TESTIMONY OF
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Before

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UNITED STATES SENATE
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I. Introduction

Chairman Grassley, Ranking Member Baucus, members of the Committee, thank you for inviting me to testify at today's hearing on the vital issue of tax policy and reform.

II. RSM McGladrey

RSM McGladrey is a leading professional services firm providing accounting, tax and business consulting to midsized companies. With combined annual revenues of $1.2 billion, RSM McGladrey and McGladrey & Pullen LLP (a partner-owned CPA firm) together rank as the fifth largest U.S. provider of accounting tax and business consulting services (source: *Public Accounting Report*, Aug. 31, 2006).

RSM McGladrey's client list represents some of the top names in manufacturing and distribution, construction, real estate, health care, financial services and the public sector. RSM McGladrey focuses on the middle market because it represents the heart of U.S. commerce and industry, with more than 500,000 businesses contributing more than 30 percent of the nation's gross domestic production and representing one third of all American workers.

Companies in the middle market are a vital sector of our economy, and we continue to dedicate resources to learn about their needs, issues and concerns.

- In February 2006 we commissioned and participated in the development of the first post-9/11 study of the present and future challenges to America's small to midsized manufacturers. Among other things, that comprehensive study identified the best practices observed by these manufacturers, presented case studies from companies following those practices and catalogued government programs that can help businesses thrive.

- This summer, we surveyed more than 1,000 CEOs and CFOs from small to midsized manufacturers across the nation to gauge their perceptions on a wide range of subjects from operations to labor to exports. The survey participants expressed an unexpectedly upbeat feeling about the health of the economy in general and their respective companies. *But the survey also identified serious concerns, one of which is the small number of these manufacturers that are taking advantage of government enterprise assistance programs and the fact that nearly 40 percent aren't taking advantage of key tax credits and deductions.*

The committee staff asked us to testify because of our unique experience working with midsized companies.

III. Clientele

Each year numerous Congressional committees listen to witnesses explain that midsized organizations are the productivity, employment and innovation engines of the U.S. economy. We think there are two important characteristics of midsized, growing companies that are infrequently mentioned. Growing organizations:

- Organize their corporate structure in a different way than larger companies; and,
- Direct their resources to managing and developing their businesses and competing with larger more well capitalized corporations. They don't invest in increasing internal administrative resources to comply with complex public policies that really are not appropriate for them, but nevertheless cover them.

These two points are important because midsized firms are often forgotten in the formulation of public policy. Large businesses actively participate in the development of tax policy. Congress often creates small business exemptions to protect the smallest firms. Unfortunately, middle market firms may not participate in policy development and are often left attempting to implement policies that don't fit their structure.

In our experience, the presumption that companies with revenues of $25 million, $100 million or even $500 million can deal with laws and regulations with the same ease as companies with $25 billion or $100 billion in revenues is flawed. An organization with $500 million of annual revenue with little or no internal tax department simply cannot cope with the numerous federal, state and local filing requirements on a routine and regular basis. Here are a couple of examples:

- Earlier this year, the Senate passed legislation that would limit the ability of integrated oil companies to use the last-in/first-out (LIFO) method of inventory accounting. As the debate continued, there was serious discussion about extending restrictions on or repealing LIFO for all companies. This would have increased tax bills on thousands of U.S. companies, many of them midsized businesses. Our study that was referenced earlier startled many with its revelation that 42 percent of midsized manufacturers use LIFO and would be hurt significantly by its repeal.
- Our survey found that less than two-thirds of midsized manufacturers are taking advantage of key tax credits and deductions that could benefit them. For example, it would be a safe bet that nearly all Fortune 500 corporations take advantage of R&D tax credits . . . but only about 60 percent of midsized manufacturers responding to our survey do so. This statistic is particularly disturbing when you consider that 1) midsized manufacturers produce more innovations per employee than their large counterparts and 2) survey respondents overwhelmingly named business process improvements as most effective means of improving operational effectiveness.

