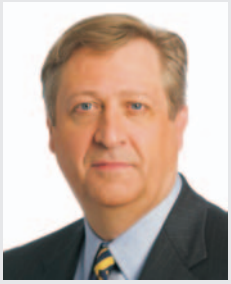
(tax or income) is not a meaningful statistic. That is because the corporate investor does not bear the burden of his expected taxes — those taxes are eliminated in calculating the purchase price.

The investor will also occasionally overestimate the corporation's income; that is, B is negative in the equation $(B(1 - t_c)(1 - t_{cg}))$ used to compute the marginal tax on the unexpected change in income (see Table 1, column 4). Using the above corporate and investor tax rates, the investor's tax burden will be reduced by 52 percent of the overestimate of income. The income, gain, and taxes are computed in the final column of Table 1 for the investor who estimates the corporation would earn $100 when it actually earned only $50. The $50 overestimation of income results in $20 (0.4($50)) in corporate tax and a reduction of $6 in the investor's CGT (from $1.09 to $4.91 tax decrease from other transactions (compare columns 3 and 4). In this example, $20 of corporate tax that is priced into the stock by the investor is never paid. The results are much the same as the cancellation of a shareholder's debt.

In summary, when evaluating the private equity investor's tax burden from a gain or loss on stock, it is meaningless to simply add the corporate tax to the shareholder tax. No double taxation occurs for the investor when he is able to accurately predict the future cash flows. When the investor underpredicts the cash flow, the shareholder pays all the corporate-level tax on the excess pre-cash flow. The benefits of this windfall are drastically reduced by the tax burden. However, when the investor overestimates the corporation's income, the reduction in taxes from the deductible loss significantly reduces his loss. If the amount of the tax priced into the stock is unknown, the effective tax rate on the private equity investor's gain cannot be determined.

Small Business and the Repair Regulations

By Donald Williamson



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Williamson argues that the temporary regulations distinguishing repairs from capital expenditures must have regulatory or statutory safe harbors for small businesses that will be unable, or perhaps even unwilling, to comply with the new rules.

Recently, I had the privilege (actually I exercised my right) to testify at the IRS hearing on the proposed regulations under section 263 regarding the deduction and capitalization of expenditures for tangible property, that is, the repair regulations.[1] My comments concerned the burden those regulations will have on small businesses that cannot afford tax counsel to parse through the detailed rules necessary to ascertain whether an expenditure attributable to a trade or business asset will add value, prolong life, or change the use of that asset to the extent that the expenditure must be capitalized.

Considering that the regulations would affect virtually every person conducting business in America and would be retroactive to January 1, 2012, I was somewhat surprised that only two others offered testimony. Compare this with the more than 20 witnesses who testified at the recent hearing on the Foreign Account Tax Compliance Act regulations affecting withholding on payments to foreign financial institutions.[2] I was even more surprised that only a few dozen comment letters were submitted. Granted, these proposed regulations are the third iteration revising drafts offered in

[1]*See* Amy S. Elliott, "Witnesses Criticize Tangible Personal Property Regs as Complex, Unfair," *Tax Notes*, May 14, 2012, p. 818, *Doc 2012-9977*, or *2012 TNT 91-1*.

[2]*See* Shamik Trivedi, "Banking Groups Seek Delay of FATCA Regs, More IRS Flexibility," *Tax Notes*, May 21, 2012, p. 942, *Doc 2012-10384*, or *2012 TNT 95-1*.

2006 and 2008, so perhaps those who wanted to weigh in on them had already done so. Despite the importance and magnitude of the project, I was left with the impression that no one outside the business community subject to the jurisdiction of the IRS Large Business and International Division is aware of these far-reaching proposals.

And, I fear, I'm being proven right. In an informal survey of the leadership of several professional organizations representing preparers of small business tax returns across the United States, most were completely unaware of the regulations, and those who were aware of them knew little of their content. As director of the graduate tax program at American University, I conducted an informal survey of our alumni, composed almost exclusively of CPAs, and found that few had any notion of what impact the repair regulations would have on their businesses or the businesses of their clients. If small-business tax practitioners and my former graduate tax students are not keeping abreast of these developments, I can safely assume there are millions of taxpayers and their return preparers who are equally oblivious to the impending burden.

Although I can condemn tax professionals for their lack of knowledge about this most significant development in the law, I empathize with average business owners who think about their income tax returns only shortly before they are due, relying on others to deal with the compliance problems these new rules present. Although the ''Big 4'' and other large accounting firms are expecting an enormous influx of business from the thousands of Forms 3115, ''Application for Change in Accounting Method,'' it is unknown whether small businesses will be able to get the help they need at a fee they can afford.

