# S Corporations & Tax Reform

June 6, 2017

S CORP

DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES

# S Corporations & Tax Reform

<u>Challenge with How We Tax Businesses</u>

- The basic challenge with the US tax code is we overtax domestic companies
    - We impose the world's highest tax rate on US based businesses; and
    - We have one of the few "worldwide" income taxes, where we tax the income of US businesses and individuals regardless of where it is earned
- Meanwhile, the rest of the world has been busy reforming taxes:
    - They have sharply lowered marginal rates on their business sectors; and
    - They have moved to territorial tax systems that focus on income earned and consumption taking place within their own borders
- The result:
    - Our high tax rates encourage companies to shift IP, production, income and jobs overseas
    - Our worldwide taxation encourages companies to move their HQ's to lower tax countries

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<u>Challenge with How We Tax Businesses</u>

- Another challenge with the tax system is our attempt to double tax business income -
  - We double tax our corporate income, with an entity level tax on the company plus a shareholder tax on dividends and capital gains; and
  - We impose two layers of tax on the foreign operations of US companies – they have to pay the foreign tax first, and then the remaining US tax when they repatriate their earnings
- This double tax has negative consequences –
  - It drives up effective rates, making it more expensive to invest in capital and jobs here; and
  - It drives bad behavior – C corporations stop paying dividends and they hoard profits, all in an effort to avoid the second layer
- The result is fewer jobs, lower wages and less production here in the United States
- It also forces the business community into “self help”

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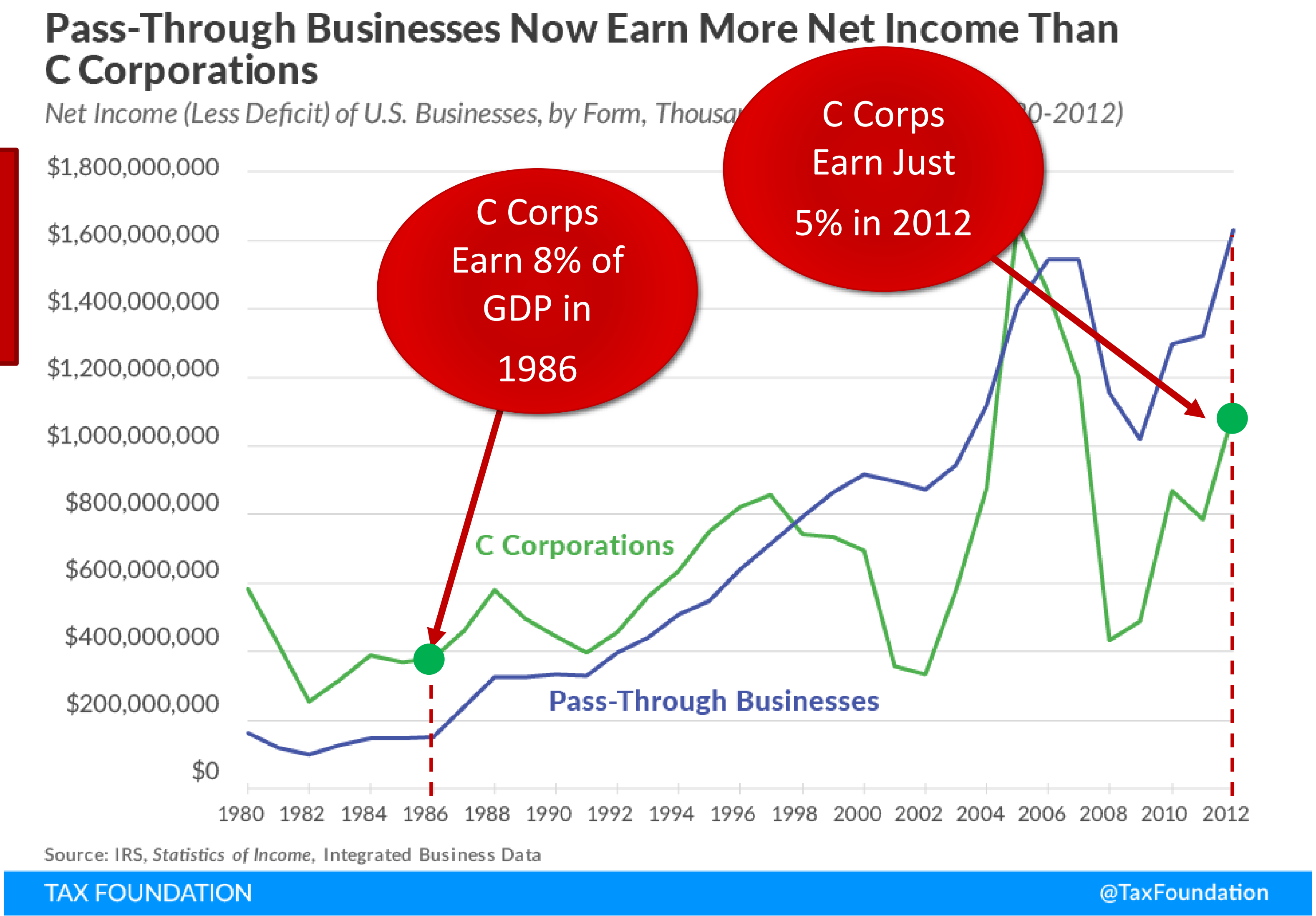
Decline of our Corporate Tax Base



