CHAPTER 10

Tax Reform and the Potential Negative Impact for Small Business and Its Qualified Retirement Plan System

PAULA A. CALIMAFDE, ESQ.

JESSICA B. SUMMERS, ESQ.

Ms. Calimafde is a principal in the Bethesda, Maryland law firm, Paley Rothman, where she heads the Retirement Plan and Employee Benefits departments. She received her B.A. degree from Swarthmore College and her J.D. degree from Catholic University. She lectures on employee benefits as well as estate planning topics nationally and is a frequent witness before Congress, particularly before the House Ways and Means Committee and the Senate Finance Committee and the House and Senate Small Business Committees. Ms. Calimafde is the Chair of the Small Business Council of America, the only national non-profit organization to represent the interest of privately owned businesses exclusively in the tax, employee benefits and healthcare areas. She is the President and General Counsel of the Small Business Legislative Council, a national non-profit association acting as a permanent coalition for its trade association members. She has co-authored or authored chapters for this Tax Institute in 1999, 2000, 2001, 2002, 2003, 2005, and 2007. She is a charter fellow of the American College of Employee Benefits Counsel, a fellow of the American College of Tax Counsel and the American College of Trust and Estate Counsel.

Ms. Summers is an associate at Paley Rothman where she is a member of the Retirement Plan, Employee Benefits, and Employment Law departments. She received her B.A. from Wheaton College, Norton, Massachusetts, and her J.D. degree from American University, Washington College of Law, Washington, D.C.

The authors would like to express their appreciation to Alson R. Martin, Esq., Lathrop & Gage, LLP, Overland Park, KS and Thomas J. Nichols, Esq., Meissner Tierney, Milwaukee, WI, for their significant contributions to this chapter.

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Ill-advised qualified retirement plan provisions combined with a lack of understanding

of the impact of business income to individuals owning pass-through entities in recent tax reform proposals could signal an economic train wreck for America's small businesses and their employees.

This chapter will analyze the various tax reform proposals being debated by Congress and their potential impact on small business. We will discuss in detail qualified retirement plan provisions contained in some of the major proposals and illustrate how they could bring a successful system to a halt, harming the retirement security of many small business employees. The chapter will also review the extent of the small business retirement system's success and how the oft-cited coverage numbers are not only incorrect but are being used deliberately to undermine the system for short-term revenue. The impact of tax reform on Sub-S corporations will also be analyzed.

§ 10.01 OVERVIEW OF THE CONTEMPORARY TAX REFORM DEBATE

[1] General Principles of Tax Reform: Momentum and Disagreement

In this era of partisan division, the assertion that the Internal Revenue Code (the "IRC" or "tax code") is too complicated and in grave need of revision or reform is one of the few points to garner consensus across political spectrum.[1] The last major piece of tax reform legislation was passed nearly thirty years ago in the form of the 1986 Tax Reform Act. Since that time, the IRC has grown into the behemoth of 73,954 pages that it is today.[2] Unfortunately, while there is broad agreement that something must be done, the accord stops there. Proposals as to what should be done to reform the tax system range dramatically and frequently contradict one another. As a whole, the Democratic lawmakers generally favor tax reform options that would raise revenues, while the Republicans advocate a revenue neutral approach to tax reform that results in lower tax rates.[3]

The widespread commitment to pursuing tax reform as well as the disparity between the Democratic and Republican approaches is reflected in the budget resolutions

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[1] In recent years, tax reform has become an important lobbying issue with entities and organizations across party lines investing significant time and resources to pursuing and protecting their interests in relation to tax reform. *See* Jerry Markon, *As Momentum Builds Toward Tax Reform, Lobbyists Prepare For a Fight*, WASH. POST, March 9, 2013, http://www.washingtonpost.com/politics/as-momentum-builds-toward-tax-reform-lobbyists-prepare-for-a-fight/2013/03/09/e46c0b3a-6ad9-11e2-af53-7b2b2a7510a8_story.html.

[2] *See Federal Tax Law Keeps Piling Up*, WOLTERS KLUWER, CCH (2013), http://www.cch.com/taxlawpileup.pdf. In 1984, the IRC at 26,000 pages was approximately 35% the size of today's code. *Id*.

[3] *See* Martin Sullivan, *If Camp's Tax Reform Bill Won't Pass, Why Is It So Important?*, FORBES (March 10, 2014), http://www.forbes.com/sites/taxanalysts/2014/03/10/if-camps-tax-reform-bill-wont-pass-why-is-it-so-important/ (arguing that the disagreement between the parties as to whether tax reform should raise revenue or be revenue neutral is a "fundamental irresolvable conflict" that has gridlocked the tax reform process).

passed by the House of Representatives and the Senate over the past few years.[4] The House budget resolution for fiscal year 2015, passed on April 10, 2014, calls for Congress to enact comprehensive revenue-neutral tax reform.[5] A similar directive was also included in the House's 2014 budget resolution.[6] Both the 2014 and 2015 House budget resolutions call for a tax reform proposal that does the following:

(1) simplifies the tax code to make it fairer to American families and businesses and reduces the amount of time and resources necessary to comply with tax laws;

(2) substantially lowers tax rates for individuals, with a goal of achieving a top individual rate of 25 percent and consolidating the current seven individual income tax brackets into two brackets with a first bracket of 10 percent;

(3) repeals the Alternative Minimum Tax;

(4) reduces the corporate tax rate to 25 percent; and

(5) transitions the tax code to a more competitive system of international taxation.[7]

The proposals to establish just two individual tax brackets of 10 percent and 25 percent and to reduce the corporate rate to 25 percent were also included in the budget resolution passed by the House in 2012[8] and partially incorporated into Ways and Means Committee Chairman David Camp's Tax Reform Act of 2014 (the "Camp Proposal") discussed further below.[9]

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[4] These budget resolutions were passed prior to the negotiation and passage of the bi-cameral Bipartisan Budget Act of 2013 which itself did not directly address tax reform issues.

[5] *See* HR Con Res 96, 113th Cong (2014). The passage of the 2014 House budget resolution was largely upon party lines. The resolution was passed with a vote of 219 to 205 and there are currently 233 Republicans and 199 Democrats serving in the House.

[6] The 2014 House budget resolution instructed that a deficit neutral tax proposal be presented to the House Ways and Means Committee no later than December 31, 2013. *See* HR Con Res 25, 113th Cong (2013). Although no such proposal was presented prior to the end of 2013, in February of 2014, Ways and Means Committee Chairman David Camp introduced the Tax Reform Act of 2014 which purports to be deficit and distributionally neutral. *See* Press Release, U.S. House of Representative Comm. on Ways and Means, Camp Releases Tax Reform Plan to Strengthen the Econ. and Make the Tax Code Simpler, Fairer and Flatter (Feb 26, 2014), http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=370987.

[7] HR Con Res 96, 113th Cong (2014); HR Con Res 25, 113th Cong (2013).

[8] HR Con Res 34, 112th Cong (2012).

[9] *See infra*. The 2015 House Democratic alternative budget, introduced as an amendment to HR Con Res 96, directly targets this proposal citing research from the Tax Policy Center stating that "it is impossible to achieve such a reduction and be revenue-neutral without large reductions in tax deductions

In 2014, on the other side of the Hill, Senate Democrats made the decision not to write a budget for fiscal year 2015.[10] However, in 2013, the Senate acted to pass a budget resolution for the fiscal year 2014.[11] Taking a less specific approach to tax reform than the House's 2014 and 2015 budget resolutions, the Senate's budget resolution instructed the following:

> Not later than October 1, 2013, the Committee on Finance of the Senate shall report changes in laws, bills, or resolutions within its jurisdiction to increase the total level of revenues by $975,000,000,000 for the period of fiscal years 2013 through 2023.[12]

As discussed further below, the Senate Finance Committee published four discussion drafts on specific areas of tax reform in late 2013, though no comprehensive tax reform proposal has yet to be presented in the Senate.

The tax reform portions of the chambers' respective budget resolutions include few specifics and are clearly more goal statements than policy proposals. However, the fact that they were passed by each chamber offers some insights into each parties' consensus regarding what tax reform should look like as well as an on the books commitment to pursue tax reform.

§ 10.02 APPROACHES TO TAX REFORM

[1] The "Leave No Man Standing" Approach

One approach is to scrap the existing IRC and start anew with a clean slate. The Camp Proposal epitomizes this approach. The Proposal is based on the assumption that today's tax code is "a broken mess . . . [i]n the last decade alone, there have been more than 4,400 changes to the code—more than one a day."[13] As discussed above, it is difficult to argue with the assumption that the tax code has become too complex and that much-needed certainty has been missing in the tax law for many years. It would

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and credits for middle-income tax-payers that would lead to a net tax increase on those families" H Amend 616 to HR Con Res 96, 113th Cong (2014).

[10] This decision was reached because Bipartisan Budget Act of 2013, passed by both chambers and enacted on December 26, 2013, already set the budget ceilings for the 2014 and 2015 fiscal years. *See* Erik Wasson, *Senate Democrats to Skip 2015 Budget*, THE HILL, February 28, 2014, http://thehill.com/policy/finance/199579-senate-dems-to-skip-2015-budget.

[11] S Con Res 8, 113th Cong (2013). The very passage of the Senate budget resolution was seen as an accomplishment in itself as it was the first budget resolution to be passed in the Senate in four years *See* Erik Wasson, *Senate Passes First Budget in Four Years*, THE HILL, March 23, 2013, http://thehill.com/policy/finance/289989-senate-passes-first-budget-in-four-years.

[12] S Con Res 8, 113th Cong (2013).

