July 17, 2017

The S Corporation Association Comments to the Senate Finance Committee

The United States is unique among developed countries in the emphasis it places on pass-through business structures – S corporations, partnerships (including limited liability companies), and sole proprietorships. Pass-through businesses make up 95 percent of all U.S. businesses, they employ the majority of private sector workers, and they contribute the majority of business income to our GDP.[1]

This reliance on pass-through businesses is not an accident or a byproduct of other priorities. Rather, it was done purposefully by successive Congresses seeking to strengthen the role of private businesses in the American economy. These deliberate actions date back to the creation of the S corporation structure in 1958 and they have worked to the benefit of the businesses themselves, the people they employ, and the communities they serve. America has more jobs, higher wages, and a more diverse economy because of the strength of its pass-through business sector.

It is critical for Congress to understand this history as it seeks to tackle tax reform in the coming months. One reason the pass-through business structure has been so successful is that it is, fundamentally, the correct way to tax business income. If Congress were in a position to start from scratch, the pass-through treatment of business income, particularly how S corporations are taxed, would be the starting point. As Eric Toder of the Tax Policy Center testified before the Senate Finance Committee:

> *I would.. note that the ideal way to tax business income is the way we tax S corporations. We would like to attribute the income to the owners and the only reason we have a corporate tax is for large and frequently traded companies – very hard to do that and identify the owners who would pay the tax. So where you can do that, we should do that, and that is the right treatment.*[2]

For publicly-owned companies with thousands of shareholders, pass-through treatment is simply not feasible. But for everyone else, allowing closely-held businesses to pay their taxes using the pass-through structure would be an improvement in tax administration and tax simplicity while helping to make U.S. business more competitive globally.

Starting with the premise that S corporation taxation is the correct way to tax business income, we encourage the Senate Finance Committee to consider the following broad principles supported by 120 national business trade associations (see attached) as it considers how to best reform the tax code and tax business income:

---

[1] Robert Carroll and Gerald Prante, *The Flow-Through Business Sector and Tax Reform*, Ernst & Young (April 2011). Available at: http://www.s-corp.org/2011/04/13/links-to-s-corp-study-and-press/

[2] Hearing entitled *How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?* Response to a question before the Senate Committee on Finance, March 30, 2011.

805 15TH STREET, NW SUITE 650 • WASHINGTON, DC 20005 • PHONE: (202) 466-8700 • FAX: (202) 466-9666
WWW.S-CORP.ORG

1. Tax reform needs to be comprehensive. Most workers in the United States are employed at pass-through businesses that pay taxes at the individual rates, not the corporate rates. To ensure that we avoid harming a large segment of American employers, tax reform needs to include both the individual and the corporate portions of the tax codes.
2. Congress needs to reduce the tax rates paid by individuals and corporations to similar, low levels. Excessive marginal rates discourage investment and hiring, while splitting business income and taxing it at significantly different rates encourages planning to circumvent the higher rates, ultimately resulting in wasted resources and lower growth. To ensure that tax reform results in a more simple and competitive tax code, Congress needs to keep top tax rates low, and it needs to keep them at similar levels.
3. Congress should continue to reduce the incidence of double-taxing business income. A 2011 study on tax reform by Ernst & Young made clear that the predominance of pass-through businesses in the United States, and the single layer of tax they face, results in higher levels of investment and employment in the U.S. A key goal of tax reform should be to continue this progress towards taxing all business income only once.

The third priority here is particularly important. If the goal of tax reform is to improve incentives for domestic job creation and investment, it needs to address the burden of the double tax on American corporations. Congress has proactively worked to reduce this burden for the past three decades, and that progress should continue in any future tax reform. As the 2011 Ernst & Young study noted:

> *In addition, the flow-through form helps mitigate the economically harmful effects of the double tax on corporate profits, in which the higher cost of capital from double taxation discourages investment and thus economic growth and job creation. Moreover, double taxation of the return to saving and investment embodied in the income tax system leads to a bias in firms financing decisions between the use of debt and equity and distorts the allocation of capital within the economy. As tax reform progresses, it is important to understand and consider all of these issues with an eye towards bringing about the tax reform that is most conducive to increased growth and job creation throughout the entire economy.*[3]

Tax reform will, by definition, include many details -- far too many to be addressed here. But if Congress successfully enacts tax reform that remains consistent with these three principles, the resulting tax code is more likely to encourage investment and job creation while reducing the complexity of both paying and collecting taxes. It will create a code that raises the revenue the federal government needs in a manner that is more conducive to economic growth.