Suggested Safe Harbors

Clearly, for small businesses, which comprise much of the economic productivity in our country, some relief is in order. Several safe harbors should be created or expanded in the regulations to ease the compliance burden on small business. For example, the de minimis rule in prop. reg. section 1.263(a)-2T(g) that provides a limited exemption from capitalization for some amounts paid to acquire or produce a unit of property requires a ''certified audited financial statement that is accompanied by a report of an independent CPA.'' Few small businesses need those generally accepted accounting principles conforming statements, and most rely instead on statements of cash flow to measure their success. Certainly, for small businesses, a compliance review or even a compilation statement prepared by a CPA should satisfy the intent of the regulations to secure an opinion of an independent professional regarding the treatment of items that are expensed or capitalized. Regardless of what constitutes an ''applicable financial statement,'' further adjustment to the safe harbor is needed to increase the aggregate exemption from capitalization above the current limit of 0.1 percent of the taxpayer's gross receipts or 2 percent of the taxpayer's total depreciation for the tax year, limits so small they will be meaningless to nearly all small businesses in the country.

Also, a second de minimis safe harbor is needed in prop. reg. section 1.263(a)-3T(e)(2)(ii) for determining when a building must be broken into its structural components to measure whether an expenditure constitutes an improvement to the building that requires capitalization. Requiring a small business that owns a building with an adjusted basis of less than $1 million to identify and separately account for the building's HVAC, plumbing, electrical, fire protection, gas distribution, and security systems as well as any elevators, escalators, or other structural components as the IRS may prescribe is unnecessary and unduly burdensome. Clearly, some dollar threshold for triggering these rules is in order.

And, taxpayers with average gross receipts no greater than $10 million for the three prior years should be exempt from the repair regulations. That safe harbor would not undermine the regulations' impact on businesses that have the resources, expenditures, and desire to alter their accounting methods to avoid tax. Section 263A(b)(2)(B) already includes a $10 million threshold for exemption from the capitalization principles of direct and indirect costs associated with the taxpayer's inventory and production of other real or personal property for resale. Providing a similar exemption in the repair regulations would offer the relief from burdensome compliance that small businesses need.

More Fundamental Revisions

Aside from these suggestions for revising the repair regulations, it may be time to consider more fundamental changes to the code itself regarding administrative rulemaking. For example, the proposed Executive in Need of Scrutiny (REINS) Act (H.R. 3765), introduced by former congressman Geoff Davis, who served on the Ways and Means Committee, would compel Congress to approve any regulation with an economic impact of $100 million or more. All tax practitioners can think of provisions in the code other than section 263 (for example, sections 482 and 1502) to which this proposal would apply.

Although section 7805(f) provides some protection from overly complex proposed or temporary regulations, such as the repair regulations, by requiring that the regulations be submitted for comment to the chief counsel for advocacy of the Small

Business Administration, the effect of these submissions is unknown. Perhaps those reviews have been sufficient in the past, but this protection might not be enough today in light of the complexity of regulations that apply to small businesses. Therefore, some formal congressional review over legislative blank checks of authority to the IRS appears in order, at least concerning a regulation's impact on small business.

Alternatively, liberalizing section 448's safe harbor for the use of the cash method of accounting would provide significant compliance relief for small businesses. Ways and Means Committee members Rick Berg, R-N.D., and Mike Thompson, D-Calif., have introduced the Small Business Tax Simplification Act (H.R. 4643), which would increase from $5 million to $10 million the maximum gross receipts for calculating taxable income using the cash method rather than the accrual method. This expansion of the section 448 election — coupled with current administrative exemptions such as Rev. Proc. 2002-28[3] for expensing otherwise inventoriable items — will effectively release 98 percent of all businesses in America from burdensome accounting rules, including many of the requirements of the repair regulations.[4]

Conclusion

With statutes such as the Dodd-Frank Act prescribing broad and vague rules that call for consumers to have access to consumer financial products and services that are ''fair, transparent, and competitive,'' and the massive healthcare legislation that no legislator has actually read, let alone come to understand, the problem of regulations' serving as substantive legislation transcends the code's frequent direction that the IRS draft regulations to carry out its rules. However, unlike healthcare or even the financial marketplace, the code offers unique opportunities to carve out safe harbors and other exemptions from complex regulations and greatly benefits small business without sacrificing federal policy goals.

Through targeted legislation or administrative exemption, relief from burdensome regulations for small business will actually improve compliance at minimal cost to technical accuracy. Demanding that small businesses adhere to lengthy, complicated technical rules such as the repair regulations — no matter how theoretically precise — will not yield significant revenue and will only serve to increase compliance costs, which will ultimately impede job creation. This universal enforcement may well backfire when small business owners discover that the cost of being found noncompliant — additional tax, interest, and penalties — is less than the time, resources, and cost spent in efforts to comply. If, during this election season, average taxpayers learn of these regulations and what they require, the regulations could well serve as a poster child for political campaigns' advocating curtailment of unnecessary government intrusions into the affairs of small business.

Those drafting our laws and regulations must understand that taxpayers will comply with rules like the repair regulations as long as they believe it is in their interest. But, when rules are incomprehensible, unworkable, impractical, or simply silly to average citizens, those rules will be ignored. A good first step is for the repair regulations to set out a comprehensive set of safe harbors for small business.

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[3]2002-1 C.B. 815, *Doc 2002-9029*, *2002 TNT 72-6*.

[4]For further discussion and analysis of this proposal, see David Kautter and Donald Williamson, ''A Simplified Cash Method of Accounting for Small Business,'' *Tax Notes*, Feb. 13, 2012, p. 863, *Doc 2012-1332*, or *2012 TNT 32-7*.