IV. Testimony Summary

We direct our resources toward serving our clients and identifying ways we can assist them. We have not attempted to comprehensively analyze the impact of the various tax reform proposals from their perspective. However, we do have a few observations about the ability of our clients to adapt to a sweeping new tax system.

Specifically, our testimony today will address:

- Tax issues facing growing firms that are organized as pass-through entities.
- Some simplification suggestions to ease a few of the complexities in the current tax system
.
- The preparedness of growing companies to implement tax reform.

VI. Tax Issues Affecting Businesses Organized as Pass-through Entities

To select the optimal business form, each growing firm must look into the future.

In the United States, there are five distinct business structures that are available, Sole Proprietorship, Partnership, Limited Liability Company (LLC), S Corporation and C Corporation. Each has its strengths and weaknesses, and most of the differences between them are prescribed by law. The initial entity decision may produce significant repercussions for the company as it grows. Many provisions of the tax law make changing the form of a business entity infeasible, impractical or extremely costly.

Today more owners organize their businesses as LLCs electing to be taxed as a partnership rather than as S Corporations. There are also many who don't want to choose the LLC structure because they want the company to have the option to change in the future. These business owners are concerned that LLC transition rules will increase the cost of returning to corporate form.

LLCs are a relatively new form of business organization. Many of our existing clients are organized as S corporations. Contrary to common perceptions, S Corporations are not just small businesses. In fact, we have S Corporation clients with hundreds of millions of dollars of annual revenue.

An S Corporation structure is extremely efficient for a growing midsized business. We believe more businesses would benefit from and be able to use the S Corporation structure if the rules governing them were simplified. We think there is a strong argument that the tax rules that distinguish the activities of both S Corporations and LLCs may benefit from a more standard approach. Specifically, we believe Congress should:

1) Lift restrictions that limit access to the equity markets for pass-through entities.

a) Currently, S corporations cannot accept capital and admit owners who are corporations, private equity groups, foreign investors and most retirement plans. The shareholder eligibility requirements limit an S Corporation's ownership structure to

individuals who are U.S. citizens, a narrow class of trusts and certain tax exempt organizations These restrictions on access to capital severely inhibit economic growth for dynamic, midsized businesses.

b) LLCs are generally the favored form of business organization; however, they face significant tax consequences if they intend to issue stock on a publicly traded exchange. To go public, these entities must generally reorganize as C Corporations after triggering a deemed liquidation of the LLC. The tax barrier to access the public markets is a concern for the owners of smaller firms.

   These rules raise some legitimate questions:

   i) If LLCs and S Corporations both flow their income and loss through to their owners, why do the tax rules treat their access to equity markets differently? As a policy matter, should LLCs have greater access to investment from private equity groups and venture capitalists than S Corporations?

   ii) An S Corporation that plans to become publicly traded can easily revoke their S election to become a C Corporation. An LLC electing to be taxed as a partnership that desires the same access to the public markets must liquidate the LLC and expose their owners to tax on the deemed liquidation. Then, the owners can form a C Corporation with their net proceeds. Is it reasonable for these organizations to anticipate what type of equity they might need in the future to choose the appropriate form of business?

   To mitigate the impact of these rules, growing organizations adopt more complicated structures. For example, a domestic S Corporation desiring foreign capital could create an LLC owned by the S Corporation and allow the foreign investor to purchase a preferred interest in the LLC.

   A simpler approach to the issue would be to make the S shareholder eligibility rules broader. It certainly would reduce the cost of raising capital and eliminate the expense and need for creating and maintaining the entities to achieve the same goal of increased capital.

c) Allow S Corps to offer preferred classes of stock to attract equity investors.

   The ability of a corporation to offer preferred stock attracts equity investors. Under the single class of stock rules, S corporations cannot offer preferred shares. For many equity investors, having the option of holding preferred stock offsets some of the risk associated with investing in new and growing businesses.