Rate Parity for S Corporations and Other Pass-Through Businesses

Consistent with the second and third priorities listed above, a primary goal of tax reform should be to establish similar, low tax rates on all forms of business income. From 2003 through 2012, the top rate

[3] Robert Carroll and Gerald Prante, *The Flow-Through Business Sector and Tax Reform*, Ernst & Young (April 2011). Available at: http://www.s-corp.org/2011/04/13/links-to-s-corp-study-and-press/

on individuals, pass-through businesses, and C corporations was effectively the same – 35 percent. This parity meant that taxpayers had little incentive to move income from one source to another, which meant business owners made decisions based on their business needs and not on the tax code.

Today, that parity is gone. Tax rates on pass-through businesses went up sharply beginning in 2013 as a result of the resolution of the Fiscal Cliff and implementation of the ACA investment surtax. These tax hikes mean that a dollar earned by an S corporation today can be subject to federal taxes totaling nearly 45 cents, whereas a dollar earned by a C corporation is still subject to a top tax of only 35 cents.

	2013	2012
Income Tax Rate	39.6%	35%
Pease Limitation	1.2%	NA
ACA Investment Tax	3.8%	NA
Total Marginal Tax	44.6%	35%

For pass-through businesses, the net effect of these higher marginal rates is to drain capital from the business. This is an important point that needs to be emphasized. S corporation taxes must be paid when the income is earned, and they are due regardless of whether the business distributes the earnings to its shareholders.

To accommodate these taxes, most S corporations make quarterly distributions to shareholders sufficient to cover the taxes owed. For example, in 2012, an S corporation making $100 would have distributed $35 to its shareholders in order to cover the federal tax. Today, that same business might have to distribute $45. In other words, the retained earnings of the business just declined from $65 to $55. That $10 decline means less money to invest and hire new workers.

Tax reform should seek to reduce marginal tax rates overall and restore the rate parity between C corporations and pass-through businesses on the initial layer of business tax. Tax rates on C corporations may be the world's highest, but the tax rate on S corporations and other pass through businesses is even higher. They both need to come down for the same reasons.

Tax reform should also seek to reduce or eliminate the double tax paid by C corporation shareholders by integrating the corporate and individual codes. This reform would put C corporations on an equal footing with pass through businesses while helping to increase investment and create jobs. Coupled with excessively high marginal rates, this double tax is a contributing factor as to why US firms are not as competitive as they should be and why so many American businesses are fleeing to other countries. It is also the reason so many businesses are organized as pass throughs and why multinational C corporations continue to hoard so much of their earnings overseas.

Eliminating the double corporate tax is not as big of a leap as it might appear at first glance. The simple fact is that the business community has already voted with its feet for a single layer of tax. For example, the Tax Foundation found that in 2012 that pass through businesses earned nearly 60 percent of business income (single layer) while C corporations earned only 40 percent (double taxation). Meanwhile, the Tax Policy Center recently reported that only *one-quarter* of US corporate stock today is

owned by fully taxable shareholders, down from four-fifths back in 1965. The rest is held by qualified plans, endowments, charities, foreign accounts, etc.

The combination of these two findings suggests that about 90 percent of all business income (pass through income plus three-quarters of C corporation income) already enjoys single layer tax treatment. Corporate integration would only affect the remaining ten percent.

Proposals to integrate the corporate tax, as suggested by Chairman Hatch (R-UT) and the Bush Treasury Department, would help the tax code catch up to the reality of business taxation today and should be included as a core part of tax reform.