[13] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; EXECUTIVE SUMMARY, at 3 (2014), http://waysandmeans.house.gov/uploadedfiles/tax_reform_executive_summary.pdf.

seem axiomatic that certainty in the tax law would benefit businesses small and large by allowing them to plan for a period longer than a year or two with some assurance that the tax code would remain unchanged.[14]

The call for comprehensive tax reform is further highlighted in the Executive Summary of the Camp Proposal published by the Committee on Ways and Means which states, "[the tax code] requires the average taxpayer to spend about 13 hours gathering all the receipts, reading all the rules and filling out all the form the IRS requires to file their taxes."[15] The Summary further notes that "over 90% of us either pay someone else to do our taxes, or purchase commercial software to help us do it ourselves"[16] and that "[a]ll totaled, American spend over $160 billion and about 6 billion hours a year trying to comply with the tax code."[17]

Chairman Camp is certainly not alone in his view of the current tax code. As the report from the National Commission on Fiscal Responsibility and Reform (Simpson-Bowles) put it,

> [t]he tax code is rife with inefficiencies, loopholes, incentives, tax earmarks, and baffling complexity. We need to lower tax rates, broaden the base, simplify the tax code, and bring down the deficit. We need to reform the corporate tax system to make America the best place to start and grow a business and create jobs.[18]

One might presume that the drafters of the Camp tax reform proposal first decided what they wanted the individual and corporate income tax rates to be and then decided which tax credits and deductions had to be cut or reduced in order to have sufficient revenue to attain the tax rates to the desired level. This process is referred to as broadening the tax base. The fewer credits and deductions one has, the more income is subject to tax. Thus, the more the tax base is broadened, the lower the tax rates can become. Of course, there are more than a few Democrats in the Senate who would be in favor of broadening the tax base, but instead of reducing the rates to the levels set forth in the Camp Proposal, they would use the additional revenue to decrease the Nation's debt and/or spend it on perceived necessary programs.[19]

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[14] *See, e.g.*, Conrad De Aenlle, *For Small Businesses, a Road Without a Map*, NY TIMES, February 9, 2014, at BU8 (discussing the impact that uncertainty in the tax code).

[15] *See supra* note 13 at 5.

[16] *Supra* note 13 at 5.

[17] *See supra* note 13 at 5.

[18] THE NAT'L COMM'N ON FISCAL RESPONSIBILITY AND REFORM, THE MOMENT OF TRUTH,at 12 (Dec 2010).

[19] *See, e.g.*, Lori Montgomery and Suzy Khimm, *Schumer: Tax reform should cut deficits, not tax rates*, THE WASHINGTON POST, October 9, 2012, http://www.washingtonpost.com/business/economy/schumer-tax-reform-should-cut-deficit-not-tax-rates/2012/10/09/a6cd8f54-1194-11e2-ba83-

The Camp proposal is a brave undertaking in that the proposal sets forth exactly which deductions and credits would get the tax, which would get trimmed and which would survive the process intact. The proposed tax reform promises to reduce the size of the tax code by 25%. In seeking this reduction, the Camp Proposal first looks to so-called "tax expenditures" to see which can be pared most easily from the tax code. Today, the term "tax expenditures" is an accepted term to encompass any provision of the tax code whereby certain income is not taxed or is subject to a lower rate. For instance, the deduction a company receives for making contributions to a retirement plan for its employees is now referred to as a tax expenditure.[20] Absent a provision in the tax code providing for this deduction, the theory holds that all of this income would be subject to tax. Not so many years ago, many Republicans rejected the concept of tax expenditures because inherent in the theory was the federal government's right to tax all income—rather, Republicans held that the government was only entitled to tax the types of income that were explicitly provided for in the tax code.

The current perspective of many Republicans and Democrats with respect to tax expenditures is reflected in the Simpson-Bowles report, which states, "[t]he current tax code is riddled with $1.1 trillion of tax expenditures: backdoor spending hidden in the tax code" and that "[t]ax reform must reduce the size and number of these tax expenditures and lower marginal tax rates for individuals and corporations—thereby simplifying the code, improving fairness, reducing the tax gap, and spurring economic growth."[21] Unlike the Camp Proposal, however, Simpson-Bowles chose not to determine which tax expenditures should continue to be included in the tax code.[22] The Commission did recommend that some provisions would have to be made on a permanent or temporary basis to support low-income workers and families, mortgage interest for principal residences, employer-provided health insurance, charitable giving, and retirement savings and pensions.[23]

It is illuminating to note how the Camp Proposal and its related roll-out documents refer to tax expenditures. Under the section of the Executive Summary entitled "Problem: The Complexity of the Tax Code Makes It Unfair to Hardworking

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a7a396e6b2a7_story.html (discussing Senator Charles Schumer's argument that "revenue raised by closing loopholes and deductions should be dedicated entirely to lowering deficits, he said, not to lowering rates—the GOP's primary policy objective").

[20] *See Federal Tax Expenditure Estimates for Fiscal Years 2013–2017*, HOUSE WAYS AND MEANS DEMOCRATIC COMMITTEE STAFF (July 18, 2013), http://democrats.waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/Tax%20Expenditures%20%282013-2017%29.pdf.

[21] *See supra* note 18, at 28.

[22] *Supra* note 18, at 31. The Report did include an illustration to show how certain tax rates could be achieved by eliminating certain tax expenditures and modifying others.

[23] *Supra* note 18, at 31.

Taxpayers," we are told that the "tax code has been riddled with lobbyist loopholes that pick winners and losers based on what favors Washington was handing out."[24] Thus, "[s]implifying the broken tax code by eliminating lobbyist loopholes and treating hardworking taxpayers fairly is why we need tax reform."[25] Under the Summary's section entitled, "What if We Fixed the Tax Code?" the proposal states that it will make the code more efficient by "getting rid of special interest hand-outs."[26] Finally, at the conclusion under the section called, "How We Got Here," the Summary states that the stakeholders in exchange for the certainty of having a lower tax rate are willing to give up "certain tax preferences that they have long held dear."[27] At various points in the documents promoting the Camp Proposal, tax expenditures are referred to as "lobbyist loopholes," "special interest hand-outs," and appreciated "tax preferences."

Unfortunately, when it comes to reaping dollars out of the so-called tax expenditures, most of the money must come from a relatively few tax expenditures and all of them fall within the category of preferences that are deemed very important to the taxpayers of the country as well as to Congress. For instance, the Joint Committee on Taxation has determined that the exclusion for contributions for health care and health insurance premiums paid by employers for their employees is the single largest tax expenditure by far.[28] The Joint Committee on Taxation has determined that the reduced rates on dividends and capital gains is a very significant tax expenditure, as is the exclusion for contributions made to retirement plans and the cost of deferring the income tax on the earnings on those contributions until they are distributed from a retirement plan or IRA.[29] The deduction for mortgage interest on personal residences is calculated to be very significant along with items such as the credit for children under age 17 and the deduction for state and local taxes. Another significant expenditure based upon the Joint Committee on Taxation's analysis is the deduction for charitable contributions.[30]

In the recent discussions and proposals on how to raise revenue (and conceivably lower tax rates through tax reform), the deduction for retirement plan contributions has been treated the same as other tax expenditures in the tax code. This is a

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[24] *See supra* note 13, at 5.

[25] *Supra* note 13, at 5.

[26] *Supra* note 13, at 13.

[27] *Supra* note 13, at 23.

[28] THE JOINT COMMITTEE ON TAXATION,JCS-1-13, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012–2017 (2013).

[29] THE JOINT COMMITTEE ON TAXATION,JCS-1-13, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012–2017 (2013).

[30] THE JOINT COMMITTEE ON TAXATION,JCS-1-13, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2012–2017 (2013).

mischaracterization because retirement plan contributions are eventually brought into income, along with any earnings, though not always within the short windows in which the budget calculations are made. A study prepared for the American Society of Pension Professionals & Actuaries reflects the value of the retirement plan tax expenditure to be roughly 55%–75% lower than estimates by the Joint Committee and the Treasury.[31] This study assumes that people will enjoy lower income tax rates during retirement than when contributions are made to the retirement plan. This assumption increases the value of the "tax expenditure." Many experts believe, however, that tax rates may be higher for most taxpayers in the future and that the "real" cost of the retirement plan tax expenditure is even lower than that set forth in the ASPPA report.[32]

There are approximately 670,000 private-sector defined contribution plans covering approximately 67 million participants and over 48,000 private-sector defined benefit plans covering approximately 19 million participants. The U.S. private retirement plan system paid out over $3.824 trillion in benefits from 2000 through 2009 and U.S. public sector plans paid out $2.651 trillion during the same period.[33] All of this money was brought into income and subject to regular income tax rates (the only exception would be money that was contributed on an after-tax basis). The only loss to the government with respect to the deduction for retirement plan contributions and tax free growth inside the plan is the time value of money. As demonstrated below the potential cost to the small business retirement system is certainly not worth this relatively minor and short-term gain in tax revenue.

In short, tax reform that has a reduction in tax rates as a primary goal can only accomplish this feat by broadening the tax base, which, by definition, means eliminating or reducing some or all of the major tax preferences. All of the major tax expenditures are based upon valid policy grounds whereby Congress is either trying to incentivize certain behavior (e.g., saving for one's retirement) or assisting the American public in realizing a certain desired goal (e.g., purchasing a home).

Determining whether closely held businesses fare better or worse under a particular tax reform proposal that calls for a broadening of the tax base requires an analysis of how the reduction or elimination of the major tax preference items, as well as other tax

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[31] Judy Xanthopoulos and Mary Schmitt, *Retirement Savings and Tax Expenditure Estimates*, AMERICAN SOCIETY OF PENSION PROFESSIONALS AND ACTUARIES (May 2011), http://www.asppa.org/Portals/2/APerspectiveOnTaxPolicyToPromoteRetirementSavingsMay2011.pdf.pdf.

[32] The reason why some financial experts contend that the tax rates will rise in the future despite the current calls for lower tax rates is because they believe the only way the country will be able to rid itself of its crushing debt will be to broaden the tax base and raise tax rates Of course, Congress will not adopt a course of action this draconian until the country is facing a crisis of significant proportions.

[33] *See* HR Res 101, 112th Cong (2012).

expenditures that are not as significant from the viewpoint of raising revenue, affect those businesses and their employees in light of the anticipated reduction in the tax rate. It is the authors' contention that the significant negative ramifications that could result from some of these proposals will outweigh the benefits of the lower tax rates, particularly for the employees of the closely held business.[34]

[2] Simplification Approach

The other approach to tax reform is to focus instead on simplifying the tax code while simultaneously attempting to inject an element of certainty into it. Simplification can be a piecemeal process since there is no goal to broaden the tax base in order to reduce tax rates or to raise revenue. Under this approach, there is a premium given to achieving clarity and certainty in the law.

