ACEC

American Council of Engineering Companies

100 Years of Excellence

David A. Raymond
President & CEO

May 27, 2015

The Honorable Orrin Hatch
Chairman
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Paul Ryan
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, DC 20515

Dear Chairman Hatch and Chairman Ryan:

Thank you for your letter of April 13, 2015 requesting our ideas on tax reform. We appreciate the opportunity to respond.

The American Council of Engineering Companies (ACEC) – the business association of the nation's engineering industry – represents engineering businesses of all sizes, from the single professional engineer to firms that employ tens of thousands of professionals working in the United States and throughout the world. Approximately three-quarters of the Council's member firms are organized as some type of passthrough entity, such as S corporations, partnerships, and sole proprietorships.

The broad distribution of ACEC members across both the C corporation and passthrough structures drives the Council's support for comprehensive tax reform. We agree with you that although reforming the corporate and individual sides of the tax code simultaneously will be challenging, it is the only approach that will not disadvantage a large segment of the business community and their employees.

In your letter, you pointed out that the current administration does not share your vision for comprehensive, revenue-neutral tax reform and is unwilling to lower the individual tax rates at which passthrough businesses pay their business income taxes. You asked ACEC for our ideas on how to address the effective tax rate of passthrough businesses if Congress is only able to lower the corporate statutory rates.

There have been public statements suggesting that tax reform would lower the corporate tax rate, and eliminate business tax credits and deductions used by both C corporations and passthrough businesses in order to be revenue neutral. At the same time, this approach to tax reform would be paired with various tax provisions designed to lower the effective tax rate of passthrough businesses. We do not think that a few enhanced tax expenditures would accomplish this goal. Specifically, these provisions would not result in a sufficient effective tax rate reduction for passthrough businesses when compared to the effective tax rate increase these firms would experience due to the loss of numerous other tax credits and deductions.

For example, it has been suggested that one such tax provision could be to increase Section 179 expensing limits. Although ACEC supports raising the Section 179 expensing limit and indexing it for inflation, the use of a capital investment tax provision in a labor-intensive profession such as engineering is naturally limited. Approximately 85 percent of a typical engineering firm's expenses can be attributed to payroll, benefits, and regular expenses such as rent, which indicates that capital purchases that could be expensed are a relatively small part of an engineering firm's expenditures. As a result, the benefit from increased Section 179 expensing limits would not offset the loss of other tax provisions that would be repealed in order to reduce the corporate tax rate in a revenue-neutral manner.

There have also been reports that the proposed legislation could expand the use of the cash method of accounting. As you know from ACEC's previous communications with the Senate Finance Committee and the House Ways and Means Committee, cash accounting is used widely by engineering firms, either because they are organized as passthrough entities or under the qualified personal service corporation provisions in IRC Section 448. Consequently, expanding the ability to use cash accounting might benefit other industries but would not provide an additional tax benefit to engineering firms that are organized as passthrough entities in comparison to those that are structured as C corporations.

We think that any combination of tax expenditures would face the same problem of uneven application to industries across the economy, and could not be commensurate with a reduction in individual tax rates that is equivalent to a reduction in the corporate tax rates. However, as an interim step on the way to comprehensive tax reform, we respectfully suggest that your committees consider establishing a tax rate for the business income of passthrough owners that is tied to the corporate tax rate. This type of business equivalency rate would tax qualified income from an active passthrough or sole proprietorship at the lesser of the individual's top marginal rate or the top corporate tax rate. Existing rules in the Internal Revenue Code could be used to distinguish business income from investment income. We think that the tax rate for qualified personal service corporations, which as you know is a flat rate of 35 percent, should similarly be tied to the top corporate rate.

Congress should also consider reducing the impact of the individual alternative minimum tax (AMT) on passthrough businesses. As you know, the individual AMT limits the use of business tax preferences such as the Section 199 domestic production activities deduction and the R&D tax credit, while the corporate AMT does not. Moreover, passthrough business income should not be counted toward adjusted gross income when determining whether a taxpayer's income exceeds the phaseout thresholds for individual tax credits and deductions.

Although the details of a business equivalency rate would need to be further developed, ACEC thinks that it is an approach to tax reform that would not disadvantage passthrough businesses by taking away tax benefits without lowering their tax rate. Once again, on behalf of the nation's engineering industry, we thank you for the opportunity to engage in this dialogue.

Sincerely,

David A. Raymond
President & CEO