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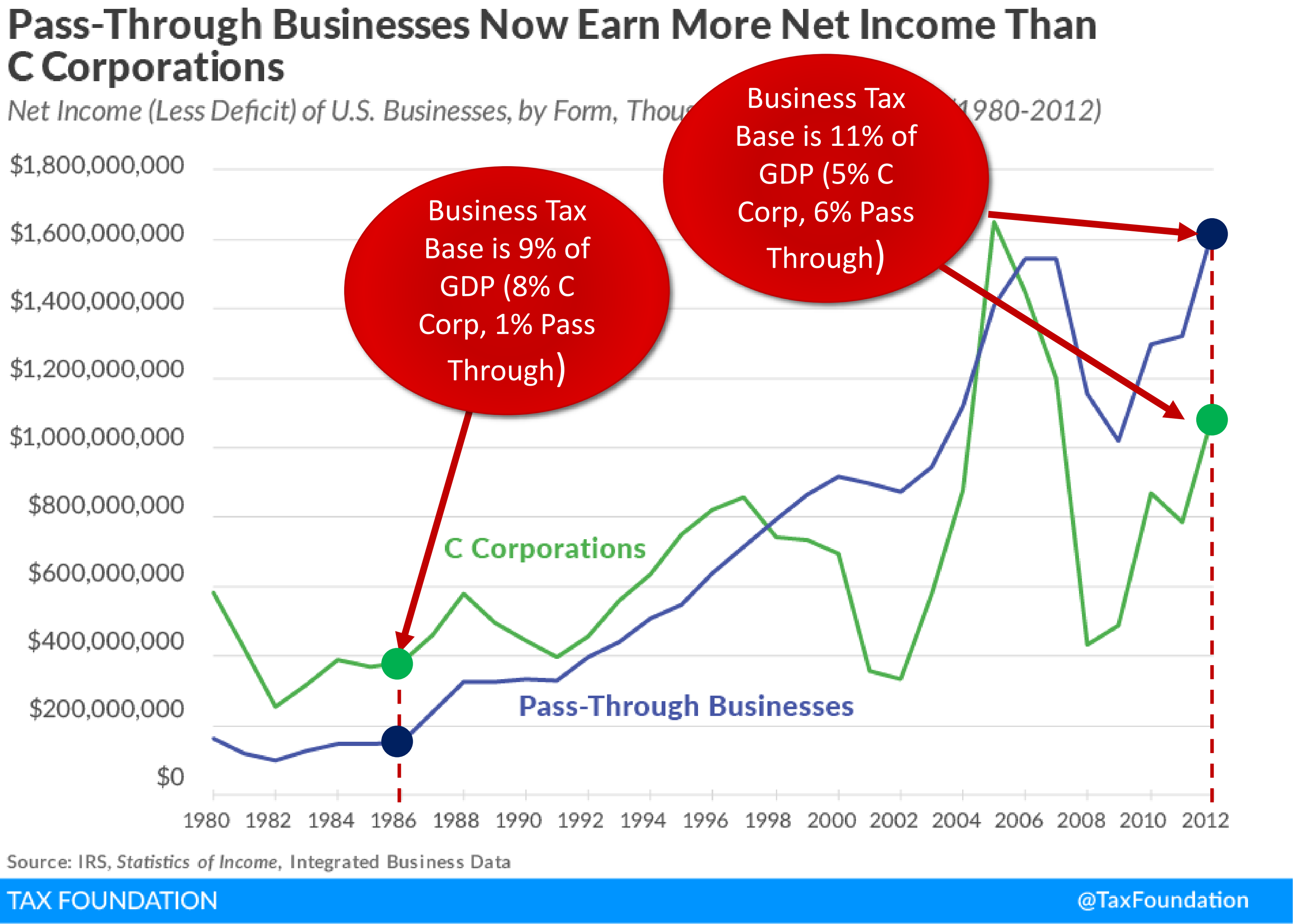
Masks the Growth of our "Business" Tax Base