Simplification could be in the form of "optional simplification," meaning that a company (or an individual, whichever the case may be) could choose to accept the simplified tax code section or stay with the current code section. A current example in the tax code is the 401(k) safe harbor provisions, which employers can choose to elect or not. Many small businesses have found the 401(k) safe harbor provisions to save them time and money—they simplify an unnecessarily complex tax code provision. However, larger businesses generally prefer to stay with the "regular" 401(k) provisions that require discrimination testing because the simplified safe harbor provision would be more difficult for them to utilize due to the additional cost of contributions required by the safe harbor as well as the cost of having to change all of their employee communications.

Under the simplification approach, "true" loopholes could also be eliminated from the code. The authors suggest defining a "true" loophole as one intended to benefit very few individuals or businesses and does not further any general policy that is or has been advanced by the Congress (e.g., Congress has determined that as a general policy employer retirement plan formation should be encouraged in order to assist employees to save for their retirement security). This approach would be a safer way to make the tax code more manageable for the American public without causing the grave, unintended results that can arise when there is a massive tax reform rooting out many tax preferences that play an important role in our society.[35]

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[34] In this chapter, we have used the terms, "small business" and "closely held business" interchangeably. While it is true that a closely held business can be a large business, virtually all small businesses are closely held. Since the vast majority of closely held businesses are indeed small businesses, we feel comfortable interchanging these terms.

[35] Many Americans and members of Congress believe that the blueprint for successful tax reform is the Tax Reform Act of 1986 that is largely attributed to President Reagan. While it is certainly true that tax rates were reduced dramatically by the law, it is also true that some changes in the tax code pertaining to so-called abusive real estate tax shelters had the unintended result of causing a severe dislocation in the

A prime example of the simplification approach is the Secure Annuities for Employee Retirement Act of 2013 (the "SAFE Retirement Act of 2013") introduced in July 2013 by Finance Committee Ranking Member Senator Orrin Hatch.[36] Section B of the SAFE Retirement Act exclusively targets common sense simplifications to the private pension systems.[37] These proposed simplifications include the following:

- Eliminating top-heavy rules.
- Allowing mid-year amendments to a safe harbor 401(k) plan as long as the amendments do not violate certain safe harbor requirements.
- Simplifying the process for making hardship distributions from a plan.
- Establishing an additional automatic enrollment safe harbor with default contributions of 6% in the first year, 8% in the second year, and 10% in all years thereafter.
- Allowing plans to consolidate multiple notices required under ERISA and other IRC provisions into a single notice.[38]

As discussed further below, these measures, as well as other proposed simplifications, would go a long way towards reducing complexity in the tax code and significantly improve the small business qualified retirement plan system without requiring a massive tax reform bill—such that it could be accomplished even by our divided Congress.

A major advantage of the simplification approach is that it can be implemented incrementally when the wholesale tax reform approach is politically unfeasible. Under the simplification approach, there are no new winners and losers—the status quo remains but everybody wins by losing unnecessary complexity, sparing Americans from having to spend extraneous time on their tax returns or saving them money by allowing them to do more of their taxes themselves without expert help. In the small business qualified retirement plan system, the benefit of legislation like the SAFE Retirement Act would be increased plan formation due to the lower costs and easier administration generated by the simplification of the rules.

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real estate market that started in Texas and the west and rolled across the country.

[36] *See* Press Release, Sen. Orin Hatch, Hatch Unveils Bill to Overhaul Pension Benefit System, Secure Retirement Savings (July 9, 2013), http://www.hatch.senate.gov/public/index.cfm/2013/7/hatch-unveils-bill-to-overhaul-pension-benefit-system-secure-retirement-savings.

[37] S 1270, 113th Cong (2013).

[38] S 1270, 113th Cong (2013).

§ 10.03 RECENT TAX REFORM PROPOSALS

[1] Camp Proposal

[a] New Personal Income Tax Brackets and Partial Loss of Deduction at 35% Level

As mentioned above, in early 2014, Chairman Dave Camp of the House Ways and Means Committee released the most comprehensive tax reform proposal in the last decade. To get a sense of the magnitude of this proposal—the Executive Summary of the proposal alone runs 25 pages, the Discussion Draft that goes through the proposal tax section by section runs 182 pages and the draft legislation itself is almost 1000 pages. This is a serious effort[39] to eliminate large sections of the tax code and to revamp other significant portions of the remaining code. Because this proposal has picked winners and losers, it is unlikely that it will receive serious attention before the election. The authors suspect that it will never be adopted intact, but that certain proposals will be picked up in future tax reform legislation.

Given the breadth of the Camp Proposal, this section will summarize only some of the major provisions that primarily affect small businesses, including those that operate as pass-throughs, particularly Sub-S corporations. The provisions that will impact the small business qualified retirement plan system will be analyzed in some detail.

Under the Camp proposal, the tax code would have three personal income tax brackets—10%, 25%, and 35%. Even though the summary of the proposal states the top tax bracket is 25%, there is an additional 10% surtax for those who earn in excess of $450,000, if married, or $400,000, if single. Call it whatever you want, our view is that this translates to an effective top tax bracket of 35%. Excluded from the 35% tax rate is income earned from domestic manufacturing activities, but only if that income is not subject to Self Employment Tax. See Section 10.05 below for more details. These rates are, of course, critical for pass-through entities whose business income is

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[39] Unfortunately, the Executive Summary released with the proposal is surprisingly partisan in a manner that is likely to temper any bi-partisan support and potentially cause doubts about the quality of the overall tax reform package itself. For example, the Summary states that President's answer to the lack of good jobs in America is "adding more complexity to the tax code, more tax increases and even more debt. The President's budget never balances, and his refusal to deal with Washington spending leads to skyrocketing debt and deficits." *Supra* note at 8. Then there are comments that are simply absurd, for example the statement that the proposal would end "the tax code's 'divorce subsidy'—which benefits divorce lawyers while helping to break up families—that allows divorcing couples to get a tax break for alimony payments." It is laughable to think that any couple has decided to get a divorce so that one of the spouses could get a deduction for alimony. Such partisanship and baseless comments are a shame because, although the authors disagree with many of the proposal's provisions and are concerned about their potential small business, there is no question that this is a carefully crafted and thoughtful document.

taxed to the owners at personal income tax rates.

Many deductions can only be taken against the 25% bracket, but not the 35% bracket. These deductions include the standard deduction, all itemized deductions except for charitable contributions, tax-exempt interest, *employer contributions to health and defined contribution retirement plans* to the extent excluded from gross income, the deduction for health premiums of the self-employed and the portion of Social Security benefits excluded from gross income among other items.[40]

This loss of part of the deduction for employer-provided defined contribution retirement plans is likely to operate as a deterrent to continued contributions to a small business retirement plan, particularly when combined with many of the other provisions dealing with small business qualified retirement plans. Additionally, the loss of the deduction does not increase the basis of the retirement funds when they are brought back into income. Unfortunately, the perception that some of the retirement plan money may be subject to double taxation is likely to turn off many small business owners from even wanting to sponsor a retirement plan. This is exactly the opposite of what the country needs at this time—Congress should be making every effort to encourage new plan formation and continued sponsorship of qualified retirement plans. This is particularly true since most American workers only save money for their retirement in qualified retirement plans.

[b] New Preferential Treatment for Capital Gains and Qualified Dividends

A new above the line deduction would replace the existing preferential tax treatment for capital gains and qualified dividends. This 40% deduction, if anything, would allow this type of investment income to receive even more favorable treatment than that afforded under current law.[41]

[c] Reduced Section 179 Expensing Level

The budget proposal makes permanent the increased expensing limits for small businesses that expired at the end of 2013 (commonly known as the Section 179 deduction) at the 2008–2009 levels.[42] Section 179 is very important for many small businesses because it allows businesses to expense the cost of certain financed or leased equipment and software. Under the Camp proposal, up to $250,000 of

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[40] *See* H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Secs 1001–1003, at 2 (2014).

[41] *See* H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Secs 1001–1003, at 3 (2014).

[42] *See* H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Secs 1001–1003, at 57 (2014).

investments in new equipment and property can be expensed, with the deduction phased out for investments exceeding $800,000, both dollar amounts indexed for inflation. This is a very disappointing modification of the important Section 179 deduction for small business.[43] The dollar amounts in 2013 were $500,000 and $2 million, respectively. Thus, this permanent extension is not even as good as the law as it stood in 2013. When compared to all of the tax reform proposals on the Hill, the Camp proposal comes in with the lowest numbers for the Section 179 deduction—a clear blow to small business and its ability to invest in new equipment and property.

[d] Cash Basis Method of Accounting Expanded to More Small Businesses

The proposal would allow small businesses to use the cash method of accounting, a far simpler method of accounting than the accrual method, if their annual gross receipts are $10 million or less. This is an increase from the current dollar amount of $5 million. The current exception for family farms of $25 million is retained, as is the exception for sole proprietors. However, personal service corporations will now be subject to the $10 million limit, whereas under current law they are exempt from the dollar limit and are allowed to use the cash basis method no matter what their gross receipts are.[44] Even though this proposal is beneficial for most small businesses, including those that have inventory, it is absurd when applied to personal service corporations. These corporations all rely upon payment for their services and it is well known that these companies frequently do not get paid for some of their services or are forced to take deep discounts. For those personal service corporations who have gross receipts in say the $10–$50 million range, being forced into the accrual method of accounting will cost needless dollars and accounting hours—the opposite of tax simplification.

[e] Elimination of LIFO Inventory Accounting Method

Under the proposal, the inventory accounting method known as LIFO (last-in, first-out) is repealed.[45] The loss of this method of accounting will hurt small businesses. In light of the relatively slim reduction in tax rates that many pass-through entities will receive (despite assertions to the contrary in the summary of the proposal, there are a significant number of pass-through entities who generate $400,000 and more of business income), the loss of LIFO will be very noticeable.

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[43] In a recent survey of the association members of the Small Business Legislative Council, the Section 179 deduction was considered to be the most valuable extender item.

[44] *See* H CO MM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Sec 3301, at 87 (2014).

[45] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Sec 3301, at 92 (2014).