Separating Pass Through & Individual Rates

One area of consensus among policymakers and the business community is ensuring that Main Street is treated fairly in tax reform. One means of doing this would be to establish a new, lower top rate on pass through businesses that is distinct from the top individual rate. But separating business and individual rates brings its own challenges, including how to ensure taxpayers don't recharacterize wage and salary income as profits to take advantage of the lower rates.

From S-Corp's perspective, creating a unique rate for pass through businesses requires two essential steps:

- First, you have to define the new pass through tax base correctly.
- Second, you have to include workable rules to reduce or eliminate the opportunity for individuals to recharacterize their wage and salary income as business profits.

The first of these challenges is fairly straightforward. A rate applying to pass through businesses should mirror the tax base for corporations and be broadly defined, embracing all the active business income earned by businesses organized as pass throughs. H.R. 116 sponsored by Representative Vern Buchanan (R-FL) is a nice example of how this could be done.

The second challenge is more problematic and has been with us since Congress eliminated the wage cap on Medicare taxes back in 1993. Exactly how do you distinguish returns from an owner's personal labor from returns on his/her investments in capital and employees? It's not easy and, more importantly, getting it wrong has the potential to completely undo the benefits of tax reform to Main Street businesses.

By way of example, a provision in the Camp tax reform draft would have established a strict, 70/30 ratio of wages to business profits for all pass-through businesses. The S Corporation Association and the rest of the Main Street business community opposed this provision, arguing that a fixed ratio recharacterizing business profits as wages was unfair and would hurt pass-through businesses with significant investments in employees and capital.

This same argument applies if the Senate were to apply the 70/30 rule to a framework similar to the House Blueprint. Ostensibly, the Blueprint has a top rate structure of 33 percent for wages, 25 percent

for pass through businesses, and 20 percent for C corporations. But applying the 70/30 test broadly to active owners would raise the top rate for S corps and partnerships to 31 percent, 11 percentage points higher than the rate applied to C corporations.

Moreover, the strict 70/30 rule has the potential to turn the Blueprint from a tax cut to a tax hike for many pass-through businesses. To understand the threat, look at how coupling the Blueprint with the 70/30 rule would affect this particular S corporation manufacturer.

Tax Reform Example -- S-Corp Manufacturer				
70/30 Approach	Current Law		Blueprint	
	S Corp	C Corp	S Corp	C Corp
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	$ 1,120,410	$ 1,102,537	$ 1,180,170	$ 898,422
* Assumes 25 percent of C corporation shareholders are fully taxable				

As you can see, not only does the 70/30 rule result in this manufacturer paying significantly more than a similar C corporation, it means the Blueprint could be an actual tax hike for this manufacturing company. Under current law, the shareholders pay $1.12 million in taxes. Under the Blueprint, they would pay $60,000 more. The Blueprint's lower rate is fully offset by the loss of state and local tax deductions, Section 199, and the ability to write-off interest expenses.

There are many other implications of imposing a strict, bright line test to pass-through rate enforcement, but the simple fact is that if Congress is going to establish a separate rate for pass-through businesses, it needs to get the enforcement challenge right. Getting it wrong means completely undoing the benefit of lower rates and the other pro-business provisions in the Blueprint.

S Corporations & Territorial

The business community is unified that tax reform should make U.S. businesses more competitive globally by reducing tax rates for C corporations and pass-through businesses alike. Similarly, reforms made to move the US away from its harmful worldwide tax system and towards a more competitive territorial system also need to apply evenly to C corporations and pass-through businesses.

Pass-through businesses of all sizes compete in a global marketplace in the same manner as C corporations. For many of these businesses, expanding their reach in foreign markets and increasing exports are key components of their growth plans. As with excessive tax rates, however, the tax code's treatment of international income hurts rather than helps these companies.

