SMALL BUSINESS LEGISLATIVE COUNCIL

SBLC REPORT

March 18, 2013 Volume XIV Issue 07

SMALL BUSINESS TAX REFORM DRAFT

Ways and Means Committee Chairman David Camp (R-MI) has released a discussion draft of his vision for reform of several key tax code provisions of interest to small business. It is one in a series of discussion drafts covering several major areas of the code.

SBLC applauds Chairman Camp for his initiative. The truth is we have wandered a long way off the road since the last reform effort in the mid-1980's and we need to get back on the highway. There will be plenty of folks coming out of the woodwork to find fault with the Chairman's proposal and he is quick to emphasize this is a starting point only but it is bold and innovative.

Most of the changes have to do with tax accounting practices and many small businesses will not consider the changes significant. The changes pertaining to partnerships, particularly complex ones, on the other hand, would change the partnership landscape dramatically.

Cash Accounting

The positive change that will affect the greatest number of small businesses has to do with accounting. The draft replaces the current tax accounting rules (such as sections 447 and 448 of the tax code) that apply to small businesses and farms with a uniform rule under which all businesses with gross receipts of $10 million or less may use the cash method of accounting. The accounting rules for farming businesses would be coordinated with the new general rule, and sole proprietors would continue to be able to use the cash method regardless of the level of gross receipts. The draft also coordinates the new cash accounting rules with the uniform capitalization rules generally to exempt small businesses from the complex capitalization rules that require the allocation to their inventory of certain direct costs (e.g., materials and labor) associated with the production of the inventory as well as indirect costs (e.g., overhead and administrative expenses). (This latter section is 263A, and it is one of those sections that if you have to live with the current version you unfortunately know it by its section number ☹. It would be nice to get rid of it completely rather than "improve" it.)

The big issue is how this change to permit more use of cash accounting will affect businesses that are typically forced to keep inventories by other sections of the tax code. The practical reality is that if you have to use inventory accounting, it is de facto accrual accounting. The ability to use cash accounting for other expenses is a nice change but not dramatic.

SBLC intends to explore this issue further with the Committee. As the expression goes, we have some history here.

(SBLC history buffs will recall SBLC friend former IRS Commissioner Charles Rossotti spoke about the $10 million cash accounting concept at one of our annual meetings and as a member of President Bush's Tax Reform Commission he got it into that Commission's report as a recommendation. You will also remember SBLC's efforts with former Senator Kit Bond (R-MO) and the IRS led to some administrative relief in the 2000-2002 era.)

Direct Expensing

Section 179 of the tax code allows businesses to write off the amount of equipment and asset purchases in the year of purchase up to a certain amount as long as the business does not spend more than a specific total amount on such purchases in a year. The "direct expensing allowance" is often referred to as a small business provision but it is the amounts that make it a small business friendly provision since larger businesses bump up against the cap.

The draft increases permanently the amounts for new equipment and property up to $250,000, with the deduction phased out for investments exceeding $800,000 (both amounts indexed for inflation). It should be noted, that without action, these current temporary levels of $500,000 and $2,000,000 will revert to $25,000 and $200,000, respectively, in 2014. Therefore, if tax reform does not make it happen, we will have to secure a new temporary increase in the allowance by the end of the year.

S Corporations and Partnerships and C Corporation Migration

The Chairman's proposal attempts to take a small step towards a unified business tax system. The draft includes two options for aligning treatment of Subchapter S corporations and partnerships. I am not going to go into the details of the two options. My assessment is complex partnerships will not be happy with the loss of current favorable partner profit and loss allocation rules. The number of partnerships, particularly complex ones, is small but there a lot of revenue at stake.

We will have a new migration of C corporations to S corporations as the draft provides an incentive for some C corporations to migrate to S corporation status (the incentive is a shortened built-in gain period for you technical aficionados). The last great migration was after the 1986 tax reform effort. The question I am asking myself is will the incentives be enough to counter the fact everybody expects C corporation tax rates to go down? The trade-off will remain the double taxation of C Corporations (entity level and dividends), albeit at lower levels, versus single layer taxation at higher personal rates.

This is a topic SBLC will explore further with the Committee.

Transition Rules

In tax reform, there are winners and losers. If your industry is in the losers' category, the words of the day are "transition rules." You want a long transition period to adjust to the loss of whatever favorable tax treatment you have enjoyed. For example, if you are a partner in a complex partnership, you will want a long transition period. It the normal transition is four years, one would probably seek something like an eight-year transition period.

This draft has some transition rules but it primarily reminds me to remind you of the need to lay some groundwork for favorable transition rules. Those of you who participated in the 1986 discussions know the lobbying was intense and the transition rules many.

Unified Deduction for Start-up and Organizational Expenses

If you are reading this, you probably do not care about this as you are already in business, but for new businesses, the draft combines three existing provisions for start-up and organizational expenses into a single provision applicable to all businesses. The draft increases the threshold for start-up expenses to $10,000 (up from $5,000), with a phase-out beginning at $60,000 of such expenses (up from $50,000) and expands the deduction to cover organizational expenses. The draft repeals the separate special rules relating to the organizational costs of corporations and partnerships. Expenses above the new limit continue to be deductible over the 15-year period following the start of the business.