

**Financial Executives International
Committee on Private Company Policy
Small Business/Pass-Through Tax Reform Recommendations
November 3, 2017**

Financial Executives International (FEI) is a professional association of more than 10,000 chief financial officers, treasurers, controllers, chief tax officers, and other senior financial executives from over 8,000 major companies throughout the United States and Canada. FEI represents both the providers and users of financial information. Nearly 60% of FEI members represent private companies, and the Committee on Private Company Policy focuses on these members' policy concerns. The following summarizes the Committee's recommendations with respect to the establishment of a tax rate for business income generated by pass-through entities. This paper represents the views of the Committee on Private Company Policy.

Recommendations for Guardrails to Apply to Pass-Through Entities in Distinguishing Business Income From Compensation

The Unified Framework for Tax Reform released on September 27, 2017 provides tax relief for small and family-owned businesses by limiting the maximum tax rate on business income and stated it contemplated that:

“the committees will adopt measures to prevent the recharacterization of personal income into business income to prevent wealthy individuals from avoiding the top personal rate.”

Pass-through businesses that are also operated by its owner(s) are required to support the bifurcation of business income from compensation under current judicial and statutory principles. Every entity should continue to consider the activities and participation of each owner when determining the characterization of income, utilizing facts and circumstances and case law, including the “intent test” described in *Paula Constr. Co. v. Commissioner*, to ensure that the bifurcation is not arbitrary nor capricious. The FEI Committee on Private Company Policy makes the following recommendations for guardrails to be included in proposed legislation, to achieve the stated objectives for tax reform, discourage manipulation, achieve fairness and simplify administration.

- Concentration of Employee/Operator Ownership – Absent a controlling interest, compensation of owner-employees/operators is driven by the adverse interests of the owners and employees/operators. Our recommendation is to adopt the controlled foreign corporation control rules in determining when control is a factor that would cause a deeper review of the split of compensation and business income of owner-employees. Specifically, considering only

owner-employees with a 10% or greater voting power (i.e. 10% owner-employees/operators), if 10% owner-employees/operators control more than 50% of the voting power of the business/entity, the burden of proof would fall on taxpayer to justify the split of employment income of owner-employees. Absent a control situation, the split of employment and business income would be accepted as filed by the taxpayer.

- **Qualified Compensation Study** – One measure to ensure that the determination of business income subject to the new minimum tax rate is appropriate is to require a higher level of support and documentation for reasonable compensation of owner-employees/operators of a pass-through entity that exceeds a set amount of average revenue, for example \$200 million. Such entities would have the means to perform analysis to justify the compensation of owners based upon market studies of compensation paid in comparable circumstances. Such documentation could be required to be prepared utilizing a study performed on a periodic basis, such as once every three years, by a qualified, independent expert. This would then require that small to mid-size businesses that earn higher levels of revenue would undergo a more robust documentation of compensation paid owner-employees/operators with any residual business income being taxed at the business tax rate, but would not penalize smaller entities that do not have the resources to do so. By adding this requirement, tax reform for small businesses can be achieved, and abuse mitigated.
- Pass-through entities that earn below a maximum amount of average revenue (\$200 million in our example) would be automatically subject to a safe harbor rule for determining reasonable compensation and thus bifurcating business income eligible for the lower business tax rate. A rule of 70% compensation/30% business income has been suggested by some authorities and was included in prior legislative proposals, including the 2014 Camp proposal. However, notwithstanding a safe-harbor rule that businesses with lower revenues could avail themselves of, an election should be available to utilize a more appropriate split of income if the owner-employees/partners are willing to meet the more burdensome requirements of properly performing and documenting a reasonable compensation study as described above.

The Committee on Private Company Policy appreciates the efforts of the House Ways & Means and Senate Finance Committees on tax reform and looks forward to working with both committees to advance tax reform legislation that advances our goals. We welcome the opportunity to discuss these issues further with you and your staff.

Committee on Private Company Policy
Financial Executives International

For Additional Information please contact:

Brian Cove
Managing Director, Technical Activities
Financial Executives International
(973) 765-1092
bcove@financialexecutives.org