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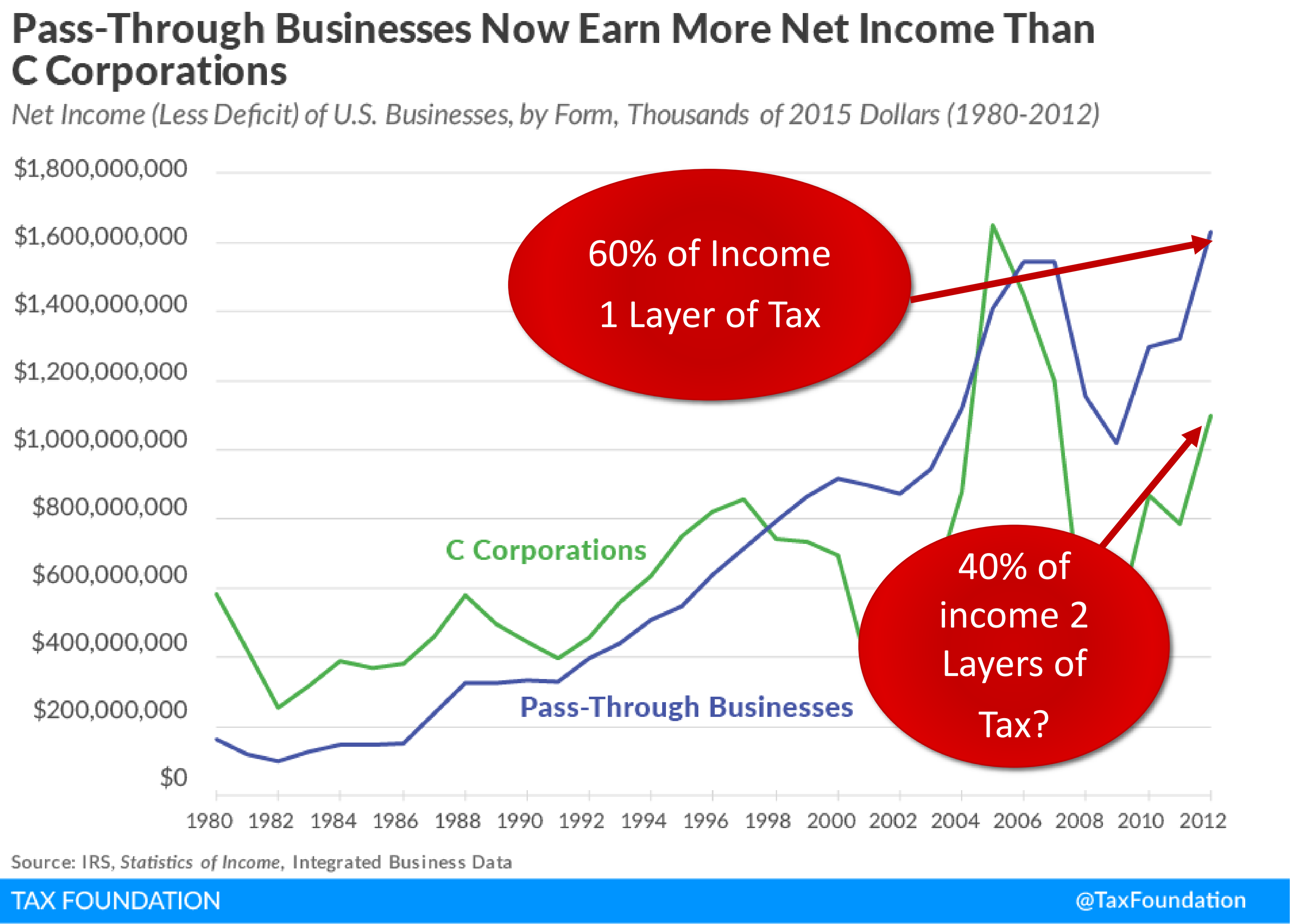
Traditional view of the Double Corporate Tax



