Internal Revenue Code is riddled with provisions affecting various types of service corporations. The special and intricate rules that apply to personal service corporations (professional corporations) are burdensome, unfair, and unnecessary. They create a significant amount of tax complexity, which could be eliminated by the removal of several Code sections. Service corporations should be able to have graduated income tax rates, the choice of fiscal year, and other options available to other corporations.

The following tax rules must be considered by all personal service corporations. The Internal Revenue Code's definition of a personal service corporation is inconsistent and not uniform among the various Internal Revenue Code sections dealing with personal service corporations. In addition, many of the provisions serve no worthwhile purpose.

There are different types and definitions of service corporations that are the subject of restrictions or penalties under the Internal Revenue Code. Only three serve any meaningful purpose. Code §§ 269A and 414(m)), and 414(m)(2)(A). They should be modified, as described below, to prevent an inadvertent application of the rules to situations for which it was not intended. Another sensible rule that need not be changed is section 448, which in part provides that the cash method may be used by a qualified personal service corporation, an organization with a two-part definition. First, such a corporation provides services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting. Second, substantially all of the stock must be held by, among others, (1) employees performing these services, (2) retired employees who had performed these services, or (3) the estate of a deceased employee or a retired employee who had performed these services. These organizations thus pay tax when money is received, which is a correct method of taxation because personal services (and not inventory or depreciable capital equipment) are the major basis for their gross income.

Internal Revenue Code § 269A

Section 269A permits the Internal Revenue Service to reallocate income and tax benefits between personal service corporations and their employee-owners to prevent evasion or avoidance of Federal income taxes or to reflect clearly the income of the personal service corporation or any of its employee-owners. This Code section performs a useful purpose. While Code section 482, which does much the same thing, is probably sufficient, the SBCA does not oppose Code § 269A.

Internal Revenue Code § 469(a)(2)(C); §469(j)(2)

The second type of "personal service corporation" is contained in § 469 dealing with the passive loss rules. This definition is broader than the 269A definition because employee-owner applies to an employee that owns any stock in the corporation. In addition, the attribution of ownership of a corporation under § 318 will apply regardless of the level of ownership of the attributing corporation. The general passive loss rules are sufficient. There is no need for special passive loss rules for personal service organizations. Section 469(a)(2)(B) applies the rules to any closely held C corporation. For example, although a C corporation generally is not subject to the at-risk rules or the passive loss rules, a closely held corporation is. For purposes of these rules, a closely held corporation is a corporation in which five or fewer individuals own at least 50 percent of the corporation's stock. Thus, there is no need for Code § 469(a)(2)(C) and §469(j)(2), which separately applies to any personal service corporation. The rules for closely held corporations are sufficient.

Internal Revenue Code § 441(i)(2)

This definition is the broadest of the personal service corporation definitions. As we know, the federal income tax system is based on an annual theory of taxation. Taxable income must be computed and taxed on an annual basis through the filing of annual returns. The return must show the net result from all of a taxpayer's transactions during the year. A taxpayer is not generally permitted to take deductions during the current tax year to adjust for deductions that the taxpayer failed to take in a previous year, and income improperly excluded in an earlier year is not properly included in a later year return. Section 441 limits personal service corporations to the use of calendar year fiscal years, or other years ending in the last quarter of the calendar year, but only if additional rules of sections 280H and 444 are followed. There is no reason to single out PSCs for this limitation on choice of a fiscal year. In addition, by forcing PSCs to a calendar year, this rule imposes an additional hardship on accountants and their PSC clients by forcing the PSC to use a year ending in most accountants' busiest time of the year. The use of a fiscal year does not result in a greater opportunity for deferral of income by professionals than any other businesses.

Qualified Personal Service Corporation - § 448(d)(2)

This definition is still different than the previous three personal service corporation definitions above. A "qualified" personal service corporation is not a subset or a type of any of the personal service corporations described above. It is a distinct definition that requires "substantially all" of the activities of the corporation involved in the performance of service in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

In addition to the type of activity requirement, there is the ownership requirement that "substantially all" of the stock of the corporation that is held directly or indirectly by employees performing services for the corporation- in connection with the activities involving a field referred to above. This ownership requirement may also be satisfied by retired employees who have performed such services, the estates of the retired or current employees, and any successor in interest to their stock for a two-year period beginning with the date of death of such person. Treasury regulations identify ninety-five percent (95%) or more as "substantially all." This ninety-five percent (95%) is based upon time spent by employees rather than measuring by compensation or payroll. The regulations attempt to explain the particular fields of service but the term "directly or indirectly" remains somewhat mysterious. The definitions above for the first three personal service corporation definitions use the attribution rules of § 318 for "indirect" ownership. There is no such use of the attribution rules for a qualified personal service corporation.