[f] Major Changes to Sub-S Corporations

The significant and largely negative changes to Sub-S corporations are explored in detail in Section 10.05 below.

[g] Retirement Plan Provisions in the Camp Proposal that Directly Impact Small Business

The proposal would make a number of significant changes to the current retirement plan provisions. These changes include:

- No new SEPs (Simplified Employee Pension IRAs) would be allowed after 2014, but existing SEPs would be grandfathered. The same is true of SIMPLE 401(k) plans but since they are seldom used, nobody cares.[46] Many very small businesses appreciate the simplicity inherent in a SEP since the employer contributions are paid over to an IRA for each employee. Thus, the employer has no fiduciary duty with respect to the investments in the employee's IRA nor any responsibility to ensure that the funds are maintained in the IRAs for the retirement security of its employees.

- For small businesses with 100 or more employees, 401(k) contributions (i.e., employee contributions) can no longer all be made on a pre-tax "traditional" basis. Employees who wish to contribute more than half of the 401(k) limit will be forced to contribute the amount in excess of 50% of the 401(k) limit on an after-tax basis to a Roth 401(k) account. This rule would not apply to small businesses with fewer than 100 employees.[47] The policy considerations behind this proposal are purportedly to make sure employees have more money when they retire since they are not aware that their retirement benefits will be taxed as ordinary income when they are distributed from the retirement plan or IRA and thus, are not contributing enough. Moreover, it is noted that this provision will only affect 17% of the employees who do make 401(k) contributions.

  This provision is more likely the result of the need to find revenue in order to lower the tax rates. Of course, the assumption is most likely made that the 17% affected employees will continue to make the same level of contributions they were making before the contributions

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[46] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Secs 1611–12, at 38 (2014).

[47] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Sec 1613, at 39 (2014).

become after-tax. This is probably not a good assumption and one that ultimately will reduce the retirement security of those impacted by this new proposal. What makes this proposal even more problematic is that we know the tax revenue numbers assigned to it are artificially inflated because of the budget time frame used to calculate these revenue estimates.

- ☐ Increased contribution limits for the SIMPLE IRA up to the 401(k) levels if the employer elects to put in the same 50% limit for employee contributions discussed above, thereby allowing only the first half of the maximum amount to be contributed on a tax free basis.[48] Today the maximum contribution that an employee can make to a 401(k) plan is $17,500 for employees under 50 and $23,000 for employees who are 50 or older. The maximum employee contribution made to a SIMPLE IRA is $12,000 for employees under 50 and $14,500 for employees who are 50 or older. The forced savings feature of a "regular" qualified retirement plan, such as a 401(k) plan, should not be underestimated and must be safeguarded. Unlike money in a SIMPLE IRA, money in a retirement plan cannot be removed on a whim. Because of its lack of fiduciary safeguards, the lack of investment selections and guidance, and the ability of employees to access the funds for any reason at any time, the SIMPLE IRA should only be considered as a starter plan. It is important, therefore, that small businesses be given incentives to move up to the qualified retirement plan system as quickly as possible. By removing the gap between the 401(k) limits and the SIMPLE IRA contribution limits, there is no reason for a small business to move to the qualified retirement plan system with its additional costs and burdens. Unfortunately, the employees will have lost the significant protections built in to the qualified retirement plan system for them and by losing the system's prevention of leakage it is less likely that the employees will retain their contributions in the IRA environment until their retirement.

- ☐ The stretch IRA would be repealed.[49] This provision would require retirement plan assets to be forced out of an IRA in most cases shortly after the passing of both spouses. The short-sighted goal of this

[48] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Secs 1613, at 39 (2014).

[49] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Sec 1614, at 40 (2014).

change is to raise revenue in the short term by eliminating the "stretch IRA." The estimate is that this provision would increase revenues by $3.5 billion over the period from 2014–2023.[50] Despite the statement in the Discussion Draft that "the modifications in the provision would not affect the ability or incentive for Americans to save for retirement,"[51] the reality is that they are likely to have a significant impact on the amount of money that will be accumulated in a retirement plan. The change also has no grandfather or transition provisions and thus, harms employees who have relied on the stretch IRA for their long term retirement planning, particularly those who are older and have few options left due to their anticipated short life expectancies.

It is logical that eliminating "stretch IRAs" (which allows the amount remaining in an IRA at an employee's death to be distributed over the life expectancy of the beneficiaries who inherit it),[52] will cause people to be wary of accumulating "too much" retirement money because of its ultimate negative tax treatment. Many people think retirement plans and IRAs provide significant income tax advantages, and they do when money is put into the plans, but when funds are removed from the plan or IRA the tax treatment is the worst—all the money is subject to state and federal income and estate tax and does not receive a step up in basis when the money goes through the estate when inside a retirement plan or an IRA. This was not always the case—years ago a portion of the money received capital gains treatment and none of the funds were subject to federal estate taxes. These advantages were eliminated over the years. The ability to "stretch" distributions from the IRA over the beneficiary's life expectancy partially made up for this very negative tax treatment.

The loss of the stretch IRA may cause employees to under-save for their retirement and could further give rise to small and mid-sized

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[50] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Sec 1614, at 41 (2014).

[51] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Sec 1614, at 41 (2014).

[52] There appears to be a misconception that a stretch IRA can continue to be paid over more than one generation of beneficiaries. However, the law is clear that a stretch IRA can extend only over the life expectancy of the beneficiary(ies) designated by the IRA owner. For instance, if the first beneficiary is a child and the child were to die before receiving all the funds in the inherited IRA, the child's children (i.e., the grandchildren) would indeed be able to continue to receive the IRA assets but required minimum distributions would be based on their parent's (the child's) remaining life expectancy not the grandchild's remaining life expectancy.

business owners freezing contributions or closing down the whole plan prematurely. It is reasonable to assume that accountants will tell their clients to stop saving in a retirement plan once they reach a level that they might not be able to use up during their retirement in much the same way they did with the equally ill advised 15% excise tax on "excess" retirement plan funds. Younger employees could choose to save only the amount they were certain to use up during their lifetimes and to save the remainder in other more tax-advantaged, vehicles.[53]

- All contribution limits to retirement plans, as well as SEPs and SIMPLE IRAs, would be frozen at the 2013 levels until 2024, at which time inflation indexing would start again based on the 2013 level.[54] While the Discussion Draft notes that, "When interest rates are relatively low, as they have been for the last several years, these provisions would have little or no effect on the annual contribution limitations," it is interesting that the revenue estimate for this suspension of indexing for inflation is expected to increase revenues by $63.4 billion over the next ten years.[55] Obviously one of these statements will not hold true over the next 10 years!

This proposal which would work to limit the amount that can be contributed to a 401(k)/profit sharing plan over the years is likely to "tip the scales" so that the small business owners would determine that from a tax viewpoint it is better to close down the plan and take out the extra funds as compensation or reinvest them in the business. Funds taken out as compensation could then be invested in capital gain assets which receive favorable income tax treatment and a step up in basis at death or in insurance products which gives rise to favorable tax treatment.

[2] President Obama's 2015 Budget Proposal

While the Camp Proposal is the most comprehensive tax reform proposal that has

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[53] Unfortunately, the data is clear that most people are only able to save in a retirement plan. Thus, it is very possible that people would choose to save less in a retirement plan because they would not want to force their beneficiaries to be hit with such draconian taxes, but at the end of the day they would simply save less because they would spend the funds outside of the retirement plan, rather than investing them in more tax-advantaged vehicles. The end result is less retirement security due to the loss of the stretch IRA.

[54] *See* H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Secs 1620–1624, at 45 (2014).

[55] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, Secs 1620–1624 at 45 (2014).

been released in the past year, Chairman Camp is not the only politician who has sought to outline his vision for tax reform. On March 4, 2014, President Obama released his 2015 budget proposal, which included a number of provisions that would change or affect the tax code. While the President is required by law[56] to submit an annual budget proposal to Congress, Congress, in turn, has no statutory obligation to consider the President's budget. The President's budget does, however, commonly serve as a discussion point and a guide for members of President's party. While President Obama's 2014 budget proposal targeted compromise across party lines,[57] the President's 2015 budget was self described as "how the President in an ideal world believes that the government should be funded."[58]

The President's $3.9 trillion[59] budget proposal would incorporate a number of substantive changes to the individual and corporate tax systems.[60] For small businesses and their owners and employees, some of the most significant changes proposed in the President's budget would be as follows:

- The President's budget would cap the total amount[61] that individuals can save in tax-advantaged retirement plans and accounts (such as 401(k) plans, IRAs, and 403(b) plans).[62] Under the President's budget, individuals would only be able to accumulate up to

> the amount necessary to provide the maximum annuity permitted for a tax-qualified defined benefit plan under current law (currently an annual benefit of $210,000) payable in the form of a joint and 100-percent survivor benefit commencing at age 62 and continuing each year for the life of the participant and, if longer, the life of a spouse, assumed to be of

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[56] 31 US Code § 1105.

[57] Reid Epstein, *Obama 2015 Budget: $3.9 Trillion*, POLITICO, March 4, 2014, http://www.politico.com/story/2014/03/obama-budget-2015-104229.html.

[58] Press Release, Press Briefing by Principal Deputy Press Secretary Josh Earnest (Feb 2, 2014), http://www.whitehouse.gov/the-press-office/2014/02/20/press-briefing-principal-deputy-press-secretary-josh-earnest-2202014.

[59] *See supra* note 41.

[60] Analysis by the non-partisan Tax Foundation concluded that, if enacted, the President's 2015 budget proposal would increase tax revenue by $1.759 trillion over ten years. *See* Andrew Lundeen and Kyle Pomerleau, *The Tax Changes in President Obama's Fiscal Year 2015 Budget*, TAX FOUNDATION-,March 5, 2014, http://taxfoundation.org/blog/tax-changes-president-obama-s-fiscal-year-2015-budget.

[61] Presently, there is no cap to the total amount that an individual can accrue in defined contribution retirement plans and accounts. There are however, limits on the annual contributions that can be made to different types of plans. *See* Carol v. Calhoun, *Maximum Benefits and Contributions Limits for 2009 to 2014* (Dec 2, 2013), http://benefitsattorney.com/charts/maximums.