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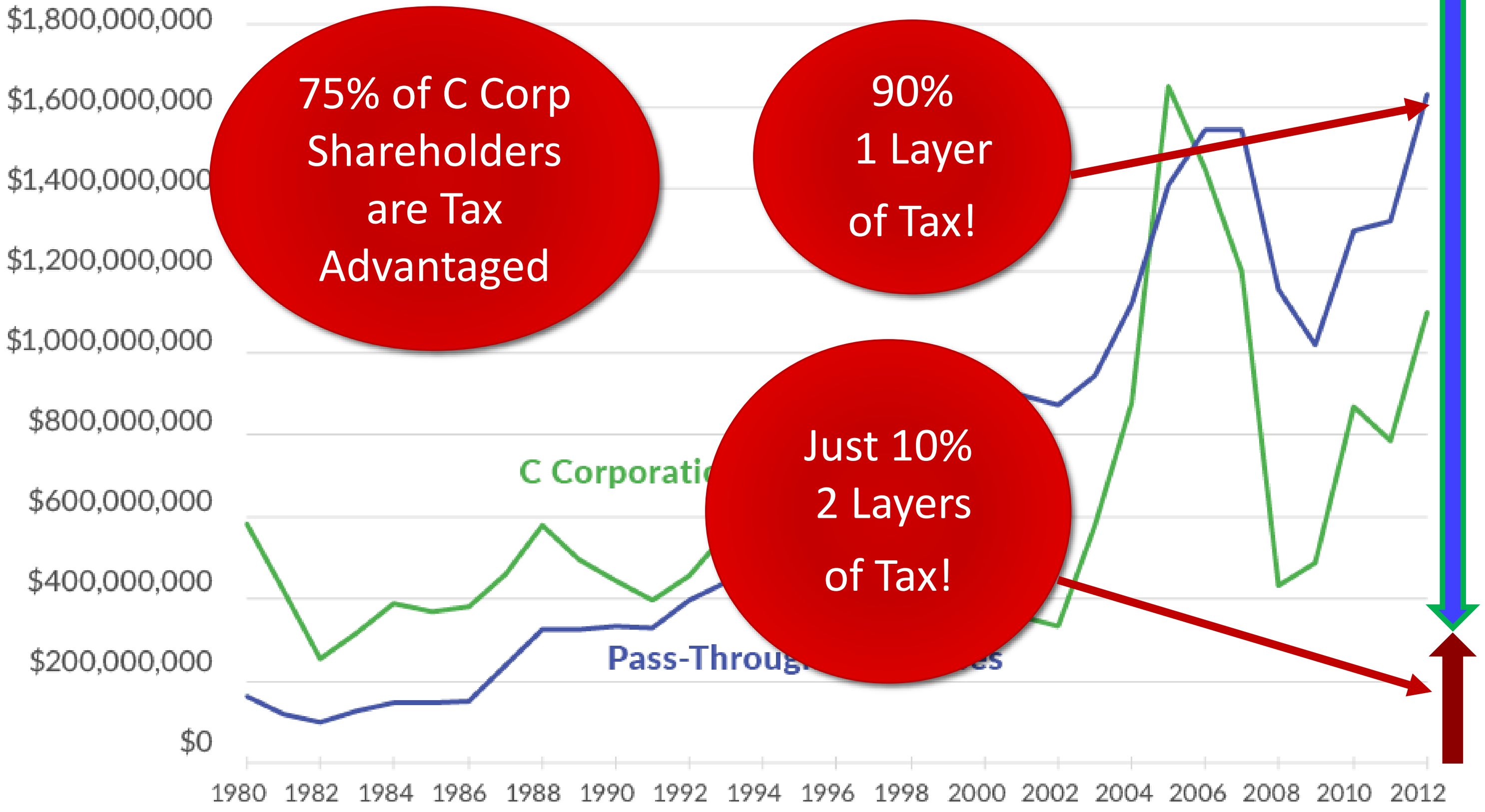
Reality of the Double Tax

## Pass-Through Businesses Now Earn More Net Income Than C Corporations

*Net Income (Less Deficit) of U.S. Businesses, by Form, Thousands of 2015 Dollars (1980-2012)*




Source: IRS, *Statistics of Income*, Integrated Business Data

TAX FOUNDATION @TaxFoundation

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## Tax Reform

- Meanwhile, there's $2.5t in overseas profits waiting to be repatriated.  Why?  To avoid paying the worldwide US corporate tax
- So C corporations avoid the double tax by:
  - Not paying dividends;
  - Attracting tax advantaged shareholders; and
  - Hoarding profits overseas
- So the C corporation community has voted with its feet for a single layer of tax both here and abroad.  Its time for the tax code to catch up!