Certain Service Corporations – Code § 535(c)(2)

A "certain service corporation" has a minimum accumulated earnings credit of $150,000 rather than the $250,000 enjoyed by all other corporations. A "certain service corporation" is one where the "principal function" is the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. While the definition is similar to the "qualified personal service corporation," there is no ownership aspect to the definition. Again, we are at a loss to distinguish a corporation whose "principal function" is in one of these fields versus a "principal activity" in the personal service' corporation definitions. One can only conclude that it is part of the strategy of the bias against service corporations by the IRS that they are able to be armed with seemingly similar but nonidentical terms.

Service Organizations § 414(m)(2)

A "service organization" is a corporation, partnership, or other organization the "principal business" of which is the performance of services. The proposed regulations provide that the "principal business" of an organization is services if they are engaged in certain activities (the qualified personal service corporation activities described above plus insurance) or if capital is not a material income-producing factor. Meeting this definition may result in the corporation not being able to have a qualified plan under § 401(a) because of the minimum participation and nondiscrimination rules under § 401(a)(26).

A Professional Service Corporation under Prop. Regs. § 1.414(m)-1(c) is a corporation organized for the principal purpose of providing professional (i.e., accountants, actuaries, architects, attorneys, chiropodists, chiropractors, medical doctors, dentists, engineers, optometrists, osteopaths, podiatrists, psychologists, and veterinarians) services and has at least one shareholder who is legally authorized to perform such service. Only professional service corporations may be considered "First Service Organizations" under IRC § 414(m).

The SBCA does not oppose this affiliated service group rule but submits that section 414(m)(2)(A) should be modified to require 50% or more common ownership for 414(m)(2)(A) to limit the rule to the situations for which it was intended in the Kiddie and Garland cases. For example, under the current 414(m)(2)(A), if an individual owns two percent of the value of a professional corporation, which in turn owns a 1/10th of one percent interest in an LLC (such as an ambulatory surgery center), the entities must be aggregated in accordance with section 414(m) and treated as one for retirement plan tax purposes, even though they are clearly two separate entities.

Nongraduated Corporate Tax Taxes - § 11(b)(2)

If a PSC is engaged in activities involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, it is denied the benefits of the graduated corporate tax rates. The taxable income of such a PSC is taxed at a flat rate of 35 percent by Code § 11(b)(2). For most taxpayers, the tax result after using the 35 percent flat rate exceeds the tax result when using the maximum (graduated) individual tax rate of 35 percent for 2006. However, the 35 percent rate does not apply to most individual taxpayers for 2006 until adjusted gross income exceeds $336,550. **The denial of graduated income tax rates for corporations with less than $100,000 of taxable income if they are professional corporations is not appropriate, as these organizations, like any other small corporation, must buy significant computer hardware and software as well as other items, and the graduated rates are necessary for PSCs, like other small corporations, to grow and prosper.**

At Risk Rules - §465(c)(7)(B)(iii)

This definition is identical to the definition in §269A except only five percent ownership is required to be an "employee-owner" rather than the 10 percent in §269A(b). The "at risk" rules do not apply to a qualified active business activity in a “qualified C corporation.” However, a PSC is not eligible to be a "qualified C corporation." This provision should be repealed, as it serves no meaningful purposes.

Currently, a small business (or in reality, its tax advisor) is required to distinguish a principal activity (§§ 269A, 469, 441), substantially all of the activities (§448), principal function (§ 535), principal business (§ 414(m)), and principal purpose (Prop. Regs. § 1.414(m)-1(a)) just to ascertain the proper degree of the corporation's involvement. There then remains the analysis of type of activity and ownership. These rules, other than the two noted above, serve no significant purpose. The SBCA believes that there is no good policy reason for service corporations to be treated differently than other corporations.

Matthew F. Kadish is the current Vice President of Legislation and a member of the Board of Directors of the Small Business Council of America, Inc., the only national non-profit organization which has represented the interests of privately owned businesses exclusively in the Federal tax, retirement, health care and employee benefits areas for more than twenty-five years. Mr. Kadish is a shareholder in the Cleveland, Ohio law firm of Kadish, Hinkel & Weibel. His practice includes a wide range of tax, business and estate planning matters, including choice of entity, business succession, exempt organizations, and representation of clients before the Internal Revenue Service and U.S. Tax Court. He formerly was an attorney-advisor to Judge Herbert L. Chabot of the U.S. Tax Court. He holds an LL.M. degree in taxation from the New York University School of Law, a J.D. from Case Western Reserve University School of Law, and a B.A. from Williams College. Prior to returning home to Cleveland, he practiced in Honolulu, Hawaii, and Washington, D.C. For further information, please see http://www.khwlaw.com/mkadish.htm.