[62] U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS (March 2014).

the same age.[63]

As discussed later in this article, such a contribution cap could cause small business owners to freeze their retirement plans or cease to offer new plans. This would negatively impact small business employees and national retirement savings a whole.

- While the President's budget would limit how much individuals can save in tax favored retirement plans, it would also require businesses that have been in existence for at least two years and have ten or more employees to offer their employees the option of enrolling in an automatic IRA funded by regular payroll deductions.[64] Employers that already sponsor a qualified retirement plan, a simplified employee pension plan (SEP) or a SIMPLE IRA would not be subject to this requirement.[65] While the stated purpose of this proposal is to help encourage individuals to properly save for retirement,[66] if not carefully implemented, the burden on small businesses of such a proposal could outweigh the benefit.
- The budget proposal makes permanent the increased expensing limits for small businesses that expired at the end of 2013 (commonly known as the Section 179 deduction).[67] Under the President's budget, the deduction limit would be set at $500,000, as opposed to $25,000 to which it reverted on January 1, 2014, and would be adjusted for inflation.[68]
- While the permanent increase of the Section 179 limits would benefit many small businesses, under the President's proposal, the earnings of many of the same small businesses would be subject to self-employment tax. As one means of paying for the budget proposal's

[63] U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS,at 182 (March 2014).

[64] U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS,at 182 (March 2014).

[65] U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS,at 182 (March 2014).

[66] U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS, at 182 (March 2014).

[67] U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS, at 182 (March 2014).

[68] U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS, at 21.

> expansion of the Earned Income Tax Credit, the proposal would subject owners of professional services businesses who "materially participate" in providing those services to Self Employed Contributions Act (SECA) taxes on their distributive shares.[69] As discussed in detail below, a similar, though distinct, proposal was also included in Camp's proposal.

As a whole, the President's 2015 budget proposal includes changes that would be helpful to small businesses but also incorporates provisions that could have a negative impact on them and their employees. While the President's budget proposal is clearly not expected to pass or receive serious debate in Congress, its provisions do merit careful consideration as tax reform proposals and negotiations rarely start from scratch and commonly draw upon previously raised proposals. Further, while the general approaches are often different, there are a number of provisions in the President's budget proposal that are similar to portions of Chairman Camp's Tax Reform Act of 2014.[70] Such areas of overlap may be targeted as points for consensus building in future tax reform efforts.

[3] Senate Finance Committee Tax Reform Discussion Drafts

Before the release of the Tax Reform Act of 2014 and the President's 2015 budget proposal, the Senate Finance Committee unveiled some of its own ideas for tax reform. Between November and December of 2013, then Senate Finance Chairman Max Baucus released four documents referred to as "tax reform staff discussion drafts" setting forth reform proposals in the areas of international taxes, tax administration, cost recovery and accounting and energy taxes. In an interesting—and likely unintended—political twist, the period during which these discussion drafts were released directly coincided with President Obama's announcement that he intended to nominate then Senator Baucus to be the next ambassador to China.

Unlike Chairman Camp's Tax Reform Act of 2014, the discussion drafts do not go so far as to set forth a comprehensive reform plan for the entire tax code.[71] For small

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[69] U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS, at 185.

[70] *See* Patrick Temple-West, *On U.S. tax reform, Obama and Republican Rival on Same Page*, REUTERS, March 4, 2014, http://us.mobile.reuters.com/article/politicsNews/idUSBREA231LI20140304.

[71] They do, however, include a number of discrete proposals covering a wide range of issues such as repealing and replacing the current deferral system for taxing foreign subsidiaries of U.S. companies, introducing tax credits to promote clean electricity and fuel, and making changes to the administrative process for filing taxes to streamline the process and reduce fraud and identity theft. U.S. SENATE COMMITTEE ON FINANCE, CHAIRMAN MAX BAUCUS, SUMMARY OF STAFF DISCUSSION DRAFT: ENERGY TAX REFORM (Dec 18, 2013); U.S. SENATE COMMITTEE ON FINANCE, CHAIRMAN MAX BAUCUS, SUMMARY OF STAFF DISCUSSION DRAFT: TAX ADMINISTRATION (Nov 20, 2013); U.S. SENATE

businesses, the most relevant proposals are contained in the Cost Recovery and Accounting Tax Reform Discussion Draft. This draft includes proposals to fundamentally change the system for depreciating tangible assets;[72] eliminate IRC Section 174 which governs deductions for research and development expenditures and instead require that such expenditures be capitalized and amortized over a five-year period; repeal LIFO accounting and like-kind exchanges; increase the Section 179 expensing limits (discussed above) to $1 million and expand the scope of what expenses can qualify; and allow all companies with gross receipts under $10 million to use the cash accounting method (increasing the threshold from $5 million), but removing the exceptions for farmers and personal service organizations.[73]

While the discussion drafts include some important proposals and considerations, it is not yet clear whether the Senate Finance Committee, now under the leadership of Chairman Ron Wyden, will continue to promote the discussion drafts or revert to a clean slate.[74]

§ 10.04 SMALL BUSINESSES' CONSIDERATIONS IN THE AREA OF TAX REFORM

With the numerous tax reform proposals out there, and more sure to come, small businesses are often in a unique and risky position. The "business community" is often mischaracterized as a single interest group. However, the interests, needs, and motivations of small businesses are often distinct and at times incongruous with those of their larger counterparts.

Small business has often been referred to as the "heart" or "backbone" of the

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COMMITTEE ON FINANCE, CHAIRMAN MAX BAUCUS, SUMMARY OF STAFF DISCUSSION DRAFT: INTERNATIONAL BUSINESS TAX REFORM (Nov 19, 2013).

[72] The discussion draft would eliminate the Modified Accelerated Cost Recovery System (MACRS) and Alternative Depreciation System (ADS) that currently govern depreciation of tangible assets and replace it with a "simplified cost recovery system" that includes a single set of depreciation rules for all businesses and does not require businesses to separately calculate depreciation for each asset. U.S. SENATE COMMITTEE ON FINANCE, CHAIRMAN MAX BAUCUS, SUMMARY OF STAFF DISCUSSION DRAFT: COST RECOVERY AND ACCOUNTING (Nov 21, 2013).

[73] The discussion draft would eliminate the Modified Accelerated Cost Recovery System (MACRS) and Alternative Depreciation System (ADS) that currently govern depreciation of tangible assets and replace it with a "simplified cost recovery system" that includes a single set of depreciation rules for all businesses and does not require businesses to separately calculate depreciation for each asset. U.S. SENATE COMMITTEE ON FINANCE, CHAIRMAN MAX BAUCUS, SUMMARY OF STAFF DISCUSSION DRAFT: COST RECOVERY AND ACCOUNTING (Nov 21, 2013).

[74] Chairman Wyden has been vocal about his support for comprehensive tax reform and has announced that during the summer of 2014 his Committee will begin holding hearings on comprehensive tax reform. Machenzie Weinger, *Morning Tax*, POLITICO (June 6, 2014), http://www.politico.com/morningtax/0614/morningtax14193.html.

American economy for good reason.[75] According to recent data from the Small Business Administration (SBA), between 2002 and 2010, small businesses[76] accounted for 48.5% of all private sector employment and 63% of new private sector jobs.[77] As is clear from these numbers, the American small business system as a whole has been largely successful. However, on an individual basis, most small businesses fight for survival in their early years. In 2014, the SBA estimated that only about half of new businesses survive their first five years, and only about a third of new businesses survive 10 years or more.[78] Thus, when it comes to tax reform, the interests, concerns, and motivations of small businesses are frequently tied to the businesses' struggles for survival and the individual interests of the small business owners themselves.

The tight budgets of most small businesses carry several implications when it comes to tax reform. Many small businesses do not have the capacity to seek accounting and legal services beyond the fundamental areas necessary to start and operate the business. With small business owners often left to negotiate and react to complicated and nuanced tax matters alone, the perceived impact of a change to the tax system can be equally as important as the actual effects of the change. This reality ties into the fact that (actual or perceived) tax savings and benefits to the small business owner considerably influence his or her decisions about how to grow and manage the business. For example, decisions to offer employee benefits such health insurance[79] or

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[75] *See, e.g.*, Proclamation No 8673, 76 Fed Reg 28623 (May 12, 2011) (President Barack Obama has proclaimed that "small businesses are the backbone of our economy and the cornerstones of America's promise").

[76] The SBA Office of Advocacy defines "small business" as "independent business having fewer than 500 employees" U.S. SMALL BUSINESS ADMINISTRATION, OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS (2014).

[77] The SBA Office of Advocacy defines "small business" as "independent business having fewer than 500 employees" U.S. SMALL BUSINESS ADMINISTRATION, OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS (2014).

[78] The SBA Office of Advocacy defines "small business" as "independent business having fewer than 500 employees" U.S. SMALL BUSINESS ADMINISTRATION, OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS (2014).

[79] In a 2011 survey of small business owners, the Small Business Majority reported that 33% of employers who did not currently offer health insurance said that the Small Business Health Care Tax Credit, introduced as part of the Affordable Care Act, would make them more likely to offer health insurance in the future. In the same survey, 31% of small businesses that did offer health insurance indicated that the Small Business Health Care Tax Credit would make them more likely to continue to offer insurance. *Small Business Owners' Views on Key Provisions of the Patient Protection and Affordable Care Act*, SMALL BUSINESS MAJORITY (January 2011), http://www.smallbusinessmajority.org/small-business-research/healthcare/small-business-healthcare-survey.php.

retirement plans[80] are largely tied to the tax deductions related to offering such plans and the fact that small business owners can only obtain the benefit of these plans for themselves by also offering them to their employees.

While small businesses and their employees are in a unique position when it comes to many tax issues, small businesses do not have the same capacity as large corporations and organizations to lobby for and promote their interests.[81] Because of the quieter, yet integral role that small business plays in the U.S. economy, it is important that tax reform proposals be assessed not only on the basis of how they would affect corporations as a whole, but specifically for the impact they would have on small business, including those that operate as pass-through entities.