   LLCs can offer preferred member interests: S corporations could attract additional capital if they had the ability to offer preferred shares.

2) Limit the tax burden for switching from C to S status.

For companies with LIFO inventory, electing S status requires the corporation to recapture their LIFO reserve over a four-year period.

Also, C corporations electing S status must recognize built-in-gain items that are realized in the first 10-years after S Corporation status is elected. The uncertainty and audit risk of

selecting an appropriate value for unrealized appreciation on property, and other intangible assets is a significant impediment to electing S status.

Finally, C corporations with January through August fiscal year ends may not retain these year ends if they elect S status. They are precluded from keeping their current tax years and paying an enhanced deposit under Sec. 444(e). Additionally, a calendar year C Corporation that plans to elect S status cannot select a September, October, November or December year end even if the corporation is willing to pay the enhanced deposit required under Sec. 444(e).

Older entities face these restrictions. Newer firms organized as LLCs will not encounter these impediments.

3) The costly rules and restrictions associated with "related parties" erect yet another barrier to midsized growing businesses and should be eliminated.

The many sanctions imposed on transactions among related parties are difficult for family owned firms. It is our experience that 50-year old siblings may have less in common than related subsidiaries in a consolidated group. Do these siblings reasonably have the same asset ownership interests compelling them to navigate so many related party restrictions?

Family members must consider the rules in Sec. 1239, 267, 318, 302 and 197. Sections 267 and 318 are particularly egregious in some instances and are widely incorporated by reference throughout the entire Internal Revenue Code (IRC) to impose in some cases a tax exceeding 200 percent of the tax that would be imposed on the same transaction if it were between unrelated parties.

For example, the related party rules prevent a related party from offsetting their gain against their basis in a Sec. 302 redemption that is not a complete termination of interest.

The related party rules can work in surprising ways. New owners could purchase 75 percent of a business and be ineligible for the tax benefits of amortizing the intangibles they have purchased. This "anti-churning" rule quells new investment needed to provide capital for growth.

Numerous related party rules are in place that treat family members as one when they *restrict* family transactions, but won't allow family members to be treated as one for provisions that *benefit* them. Such relationships do not operate in all circumstances where they would cause an ownership interest to be treated as owned by another and thereby receive tax-deferred treatment, such as transfers of property to "controlled" corporations under Sec. 351.

These impediments block the access of midsized companies to more sophisticated business structures.

4) Increase an S corporation shareholder's tax basis in their S stock for debt guarantees

S corporation shareholders may increase their tax basis in their S stock by the amount of a loan from the shareholder to the S corporation. A shareholder guarantee of an S corporation loan will not increase the shareholder's basis in their S stock even though the risk associated with the entrepreneur/owner's commitment is virtually identical.

Commercial lending practice requires the personal guarantee of significant shareholders for corporate debt. We are often asked by our clients to explain to the bank the need for the financial institution to lend the money separately to the shareholder so they can then contribute the loan proceeds to the S corporation. We suggest the rule be changed to permit S corporation shareholder guarantees to increase S stock basis.

V. General Recommendations to Ease Complexity

The Internal Revenue Code is filled with duplicative, insignificant and unnecessary requirements that impose incalculable burdens on the midsized companies we represent.

Simply stated, some code requirements wouldn't meet an objective cost-benefit test. Some tax provisions are sufficiently complex that an IRS examining agent will ignore certain tax return line items after a cost/benefit analysis. Regrettably, our clients must still accumulate this information to make the computation required by the law although it may have a minor impact on their ultimate tax liability.

There are hundreds and hundreds of examples of penalties, reporting requirements and other burdens that prove onerous for midsized companies, but aren't significant or meaningful for the government. Here are a handful of examples:

- Under Sec. 9100, the IRS grants relief to taxpayers that have missed non-statutory deadlines for statutory rules that are too complex. The IRS is authorized to assess relatively hefty user fees to grant this relief. Why should a taxpayer be punished for missing a deadline for rules that the IRS admits are extremely complex? These user fees should be eliminated.