Specifically, S corporation shareholders are eligible for the Section 901 direct foreign tax credit, but not the Section 902 indirect foreign tax credit. An S corporation could elect to work through a controlled foreign corporation (CFC) and defer paying U.S. tax on its foreign income, but because of the 902 rules

the effect of that would be to treat any foreign taxes paid by the S corporation as a deduction rather than a credit. In order to be fully credited with the foreign taxes they have paid, most S corporations organize their foreign operations as branches and have their worldwide income subject to U.S. tax on a current basis only. In most cases, deferral simply is not a viable option.

Since, through necessity, pass-through businesses primarily operate using foreign branches, we recommend that the transition to territorial be made available to foreign branches as well as CFC's. Applying a territorial tax system to foreign branches should not be overly difficult. A number of foreign countries, including the United Kingdom and Australia, already allow territorial taxation for branches by treating such foreign branch distributions the same way they treat dividends from separate corporate entities.

This deemed treatment of foreign branch earnings should not present an administrative burden either, as S corporations are already required to make the income and loss calculations necessary to conform to territorial treatment. S corporations already track the separate income, expense and distributions of foreign branches when they calculate their foreign tax credits. They also are required to calculate any section 987 gains or losses with respect to their foreign branches.

The S Corporation Association believes closely-held pass through entities should be allowed territorial taxation to be more competitive with their foreign competitors in the same way that subchapter C corporations will be made more competitive by territoriality. [4]

Estate Tax Repeal & Section 2704

The estate tax effectively forces a family business to buy back a portion of the company from the federal government every generation. This tax burden is in addition to the high income tax rates pass through businesses already pay, and it falls on the one of the primary engines of growth and job creation in the economy.

Advocates of the estate tax argue that it helps raise revenue while reducing income inequality. It does neither to any significant degree, but as a tax on capital, it does hurt investment and job creation while making life more difficult for families when their father or mother dies.

Earlier this year, the S Corporation Association joined several other trade groups to release a new study highlighting the contributions of these family businesses to the American economy. The study found that family-controlled businesses are a significant source of earnings and employment in the US economy. According to the study:

- Large family businesses account for 31.8 percent of U.S. business revenues, 30.7 percent of U.S. private employment, and 31.1 percent of U.S. payrolls.

[4] In the event that closely help pass-through entities are not eligible for territorial taxation, a one-time exemption should be provided to allow pass-through entities to restructure their foreign operations into CFCs to become eligible for territorial taxation without incurring potential outbound incorporation costs under section 367.

805 15TH STREET, NW SUITE 650 • WASHINGTON, DC 20005 • PHONE: (202) 466-8700 • FAX: (202) 466-9666
WWW.S-CORP.ORG

- Large family businesses have less employee turnover, leaner cost structures, and smaller debt burdens; they also invest at higher rates and over longer time horizons than comparable non-family businesses.

Despite these contributions, the tax code continues to target these businesses for higher taxes through the estate tax. The challenge of the estate tax is easy to identify – nobody knows when they are going to die, very few people know exactly how much their estate is worth, and even fewer have the liquid assets on hand to pay the tax. This uncertainty results in excessive and often wasted tax planning costs. A simple solution would be to trade the estate tax for a capital gains tax applied when the assets are sold. Such an approach would be more humane and it would eliminate the uncertainty and expense of the estate tax.

While Congress debates the estate tax, another action the Senate could take would be to encourage Treasury to withdraw the harmful Section 2704 rules proposed back in August of 2016. These rules would preclude family business from taking control and marketability into account when transferring the company from one generation to the next. The result would be to raise estate and gift taxes on them by 30 percent or more.

Regarding Section 2704, our recent study found that:

- Limiting valuation discounts under the Proposed Rule would increase estate taxes for large family businesses by $633.3 billion, in present discounted dollars, over the next 46 years.

- To prepare for this additional burden, these businesses would divert resources, equivalent to the additional tax they will owe, from their normal business investments.

- The projected reductions in their investments in equipment and machinery would reduce GDP growth, in 2016 dollars, by $2,476 billion from 2016 to 2062.