§ 10.05 POTENTIAL IMPACT OF THE CAMP TAX REFORM PROPOSAL ON PASS THROUGH ENTITIES

[1] Overview

Some of the major reforms contained in the Camp Proposal deal with the tax rules that apply to Sub-S corporations (sometimes "S corporations"). Even though the Camp Proposal contains some constructive technical improvements to the S corporation tax rules, it also contains a number of far-reaching changes that could prove to have a much greater, and negative, impact on S corporations and other pass-through entities (including partnerships and limited liability companies treated as partnerships).

The Camp Proposal appears to benefit regular C corporations, including large multinationals, at the expense of small and midsize pass-through companies, whose owners will pay for the C corporations' tax reduction. Under the proposal, large C corporations would see their overall statutory rates reduced significantly, whereas owners of pass-through entities, who pay tax at the individual level, would experience only a modest decrease in their already higher marginal rates. At the same time, both C corporations and pass-through entities would pay equally for the base-broadening

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[80] "For a small business owner, the ability to use tax savings on his or her contributions to generate all or part of the cash flow needed to pay required contributions for other employees is an important factor in the decision to establish and maintain a retirement plan." Small Business Owners and Retirement Savings Tax Incentives, AMERICAN SOCIETY OF PENSION PROFESSIONALS AND ACTUARIES (2012), http://www.asppa.org/Portals/2/current%20incentives%20and%20small%20Business%20TPs%20with%20worksheets%20July%202012%20.pdf.

[81] For example, in 2014, the Business Roundtable, which describes itself as "an association of chief executive officers of leading U.S. companies working to promote sound public policy and a thriving U.S. economy" spent over $12.3 million on lobbying activities. *About*, BUSINESS ROUNDTABLE http://businessroundtable.org/about (last visited June 19, 2014); *Business Roundtable, Client Profile Summary 2013*, CENTER FOR RESPONSIVE POLITICS (April 28, 2014), https://www.opensecrets.org/lobby/clientsum.php?id=D000032202&year=2013.

measures, such as the elimination of bonus depreciation that the Camp Proposal uses to fund the rate cuts.[82]

Historically, start-up businesses, the vast majority of which are organized as pass-through entities, have accounted for a disproportionate share of new jobs in this country. If Congress desires to do something positive for the future of American business, it is critical that it address the needs of all businesses, ranging from large publicly-held C corporations to closely-held S corporations, partnerships and sole proprietorships. Partnerships, S corporations and LLCs are not subject to tax, but their owners are, and their rates are now higher than the corporate tax rate—35% versus 39.6%. Tax rates on business income are important. Therefore, if Congress wants to encourage more investment and jobs in the U.S., then it has to focus as much on the individual rates that are applicable to pass-through entity owners, as it does on the rate for C corporations.

[2] Expansion of Self-Employment Tax to S Corporations

Many family and other entrepreneurs own and operate capital intensive businesses through S corporations. Under current law, and assuming those owners pay themselves reasonable compensation for the services they provide (and there are no published cases suggesting that unreasonably low wages are ever a concern for these capital intensive businesses), entrepreneurial profits earned by those owners, whether retained by the S corporation or paid as dividend distributions, are subject to income tax but not the Federal Insurance Contribution Act ("FICA") or Self-Employment Tax ("SE Tax"). This is consistent with the policy behind the FICA/SE Tax structure, which is a payroll-based system whereby employees and employers are required to set aside income during the employees' working years to meet the employees' retirement income and health care needs. In this respect, the S corporation tax structure also meshes well with the C corporation tax structure, which does not impose any FICA or SE Tax on profits earned at the corporate level, whether retained or paid to shareholders as dividends.

The Camp Proposal would dramatically change this system. Under the Proposal, all pass-through businesses, including S corporations, would be forced into a rigid system, whereby 70% of their income would be subject to the SE Tax.[83] This would result in

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[82] *See* H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY (2014).

[83] See H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, § 1502 at 32 (2014). The Executive Summary for the Camp Proposal indicates that this change is designed to close the John Edwards/Newt Gingrich tax "loophole" whereby a sole shareholder of an S. corporation tries to treat what is essentially wage/compensation income as business income not subject to the SE Tax. *See supra* note 13, at 23. However, the Proposal's impact is much broader than that, and would apply to all S corporations, even those operating capital intensive businesses

a significant reduction in FICA/SE Tax for many existing partnerships, which have voluntarily chosen the current partnership tax treatment. However, this revenue loss would be more than offset by a substantial increase in the SE Tax liability of S corporation owners using the simpler, but less flexible, S corporation structure. The Joint Committee of Taxation has estimated that this provision would increase revenues by $5.1 billion over the time period of 2014 through 2023.[84] Again, this reflects the overall concept of the Camp Proposal, discussed above, to increase revenue in order to reduce tax rates. The bottom line is that the owners of closely-held pass-through businesses would no longer have any vehicle available to them in order to avoid paying FICA/SE payroll-type taxes on their entrepreneurial profits,[85] even when they are paid reasonable wages that are subject to the FICA tax.

[3] Unequal Treatment of C Corporations and Pass-Through Businesses

Unlike S corporations, regular C corporations are not pass-through entities but separately report their taxable income and pay income tax on that taxable income. Under current law, the top marginal rate for C corporations is 35%, whereas the top marginal rate for income earned through S corporations, partnerships and sole proprietorships is 39.6% (passive investors are also subject to an additional 3.8% "Medicare tax" on net investment income exceeding a specified annual threshold). Prior to calendar year 2013, the top marginal rate for both individuals and corporations was 35%. That placed pass-through businesses, which constitute the large majority of business enterprises and employ over half of the employees in the United States,[86] on the same footing as publicly-held and private C corporations.

Unfortunately, the current percentage point gap between the C corporation and pass-through top marginal rates would be substantially expanded under the Camp Proposal. In particular, virtually all C corporation taxable income would be taxed at a

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where the Edwards/Gingrich "loophole" has no application.

[84] *See* H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 32 (2014).

[85] Some have suggested that such entrepreneurs should simply elect C corporation status in order to avoid this result. However, policymakers have recognized that the double-tax C corporation system produces arbitrary results and is subject to manipulation. As a consequence, the Tax Code has encouraged and fostered a dramatic movement toward the single-tax S corporation/partnership structure ever since the Tax Reform Act of 1986. *See* Thomas J. Nichols, *Testimony Before the Committee on Ways & Means United States House of Representatives*, at 4–5 (March 7, 2012), http://waysandmeans.house.gov/uploadedfiles/nicholstest03.07.2012.pdf.

[86] Drs. Robert Carroll and Gerald Prante, *The Flow-Through Business Sector and Tax Reform* at 5, Appx. B, ERNST AND YOUNG (April 2011), http://www.s-corp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf.

flat 25% corporate rate.[87] However, as explained in more detail below, pass-through businesses would be subject to a 25% or 35% top marginal rate, depending upon the nature of the business.

A consideration of overall effective tax rates further bolsters the proposition that a reduction in tax rates for C corporations alone is not warranted. The effective tax rate (i.e., the rate on all income, rather than just the top marginal rate applicable on net additional income earned) is 31.6% for S corporations, whereas the effective rate for C corporations is between 17.8% and 27.1%, depending upon various factors, such as foreign earnings.[88] While the authors are in favor of eliminating genuine loopholes and reducing marginal rates for all taxpayers (including C corporations), with the proviso that closely held businesses and the owners of pass-through entities would be in at least as good a position as they would have been before tax reform (i.e., prior to the loss of credits and deductions combined with a somewhat lower tax rate), substantially increasing the current disparity between the top marginal and overall effective tax rates for C corporations versus S corporations and other pass-through entities could wreak havoc. The S corporations and other pass-through entities that retain and reinvest earnings would be placed *by the tax code* at a substantial disadvantage vis-à-vis their C corporation counterparts, many of which are publicly held.

[4] Simplification—We Think Not—New Complicated Rate Structure for Pass-Through Businesses

The Camp Proposal would make several changes that would constitute significant steps forward toward the goal of tax simplification. This would include the repeal of the corporate alternative minimum tax,[89] the individual minimum tax,[90] and the deduction for domestic production activities.[91]

However, the Camp proposal would also introduce a new bifurcated tax system for upper income individuals under which most categories of income would be subject to

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[87] *See* H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY (2014).

[88] *Entity Choice and Effective Tax Rate,* QUANTRIA STRATEGIES, LLC (2013), http://waysandmeans.house.gov/uploadedfiles/quantria_study_etr_8613_final_pm_embargoed.pdf. This study took into account the double-tax on C corporation dividends. However, the investigators were unable to adjust for the basis adjustment attributable to income/loss passed through from S corporations and other pass-through businesses due to lack of available data. *Id.* at n9.

[89] *See* H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 47 (2014).

[90] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 47 (2014).

[91] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 62 (2014).

a 35% marginal tax rate (without the benefit of many deductions currently available), but under which "qualified domestic manufacturing income" would be subject to only the 25% regular income tax without the additional 10% "surtax."[92] While the phase-out and repeal of the deduction for income attributable to "domestic production activities" would simplify the tax code by eliminating the need to distinguish between "domestic production" and other activities, this new two-level tax structure for pass-through entities would require their owners to distinguish between "qualified domestic manufacturing income" and all other income. Any such attempt to "pick winners and losers" unavoidably involves some arbitrary and random line drawing. It also triggers the diversion of resources from productive activities into corporate structuring and other tax planning designed merely to procure the benefit of the favored tax status.

In addition to the complications caused by this bifurcated tax system, the Camp Proposal introduces even more complexity when the new SE Tax provisions described above are taken into account. This arises because domestic manufacturing gross receipts eligible for the favored 25% top rate "shall not include any amount which is properly allocable to the taxpayer's net earnings from self-employment (determined after any reduction provided under Section 1402(m))."[93] Proposed new subsection 1402(m) provides that individuals who materially participate in a pass-through business will be able to deduct 30% of the net earnings from that business in determining their SE Tax, but that a passive investor will be entitled to exclude 100% of such income for purposes of the SE Tax.[94] The 100% exclusion for passive investors makes sense, because such taxpayers are subject to the new 3.8% "Medicare Tax" under Section 1411 of the Tax Code on net investment income above the annual income threshold.[95]

This interaction between the SE Tax provisions and the regular tax provisions cited above creates the anomalous result whereby the top marginal tax rate for individuals materially participating in a manufacturing business is substantially higher than that for passive investors in the same manufacturing business. Under the rules explained

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[92] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 1 (2014) (amending IRC §§ 1(a)(3), 2(b)(1)(B)(ii), (c)(1), (4)).

