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The Art of Running a Small Business

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### House Republicans Try to Simplify Small-Business Taxes

By [ROBB MANDELBAUM](#)

This month, Republicans in Congress unveiled proposals to radically remake the way many small businesses are taxed. As with many radical Republican proposals, this one from the House Ways and Means Committee chairman, David Camp, furthers a partisan agenda — if implemented, it would almost certainly reduce revenue to the federal government. But it also wins praise from independent tax experts for repairing what they call a body of law almost too complicated to comply with or to enforce.

The proposals would streamline the tax rules for flow-through entities — companies that do not file their own tax returns but instead are structured to pass their profits or losses directly to their investors, which is how many small businesses are organized. “The tax code ought to be easier to understand and less expensive for small businesses to comply with,” Mr. Camp said in a [press release](#) accompanying the draft legislation ([pdf](#)), “because every dollar they aren’t spending on taxes is a dollar they have to invest in equipment, start a new production line, hire a new employee or provide more in wages and benefits.” But it is unclear how much most small businesses will benefit from the changes Mr. Camp has proposed.

At the heart of Mr. Camp’s ideas, embodied in an early stage of legislation known as a discussion draft, are two alternatives to revamp the rules for the two main kinds of flow-through structures, partnerships and S corporations. S corporations, named for a section of the Internal Revenue Code, operate like regular corporations and are governed by fairly rigid rules, while partnerships are granted more flexibility.

The first alternative mostly tinkers with the rules to make it easier to operate as a flow-through company. The second option would repeal the laws regulating both kinds of entities and replace them with a single set of rules, regardless of whether the company is organized as a corporation or partnership. The new rules would be based mostly on current partnership law, with a couple of S corporation provisions thrown in (they also include most of the changes proposed in the first option). Any partnership or privately held company that is now eligible to elect S corporation status would be able to file taxes under the new arrangement.

Tax lawyers and analysts cheered the prospect of simplifying this area of business taxes. “Many professors and academics who study partnership law felt like the whole

partnership system was falling apart, because it had become so complicated and not administrable,” said Martin Sullivan, the chief economist for Tax Analysts, the tax news and analysis publisher. “The I.R.S. was having trouble enforcing the law. Even the most sophisticated taxpayers could not comply with the law. Everybody had to adopt an informal, ad hoc process.”

Businesses, though, may be less enthusiastic about a one-size-fits-all regimen. Many more small companies are organized as S corporations than partnerships, and S corporations, especially those engaged in more complex businesses, may find that filing their taxes is more complicated under the new regime, though tax experts disagree on how much more complicated. On the other hand, Mr. Sullivan said, these businesses may appreciate the additional flexibility — for example, they would no longer be limited to just 100 shareholders or face restrictions on the type of shareholders.

Partnerships, meanwhile, would find some of their options limited, particularly when it comes to strategies for avoiding taxes. Steven Schneider, a Washington tax attorney and an adjunct professor at Georgetown University Law Center, said that S corporations and partnerships are often organized in different circumstances. S corporations often build their assets from scratch, for example, while investors in partnerships often contribute existing, and valuable, property to the venture. But one element of the overhaul, imported from S corporation law, could make investors reluctant to contribute that property to the partnership, because it would require those investors to pay tax on the asset’s built-in gains should the partnership dissolve. (Built-in capital gains are the increase in value of an asset that occurs before it becomes part of a new venture.)

“They took a rule that made some sense in S corporations because it’s simple but applied that to partnerships, which were intended to allow flexibility to allow people to get together and break up again,” Mr. Schneider said. “So if I want to do a joint venture with another big business, I’m going to really think about it if I’ll have to recognize all my inherent appreciation.”

Though provisions like these would force entities to recognize more taxable income, overall the proposal would likely cost the government money, said Mr. Schneider and Steven Rosenthal, a visiting fellow at the Tax Policy Center. That is because it would encourage existing C corporations — whose profits are taxed twice, first at the corporate level and then on shareholders’ individual returns — to convert to flow-through entities. The sweetener is a provision that would make it easier for the new entity to shield the built-in gains on assets it sells from a 35-percent tax. Right now, thanks to a temporary stimulus incentive, a company only has to wait five years before selling those assets to avoid the tax. In 2014, the waiting period reverts to 10 years. (The rule is meant to discourage companies from converting simply to avoid the tax.) Both Camp proposals would make the five-year period permanent.

It is not clear how much support either proposal will win from Democrats, though some elements of the first option have appeared in bills sponsored by a Democrat, Ron Kind of Wisconsin. In a [statement](#), the top Democrat on the House committee, Sander Levin of Michigan, called for more study on small-business tax policy.

Mr. Camp and Mr. Levin have invited small-business owners who might be affected by the proposals to [submit comments to the committee](#). The suggestion box will be open until April 15 — Tax Day. Of course, as always, Agenda readers can comment below.