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## Tax Reform

- These realities underlie our “Pass-Through Principles” letter that more than 120 businesses groups signed on to last year:
    1. Reform needs to include both individual and corporate tax codes
    2. Top tax rates on individuals, corporations, and pass-through businesses should stay equal and low
    3. Business income should be taxed once, and only once
- The S Corporation Association has been pursuing this message for six years

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## Tax Reform

- How do the current tax reform proposals stack up to the principles? Pretty well
- Both the Blueprint and the Administration’s outline move in a positive direction
- The plans:
  - Reduce rates on corporations and pass through businesses to more competitive levels;
  - Move from a worldwide to a territorial tax system
  - Eliminate the Estate Tax, the Alternative Minimum Tax, and the ACA Surtax;
  - Reduce tax rates on dividends and capital gains.
- Neither approach completely embraces rate parity or eliminates the double tax, but they do make great strides:
  - The move to territorial eliminates the double tax on overseas income; and
  - The rate cut and lower taxes on shareholders reduces the double tax on C corporations.

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## Remaining Challenges

- So the tax reform proposals put forward to date move the Tax Code in a positive direction. What are the remaining challenges?:
    1. Pass Through Tax Base: Separating wage tax rates from pass through business rates requires the tax base for the lower, pass thru rate to be defined. Our goal is to make this base as broad as possible, just like the lower C Corp rate
    2. Rate Parity & Single Layer of Tax: Both plans go a long way towards the goal of taxing all business activity once at the same, reasonable rate. We plan to continue to work with tax writers to reach the ultimate goal of rate parity
    3. Pass Through Rate Enforcement: Taxing pass through businesses at lower rates creates an enforcement challenge. How to meet this challenge is not easy, and it gets harder the larger the gap. A "one-size-fits-all" approach would not work for all, or even a majority, of businesses

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## Pass Through Tax Base

- It is imperative that Congress define the tax base for pass through businesses correctly
- S-Corp worked with Grant Thornton on their Business Equivalency Rate concept and with Ways & Means Member Vern Buchanan on his “Main Street Fairness Act” (HR 116) introduced in the House earlier this year.
- Key elements of these approaches:
  - Uses a broad definition that tracks the C corporation tax base;
  - Focuses on active pass through business income measured at the business rather than the shareholder level; and
  - Refrains from narrowing the base by limiting the pass through rate based on number of employees, amount of revenues or income, whether the owner works at the business, or the industry in which the business operates

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| Tax Reform Example -- $80m Manufacturer | | | | | |
|---|---|---|---|---|---|
| **First Layer of Tax** | | S Corp | C Corp | Blueprint - S | Blueprint - C |
| Income | $ 3,500,000 | $ 3,500,000 | $ 3,500,000 | $ 3,500,000 | $ 3,500,000 |
| Deductions | | | | | |
| *Section 199* | 9.0% | $ 315,000 | $ 315,000 | | |
| *Interest* | | $ 500,000 | $ 500,000 | | |
| *State Tax* | 5.0% | $ 175,000 | $ 175,000 | | $ 175,000 |
| *Local Tax* | 2.0% | $ 70,000 | $ 70,000 | | $ 70,000 |
| | | | | | |
| Total Deductions | | $ 1,060,000 | $ 1,060,000 | $ - | $ 245,000 |
| Taxable Income | | $ 2,440,000 | $ 2,440,000 | $ 3,500,000 | $ 3,255,000 |
| Tax Rate | | 39.6% | 35.0% | 25.0% | 20.0% |
| Tax | | **$ 966,240** | **$ 854,000** | **$ 875,000** | **$ 651,000** |

**C Corps Do Much Better**

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| Tax Reform Example -- $80m Manufacturer | | | | | |
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| Taxable Income | | $ 2,440,000 | $ 2,440,000 | $ 3,500,000 | $ 3,255,000 |
| Tax Rate | | 39.6% | 35% | 25% | 20% |
| First Layer | | $ 966,240 | $ 854,000 | $ 875,000 | $ 651,000 |
| Second Layer (100%) | | | $ 377,468 | | $ 429,660 |
| Total Tax | | $ 966,240 | $ 1,231,468 | $ 875,000 | $ 1,080,660 |