[93] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 1 (2014) (amending IRC § 2(c)(5)).

[94] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 32 (2014) (amending IRC § 1402(a)(1), creating IRC § 1402(m)).

[95] The net effective rate for the new "Medicare Tax" is actually slightly higher because, in contrast to the SE Tax, no portion of it is deductible for income tax purposes. In order to avoid unnecessarily confusing the analysis, this chapter does not illustrate the slightly varying rates resulting from this integrated deductibility system.

above, none of the manufacturing income of the passive investor is subject to the SE Tax, which means that all of that income is subject to the tax-favored 25% rate plus the 3.8% "Medicare Tax," for a top combined marginal rate of 28.8%. However, only 30% of the active owner's income will be eligible for the tax-favored 25% rate (and exempt from the 3.8% top SE Tax), while the remaining 70% will not only be subject to the 35% rate, but also the 3.8% Medicare Tax. This results in a rate of 34.66% [(30% x 25%) + (70% x [35% + 3.8%]) = 34.66%]. This policy does not seem to be consistent with the concept of promoting the development, and even the repatriation, of manufacturing business within the United States.

[5] Closing "False Loopholes"

As discussed above, a fundamental principle of tax reform is to eliminate unwarranted tax benefits for taxpayers and use the additional revenue generated thereby to lower rates for all taxpayers. However, it is absolutely critical to distinguish between "loopholes" that constitute genuinely unwarranted tax benefits and those provisions that are solidly based in fundamental tax policy.

There are many examples of loophole elimination in the Camp Proposal, such as the repeal of percentage depletion, whereby taxpayers may deduct an amount in excess of the amount actually paid for mineral properties.[96] However, there are a number of other provisions in the Camp Proposal that are aimed at closing tax "loopholes" that are not unwarranted tax treatment and thus are not loopholes that should be reformed ("false loopholes").

One obvious example of a false loophole is proposed new Section 409B.[97] This new provision would require all employees to include deferred compensation in their taxable income as soon as there is no substantial risk of forfeiture, notwithstanding the fact that the deferred compensation has not yet been paid and may not be paid for many years or may never be paid if the business becomes insolvent. Forcing employees to pay tax on money that they have not received does not appear to serve any policy purpose. Instead, it is punitive and unfair. The non-abusive nature of the current tax treatment of deferred compensation is made more obvious by the fact that current law already clearly provides that the employer in these circumstances is not entitled to deduct any such deferred compensation unless and until the employee is paid and includes the compensation in income.[98] Thus, the net effect of the Camp

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[96] *See* H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 66 (2014).

[97] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 135 (2014).

[98] *See* IRC § 404(a)(5). In this respect, new Section 409B would suffer from the same infirmities as Section 409A, a similar "loophole" closing provision enacted in 2004. American Bar Association Tax

proposal would further (1) complicate the tax code and compliance and (2) punish many unsuspecting taxpayers who are engaging in perfectly legitimate business activities that are not abusive. Another prime example of a false loophole is the tax deduction given to contributions made to retirement plans and the tax free growth on these contributions until they are removed from the retirement plan or IRA.[99] This critically important tax preference for small businesses and their employees will be discussed in greater detail below.

We understand that even true tax loopholes have their defenders, and we are not suggesting that true tax loopholes should not be eliminated. Tax "loopholes" that benefit a select few without any meaningful policy justification for the disparate treatment should be eliminated and the revenue generated should be used to reduce tax rates for all taxpayers.

[6] S Corporation Improvements

As noted above, the Camp Proposal does contain a number of changes to the S corporation rules that are clear improvements from the standpoint of both tax policy and administration. These include the following:

1. Making permanent the reduction in the built-in gains tax recognition period (a time period after a C corporation becomes an S corporation) from 10 years to five years.[100] This serves to free up capital for S corporations, which is important because S corporations, unlike publicly-held C corporations, do not have the ability to raise capital in the public markets. Moreover, the five-year period is clearly sufficient for whatever policy justifications there are, if any, for discouraging S corporations from selling assets that appreciated during any period prior to the election of S status.

2. Increasing the passive investment income tax floor from 25% to 60% and repealing the provision triggering termination of S corporation status as a result of excess passive investment income.[101] This change would conform the S corporation passive income tax rules with the personal holding company rules for C corporations. Both sets of rules

Section, *Letter re IRC Section 409A* (July 31, 2006); SMALL BUSINESS COUNCIL OF AMERICA, Section 409A Whitepaper (2014).

[99] *See* H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 40 (2014).

[100] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 113 (amending IRC § 1374(d)(7)).

[101] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 113 (amending IRC §§ 1375(a), 1362(d)).

are intended to reduce the incentive for "incorporated pocketbooks," and it makes sense for comparable rules to apply to both types of corporations.

3. Expansion of qualified beneficiaries for electing small business trusts to include nonresident aliens.[102] This provision would also allow S corporations to access an additional source of capital by enabling nonresident aliens (in addition to U.S. citizens and resident aliens) to invest in S corporations. Given the fact that any income allocable to such newly eligible owners would automatically be taxed at the highest applicable individual income tax rate, this change should cause little, if any, revenue loss to the government. In fact, for this reason, it makes sense for any individual or entity to be able to qualify as a shareholder in this fashion, i.e., subject to the top individual rate. This would facilitate S corporation access to new sources of capital with little or no cost to the government in terms of lost revenue.

4. Allowing corporations to make their S corporation election on their initial tax returns.[103] Under current law, S corporations must make their S election within the first 2-1/2 months of their initial taxable year. However, many corporations, especially start-up entities, may not consult their tax accountant until it is time for them to prepare and submit tax returns for the year. This reform provision would enable corporations to make that initial S election as part of the tax return preparation process, rather than having to wait at least one additional year and potentially having to deal with cumbersome calculations, including the built-in gains tax, as a consequence.

Each of these changes is consistent with good tax policy. However, although each of them could have a substantial impact on the specific S corporations to which they apply, these changes would have no impact on the vast majority of S corporations, whereas the rate and other changes described in the earlier sections of this chapter would have a substantial and negative impact on the entire pass-through community.

§ 10.06 TAX REFORM AND THE SMALL BUSINESS RETIREMENT PLAN SYSTEM

[1] The Importance of Promoting Small Business Retirement Plan Savings

For small businesses and their employees one of the more significant areas that

[102] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 113 (amending IRC § 1361(b)(1)).

[103] H COMM ON WAYS AND MEANS, 113TH CONG, TAX REFORM ACT OF 2014; SECTION-BY-SECTION SUMMARY, at 115.

comprehensive tax reform could impact, for better or worse, is the small business retirement system.

Longer life expectancies are requiring increased retirement savings.[104] It has been well documented that individuals of all economic levels are far more likely to properly save for their retirement if they participate in some form of retirement plan. Further, according to research by the American Society of Pension Professionals and Actuaries (ASPPA), workers earning between $30,000 to $50,000 are 14 times more likely to save in a retirement plan offered by their employer than to save through an IRA.[105] By using payroll deductions, these plans encourage savings because they automatically remove the money before it ever goes into the employee's pocket.

Small businesses face particular challenges when it comes to sponsoring retirement plans. As discussed above, in their first years, many small businesses are simply struggling to stay afloat. No matter how much a small business owner cares about his/her/their employees, offering a retirement plan is often a secondary concern to the survival of the business and the decision of whether to offer a plan comes down to a cost benefit analysis. Once small businesses survive the initial period of uncertainty and become more established they are far more likely to sponsor a retirement plan, but again only if it makes economic sense for the owners to put the money into a retirement plan, rather than putting the money back into the business or taking it out as compensation.

Despite the challenges, many small businesses still offer plans and make meaningful contributions for their employees. Unfortunately, there is a problematic misconception that plan sponsorship among small businesses is very low. In fact and in contrast to the statements of members of Congress and other experts who should be aware of the data, the small business qualified retirement plan system has been very successful in providing retirement security for its workers.

In a study[106] which used actual data from employees' W-2 forms, researchers found that 77% of all employees who work in companies with 10 or more employees are offered a retirement plan and that of these employees, 62% made 401(k) contributions. It is interesting to note that the reason why this study shows higher retirement plan

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[104] On January 6, 2014, the National Center for Health Statistics reported between 2008 and 2009 alone, the life expectancy for all sectors of the U.S. population increased notably. U.S. CENTERS FOR DISEASE CONTROL AND PREVENTION, NATIONAL CENTER FOR HEALTH STATISTICS, NATIONAL VITAL STATISTICS REPORT VOL 62, NO 7 (2014).

[105] *See 401k is Main Street's Savings Plan*, THE AMERICAN SOCIETY OF PENSION PROFESSIONALS AND ACTUARIES (2012), http://www.asppa.org/Portals/2/401_k_%20is%20Main%20Street%20November%202012.pdf.

[106] Dushi, Iams and Lichtenstein, Social Security Bulletin, Vol 71 No 2 2011, Assessment of Retirement Plan Coverage by Firm Size, Using W-2 Tax Records.

coverage than is reflected in other studies is because this study relied upon *actual W-2 data* to determine if an employee was covered by a plan. Most other studies have relied upon surveying employees to find out if they were covered by a retirement plan. There is a discrepancy between employees who report they are not covered by a plan compared to the actual data. Surprisingly to anybody who is not involved in the retirement plan field, employees do not always know or understand that they are making employee contributions to a plan, or that their employer is making a contribution for them.

This study broke down retirement plan coverage by the size of the company and determined that the size of a small business makes a significant difference as to whether a company offers a retirement plan for its employees. W-2 data reflects that 46% of small businesses with more than 10 employees but less than 25 offer a retirement plan. The same data reflects that 60% of small businesses which employ 25 employees but less than 50 offer a retirement plan. 70% of small businesses which employ 50 employees but less than 100 offer a retirement plan. 84% of businesses with more than 100 employees offer a retirement plan. There is no further breakdown given for over 100 employees so we do not know the coverage data for small businesses who have more than 100 employees but less than 500. It appears that once the small business has 100 employees or more, the retirement plan coverage for those employees is in line with the coverage provided by larger businesses.