- It makes sense to require information reporting for hedge fund transactions that shelter taxes, but we should revisit reporting requirements for transactions that don't have a tax sheltering impact.

- The uniform capitalization rules add complexity for midsized firms with limited revenue enhancement for the federal government. We believe Congress shouldn't force a firm to use the unicap rules unless they have $100 million in inventory or $500 million of sales.

VI. Broad Tax Reform Issues

We applaud any and all efforts to reduce business tax rates. Lower income tax rates help growing organizations. Entrepreneurial businesses often lack the full-time tax staff with the expertise to analyze the law and collect the data to take advantage of complex incentives.

We strongly support the repeal of the Alternative Minimum Tax (AMT). Our current AMT structure causes unpredictable tax results and undermines Congressional incentives. For individuals who report income or loss from a pass-through entity on their individual returns, the general disallowance of regular tax credits against individual AMT may negate a desirable business activity. For example, the benefit of jobs credits and rehabilitation credits are lost to a pass-through entity whose owners are in the individual alternative minimum tax.

We believe that companies benefit from a generous Sec. 179 expensing allowance. The current phase-out range limits the utility of the benefit. A larger Sec. 179 expensing allowance to $10 million with a higher phase out range from $15 million to $20 million of asset additions would simplify the asset planning activities for many of our clients and, more importantly, provide a meaningful capital resource incentive for midsized organizations to expand their U.S. based manufacturing capacity.

We also believe that tax incentives should be permanent to give midsized organizations the confidence they need to make the relatively sizeable investments necessary to take advantage of them. Research and development activities are inherently long-term undertakings. A permanent research credit will have a disproportionately greater effect on midsized firms who are more reluctant to devote scarce resources to an activity with a temporary incentive.

***Generally*, we support efforts to reform our nation's tax laws.** The President's Task Force on Tax Reform identified growth approaches and simplification approaches to tax reform. We would prefer a growth approach undertaken with an attempt to consider the administrative burden associated with this alternative. Congress will need to strike the best balance between equity and fairness, while considering the administration of the future system and the compliance burden it places on businesses.

However, from the perspective of America's midsized organizations, there are some caveats to our support for tax reforms:

- Transition rules accompanying any significant tax reforms need to be carefully crafted and gradually implemented to allow midsized companies time to adjust.

- We suggest you seek advice from the information technology community about the type of financial information that midsized organizations currently gather and the feasibility of gathering different data that might be needed for a new tax system.

We strongly support the need for clarification and simplification of the tax code. It is right for our clients and will result in a more vibrant economy. After a two-hour discussion on tax complexities and compliance, an exasperated client told me "I wish we had the time to discuss how to run and grow my business!"

We believe that complexity makes many tax incentives more beneficial to big business than to small and midsized organizations. Consequently, the law can unintentionally favor big business over small. The domestic manufacturer's deduction was designed as an incentive for one of the largest and most important drivers of our economy – domestic manufacturers. Incredibly over one third of the 1000+ CEOs and CFOs who responded to our survey aren't taking advantage of this important growth incentive. Although we didn't ask, we suspect that they don't think the benefit of the phased in 3 percent deduction is worth the aggravation of the myriad calculations required by the regulations to claim the deduction.

Many of our clients are attempting to comply with anti abuse provisions enacted during the Enron era. Ironically, these reporting requirements and complexities were put in place to control abuses by the largest businesses, but the resulting administrative burden puts midsized businesses at a competitive disadvantage.

VII. Conclusion

RSM McGladrey believes that any tax reform plan should consider the ability of growing companies to comply and thrive under the new regime. We applaud your effort to identify tax impediments under current law that impedes the growth of midsized organizations. Any new system will need a workable transition schedule to allow administratively lean businesses to understand and administer the new system. We hope that the system you select will reduce the economic cost of tax administration and restore the faith of taxpayers in the fairness of the system.