**S Corps Do Much Better**

# S Corporations & Tax Reform

| Tax Reform Example -- $80m Manufacturer | | | | | |
|---|---|---|---|---|---|
| **Second Layer of Tax** | | S Corp | C Corp | Blueprint - S | Blueprint - C |
| Income | $ 3,500,000 | $ 3,500,000 | $ 3,500,000 | $ 3,500,000 | $ 3,500,000 |
| Total Deductions | | $ 1,060,000 | $ 1,060,000 | $ - | $ 245,000 |
| Taxable Income | | $ 2,440,000 | $ 2,440,000 | $ 3,500,000 | $ 3,255,000 |
| Tax Rate | | 39.6% | 35% | 25% | 20% |
| First Layer | | $ 966,240 | $ 854,000 | $ 875,000 | $ 651,000 |
| Second Layer (25%) | | | $ 94,367 | | $ 107,415 |
| Total Tax | | $ 966,240 | $ 948,367 | $ 875,000 | $ 758,415 |

**C Corps Do Much Better**

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## Rate Parity

1. All businesses do better under the Blueprint, but its no giant giveaway – the base broadening provisions offset much of the tax relief
2. C corporations do better than S corporations, at least when you look at the initial layer of tax
3. Accounting for the second layer of tax on C corporations requires assumptions about the tax status of their shareholders and their dividend policies
4. Assuming the national average for fully taxable C corporation shareholders (25%), C corporations continue to do better than S corporations

# S Corporations & Tax Reform

| Tax Reform Example -- $80m Manufacturer | | | | |
|---|---|---|---|---|
| **70/30 Approach** | S Corp | C Corp | Blueprint - S | Blueprint - C |
| Business Income | $ 3,500,000 | $ 3,500,000 | $ 3,500,000 | $ 3,500,000 |
| Owner Salary | $ 500,000 | $ 500,000 | $ 500,000 | $ 500,000 |
| Deductions | $ 1,060,000 | $ 1,060,000 | $ - | $ 245,000 |
| Total Taxable Income | $ 2,940,000 | $ 2,940,000 | $ 4,000,000 | $ 3,755,000 |
| Blended Tax Rate | 39.6% | 35.6% | 30.6% | 21.6% |
| Total Tax (One Layer) | $ 1,164,240 | $ 1,045,905 | $ 1,224,000 | $ 812,019 |
| Total Tax (w 25% Taxable) | $ 1,164,240 | $ 1,140,272 | $ 1,224,000 | $ 899,293 |

**S Corp Tax Hike Under 70/30**

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## Pass Through Enforcement

1. How Congress elects to enforce the new, separate rate on pass through businesses has significant effects on their resulting tax burden
2. Roughly calculated, the Camp-style 70-30 approach results in an sizable tax hike over current law in this example and a tax burden that is significantly higher than the C corporation alternative
3. Under the 70/30 approach, the resulting wage to profits ratio does not reflect the levels of profits resulting from a business' investment in capital and employees
4. S-Corp opposes using a fixed ratio test to distinguish wage and salary from business profits

*Caveat – S-Corp did not attempt to calculate the owner's income using graduated rates and individual deductions (aside from state and local). We also did not attempt to calculate the effects of the AMT or the new expensing provision. On the other hand, we didn't include payroll taxes either. This is a rough estimate that gives a general comparative sense of how this particular company would do under the differing plans.*

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Take-Aways

- For six years, S-Corp has advocated for tax reform that is comprehensive, restores rate parity, and seeks to reduce or eliminate the double tax on some corporate profits
- The business community already has voted with its feet and its actions – it is clear it prefers a territorial system with a single layer of tax
  - Today, the vast majority of business activity is taxed that way, even if the tax code says something else
- Tax reform should help the Tax Code catch up with the reality of business ownership by taxing all business income once, at low reasonable rates, when the income is earned
- Establishing a new, tax rate for pass through businesses will help with rate parity, but creates a significant enforcement challenge
  - The bigger the differential, the bigger the challenge
- S-Corp supports a separate pass through tax rate, but opposes efforts to limit the pass through tax base or to reduce the value of the rate through fixed enforcement rules

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