- This slower growth also would reduce job creation over the next decade by 105,990 jobs.

Withdrawing the Section 2704 rules is an easy fix that will help the economy and save jobs. Repealing the estate tax entirely would be even better.

S Corporation Modernization

Lowering rates, moving to territorial, and repealing the estate tax are not the only way tax reform can help S corporations. Since their creation in 1958, S corporations have grown to become the dominant form of private business. Despite this popularity and commensurate contribution to investment and jobs, the S corporation structure is extremely rigid, especially when compared to the partnership rules. Subchapter S limits the number of shareholders, the types of shareholder, and the classes of stock an S corporation may have. None of these limitations apply to partnerships and limited liability companies. As noted in a recent letter signed by 18 trade associations:

These outdated rules hurt the ability of S corporations to grow and create jobs. Many family-owned businesses would like to become S corporations, but the rules prevent them from doing so. Other S corporations are starved for capital, but find the rules limit their ability to attract investors. Well into the 21st century, America's most popular form of business organization deserves rules adapted to today, not fifty years ago.

Accordingly, we strongly support implementation the S Corporation Modernization Act (S. 711), as introduced by Senators John Thune (R-SD) and Ben Cardin (D-MD). This legislation would:

- Allow Nonresident Aliens to Own S Corporations through an ESBT: Nonresident Aliens are not allowed to own S corporation shares, closing off foreign investment as a source of capital. This provision allows nonresident aliens to invest in S corporations indirectly as the beneficiary of an ESBT. The Act will not allow for tax avoidance. ESBT rules ensure that all taxes are paid at the trust level and at the highest applicable tax rate.
- Modify Passive Income Rules: The excess passive investment tax is a corporate-level penalty levied against S corporations on their passive income (e.g. rents, royalties, interest and annuities) that exceeds 25 percent of the S corporation's gross receipts. The Act would raise this threshold to 60 percent of gross receipts and eliminate the "three strikes and you're out" penalty, consistent with recommendations made by the Joint Committee on Taxation and the rules that apply to C corporations.
- Charitable Contributions for ESBTs: Current law does not allow electing small business trusts to deduct certain charitable contributions attributed to an S corporation, even though individual shareholders of the S corporation are eligible for the deduction. The Act would allow electing small business trusts to deduct these charitable contributions.
- Basis Step-up for S Corporation Assets: Individuals who inherit appreciated shares in an S corporation are treated differently than those who inherit interests in a partnership because there is no election available to adjust the inside basis of the S corporation's assets. The Act would provide greater parity for S corporations by allowing an election to adjust the inside basis of the S corporation's assets upon the death of an S-corporation shareholder. S-Corp is working with our sponsors to revise and expand this provision to address additional transfers of assets.
- Streamlined Procedures for S Corporation Elections: The Act would simplify the election process by permitting a corporation to elect on its income tax return to be treated as an S corporation for the tax year to which the return relates, provided that the return is filed by the applicable due date (with extensions).

In addition to these provisions, other reforms that would ease the governance of S corporations include increasing the current limit on the number of S corporation shareholders, removing limits on the types of S corporation shareholders, and allowing S corporations to have more than a single class of stock. Such reforms would increase the ability of S corporations to grow and raise capital, as well as to ease their transition from one generation to the next and to improve day-to-day management of the business.

Conclusion

The S Corporation Association appreciates the opportunity to comment on these issues and strongly supports efforts to enact comprehensive tax reform that lowers rates and broadens the base.

Consistent with the principles listed above, we call on the Senate to enact comprehensive reform that lowers the top rates on individuals, pass-through businesses, and corporations alike while continuing to reduce the harmful double tax on corporate income. Reform that is consistent with these principles and the other policies listed above will help achieve the goal of making the tax code more simple and fair, while helping to make American businesses more competitive.

805 15TH STREET, NW SUITE 650 • WASHINGTON, DC 20005 • PHONE: (202) 466-8700 • FAX: (202) 466-9666
WWW.S-CORP.ORG