In light of the cost to a small business of offering a plan and the large number of employees who are actually covered by the qualified small business retirement plan system, any changes that would make plan sponsorship more costly or burdensome, or otherwise motivate employers to freeze or eliminate the plans could have significant and detrimental long term repercussions. Such a move away from plan sponsorship by small business would be concerning not only for small business employees but for national financial stability as a whole. This is particularly true in light of the demographics of the employees who participate in retirement plans. Nearly 80% of all plan participants make under $100,000 per year and 43% of all participants make less than $50,000 annually.[107]

[2] High Cost for Small Businesses of Sponsoring a Plan

While small business plan sponsorship is a very important part of the retirement system and plays an integral role in ensuring that Americans have sufficient retirement savings, there are a number of costs and barriers that can deter small business owners from sponsoring a plan. Plan sponsorship comes with heavy administrative require-

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[107] *See 401k is Main Street's Savings Plan*, THE AMERICAN SOCIETY OF PENSION PROFESSIONALS AND ACTUARIES (2012), http://www.asppa.org/Portals/2/401_k_%20is%20Main%20Street%20November%202012.pdf.

ments including notice requirements, top-heavy rules, and discrimination testing. Further, because of the plan size and the bargaining capacity of the employer, the administrative costs of sponsoring a plan in relation to the businesses' income is generally higher for smaller businesses than for large businesses.[108]

While, as discussed further below, the preservation of tax provisions that motivate small business plan sponsorship is extremely important, tax reform also provides an opportunity to amend or eliminate those provisions that unnecessarily inhibit small business plan formation.

A prime example of an area where tax reform could have a meaningful impact to facilitate small business plan sponsorship is the top-heavy rules. When first enacted, the top-heavy rules imposed additional minimum contributions and accelerated vesting on small and mid-size retirement plans that were almost always top-heavy due to the mathematical tests used to determine such status. Over the years, the rules have changed so significantly that the top-heavy rules in the defined contribution context[109] (e.g., profit sharing and 401(k) plans) are now an archaic appendage similar to that of the appendix in the human body—they do nothing but cause problems.

While the ultimate solution would be to repeal the top-heavy rules altogether (see the discussion below above on the SAFE Retirement Act of 2013[110] sponsored by Senator Orrin Hatch, Ranking Member of the Senate Finance Committee), there are

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[108] A 2012 study by the Government Accountability Office found that "the average amount sponsors of small plans reported paying for recordkeeping and administrative services was 1.33 percent of assets annually, compared with 0.15 percent paid by sponsors of large plans." UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, 401(K) PLANS INCREASED EDUCATIONAL OUTREACH AND BROADER OVERSIGHT MAY HELP REDUCE PLAN FEES, GAO-12-325 (April 2012).

[109] The vast majority of small business retirement plans are defined contribution plans. This is largely due to the arcane rules governing defined benefit plans which among other things do not allow contributions to be made in an amount which is consistent from year to year and so do not allow companies to be able to budget for the contributions over a period of time, say five years. This lack of ability to be able to plan for what is often a significant expense cannot be handled by many small businesses. Also, the laws dealing with reversions changed many years ago in a way that further chilled new defined benefit plan formation. In the past, businesses that sponsored a defined benefit guaranteed the interest rate on the contributions inside the plan and guaranteed the retirement benefit; however, businesses were allowed to keep any excess funds that might have been generated by good investments upon termination of the plan. Today, the small business must still guarantee investment results and more importantly, the retirement benefit, but now they must pay a significant tax on any excess assets remaining upon termination of the plan, particularly if the company is closing down at the same time so that the excess funds cannot be sent to a defined contribution plan sponsored by the same company. In other words today, with respect to investment and benefit guarantees and possible excess funds within the defined benefit plan and the tax code—the equation is: tails I win, heads you lose.

[110] *See* Sec 212. Termination of application of top-heavy plan rules, Title II, Private Pension Reform of S-1270, SAFE Retirement Act of 2013.

other intermediary options that would also bring notable improvement. One such option would be to eliminate top-heavy contributions for plan participants with less than one year of service so that employees are allowed to make 401(k) contributions during their first year. Because of the top-heavy rules, small and mid-size plans that are top-heavy cannot allow recent employees into the 401(k) portion of their profit sharing plan without these employees receiving an employer contribution even though they have not met the requirements for the regular "profit sharing contribution." Such a result is directly counter to the interest of encouraging all employees to begin saving for their retirement as soon as possible. A simple change to the regulations would eliminate the typical one year wait period to enter the retirement plan and allow employees to start participating in the 401(k) portion of the plan sooner.

Another option for revising the top-heavy rules to facilitate retirement savings would be to allow small and mid-sized companies to sponsor employee-pay-all 401(k) plans without the 401(k) contributions made by key employees triggering the top-heavy rules. Under current IRS regulations, when a key employee makes a 401(k) contribution, that employee contribution is deemed to have been made by the company and the company is then required to make top-heavy contributions for the non-key employees. Because of this rule, small to mid-size employers who would like to offer 401(k) plans must either commit to make company contributions to non-key employees or to exclude key employees from participation in the 401(k) plan. Many companies cannot afford to make company contributions and most owners will be unmotivated to offer plans in which they, and other key employees, cannot participate. On the other hand, larger companies (which because of the mathematical tests are never top-heavy) can sponsor employee-pay-all 401(k) plans. Thus, small and mid-sized employees who might have made 401(k) contributions are not given the opportunity to do so because their employer is unable or unwilling to operate a plan under the current top-heavy regulations.

To illustrate how necessary tax simplification is for the tax code and the retirement plan provisions, in particular, note the definition of a key employee[111] under the tax code and the regulations thereunder. A key employee is defined as any employee or former employee (including deceased employees!) who at any time during the plan year is (i) an officer of the employer having compensation greater than $130,000 (as adjusted under § 416(i)(1) of the tax code—this year the compensation amount is $170,000), (ii) a 5% owner of the employer or (iii) a 1% owner of the employer having compensation in excess of $150,000. In fact, the IRS' Internal Revenue Manual[112] which sets forth the steps agents need to take to determine whether a plan is top-heavy encompasses page after page of explanations, including among other items, how the

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[111] IRC § 416(i).

[112] *See* www.IRS.gov/irm/part4/irm_04-072-005.html.

aggregation rules under IRC 414(b), (c), and (m) apply, what the determination date is, what a key employee is, including how to determine who is an officer and how to determine a 5% owner and a 1% owner, etc. Thus, not only must an IRS agent spend hours going through this absurd complexity, but worse the small business owners must make sure they are dealing with advisors who are navigating these crazed waters as well. What a colossal waste of time and effort to ensure whether a company is falling within a totally unnecessary tax code section that one could argue actually works today to keep employees from saving for their retirement for an entire year. Nor should one take comfort that the authors have selected a particularly complex definition in which to illustrate their point. Determining who is a key employee is no more complex than most of the retirement plan provisions in the tax code and we think one could argue that it is simpler than many!

Much of tax reform has become focused on making changes to raise money to pay for other changes. However, discrete revenue neutral reforms are often the low hanging fruit that can engender compromise and result in positive change.

[3] Relationship Between Small Business Retirement System and Tax Incentives

For small business owners the decision of whether to offer a retirement plan is at its heart a business calculation. Each year, the owners can choose to reduce the profits by paying themselves additional taxable compensation and/or they can retain the profits inside the company and "grow" the business and/or they can contribute all or a portion of the profits to a retirement plan sponsored by the business. It is typical for the owners to weigh the tax consequences of these various options when deciding what to do with any excess revenues. Some of the factors taken into account by small business owners when deciding to sponsor a retirement plan include the employees' preference for cash or health care coverage (i.e., lack of appreciation by the employees for contributions made by the employer into the retirement plan for their benefit), the uncertainty of the business' revenue from year to year, the costs of setting up the plan and the ongoing costs of administering it and the amount of the required company contributions for non-key or non-highly compensated employees required under the tax code (interestingly not because of the top-heavy rules, but because of the laws passed after the top-heavy rules).

Because of this calculus, the viability of the small business retirement system is almost uniquely dependent upon the availability of sufficient tax incentives to the owners in order to offset the administrative costs of sponsoring a plan, the mandatory contributions for the non-owner employees required under the anti-discrimination rules set forth in the IRC and the fiduciary responsibility that comes with sponsoring a retirement plan. Thus, unless the owners come out ahead by making contributions to the retirement plan (taking into account the initial deduction for contributions made to the plan, the tax free growth, the eventual distributions being subject to regular income

tax rates, the costs of running the plan and the costs of making the contributions necessary for staff employees) as compared to distributing the profit to the owners as taxable income and investing the net after tax compensation as they choose (with eventual favorable capital gains and/or dividend rates), small business owners are likely to forgo the retirement plan option.

Perhaps the most significant threat to the small business retirement system are proposals, like that included in the President's 2015 budget and the Camp proposal, that would limit the total amount that individual can save in a tax favored accounts or reduce the annual contribution limits to such account. Reducing how much a small business owner can save for him or herself will also reduce his or her motivation to sponsor a plan. This would be a serious blow to the small business retirement system. On the other hand, capping contributions or reducing contribution limits would have a little to no positive effect in the scheme of tax reform.

§ 10.07 CONCLUSION

While, given the political climate, there is little expectation that any comprehensive tax reform legislation will be passed this year, there is a strong momentum from all sides to reform the cumbersome tax code. In the context of tax reform, small businesses find themselves in a unique and challenging position. Although small businesses would benefit from greater simplicity in the tax code and many other proposed reforms, small businesses and their employees also have a lot at stake when it comes to tax reform and do not have the same capacity as their larger counterparts to advocate for their own interests. Given the critical role that small businesses play in the American economy it is critical to ensure that any reform, whether comprehensive or piecemeal, does not unduly burden small business or trigger results that would be harmful to small business employees. As outlined in this article, protecting small businesses and making it easier for them to provide jobs and benefits their workers should be a key principle of any tax reform plan in order to ensure the stability and functionality of the small business qualified retirement system and the American job market as a whole.