S Corporations & Tax Reform

January 16, 2018

S CORP
DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES

S-Corp Monthly Member Call

Tax Reform Overview - Corporations

- If you view the tax bill as "corporate tax reform" designed to reinvigorate the economy and instill some animal spirits, it has to be considered a major success
- The markets certainly like the bill – the DOW is up 2300 points since the Senate passed its budget resolution calling for a big tax bill on October 19th
- Meanwhile, Walmart, Comcast, AT&T, B of A, Wells Fargo, JetBlue and many others have announced tax cut related bonuses and wage hikes for their employees

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Tax Reform Overview – Pass-Throughs

- But what about for Pass-Through Businesses & Families? The answer there is much more complicated
- Start with the fact that pass-through businesses face multiple effective top rates
  - Rates vary by industry, payroll, participation levels of the owners, and the location of business

S Corporation Effective Marginal Rates				
Specified Service Business		**No Income Tax State**	**Average-Income Tax State**	**High Income Tax State**
	Active Shareholder	37.0%	39.0%	41.0%
	Inactive Shareholder	40.8%	42.8%	44.8%
Non-Specified Service Business				
	Active Shareholder	29.6%	31.6%	33.6%
	Inactive Shareholder	32.7%	34.7%	36.7%

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Tax Reform Overview – Pass-Throughs

- Add to that the fact that Congress retained the Individual AMT , Estate Tax, and Net Investment Income Tax
  - Congress had a chance to vastly simplify taxation for pass-through businesses by eliminating these additional tax codes
  - They eliminated the corporate AMT -- but chose not to do the same for the individual AMT
  - Meanwhile, the estate tax relief is temporary and expires in 2026
- And then consider the revenue raisers included in the final bill:
  - These raisers apply to both C and S corporations, but with pass-through businesses paying a higher marginal rate, S corporations get hit harder

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Tax Reform Overview – Pass-Throughs

- And finally, the pass-through deduction is temporary!
  - The new pass-through deduction goes away after 2025, but the revenue raisers in the bill are permanent
- Moreover, the combination of complex new rules and sunsets makes planning extremely difficult
- Consider an S-Corp with high levels of projected cap-ex:
  - Expensing now would push the S-Corp's tax liability into the future
  - But the pass-through tax rate reverts back to 39.6% in 2026
  - Do they expense now and convert later, convert now and expense, stay as an S corporation and use standard depreciation?
- The questions are endless

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Tax Reform Overview – Pass-Throughs

- It could have been worse!
- S-Corp worked with its allies and several key Hill offices to win improvements to the original tax reform bills
- Senators Johnson (R-WI), Daines (R-MT) and Inhofe (R-OK) in particular led the way in getting key changes made, including:
  - An increased pass-through deduction
  - A lower individual top rate
  - Preserved IC-DISC benefits
  - Expanding the deduction to include trusts and estates
- These changes should enable many S corporations to remain as S corporations in the future

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Tax Reform Overview

- The result was a bill that was significantly improved
  - Note: Assumes the second layer adds 5% to the corporate tax. Does not include most of the base-broadening in the bill

S-Corp Exporting Manufacturer	**Prior Law**	**Senate Bill**	**Final Law**	**C Corporations**
Top Marginal Rate	39.6%	38.5%	37.0%	21.0%
Pass-Through Deduction	0.0%	-6.7%	-7.4%	0.0%
IC-DISC Repeal	0.0%	4.4%	0.0%	0.0%
SALT Deduction Limitation	0.0%	2.5%	2.5%	0.0%
3.8% Affordable Care Act Tax	3.8%	3.1%	3.1%	0.0%
1.2% Pease Limitation	1.2%	0.0%	0.0%	0.0%
Corporate Shareholder Taxes	0.0%	0.0%	0.0%	5.0%
Effective Marginal Rate	**44.6%**	**41.8%**	**35.2%**	**26.0%**

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Tax Reform Overview

- Final Check-List:

	Original Bill	Final Bill	Corporate
Size & Rate	17.4% (31.8%)	20% (29.6%)	21%
Trusts & Estates	No	Yes	Yes
IC-DISC	No	Yes	Yes
Territorial	No	No	Yes
SALT Deductions	No	No	Yes
Large Services Corporations	No	No	Yes
Small Services Buinsesses	Yes	Yes	Yes
REITs, PTPs, Coops	Yes	Yes	Yes
Limited to % of Payroll & Capital	Yes	Yes	No
Limited to Domestic Income	Yes	Yes	No
Engineers & Architects Qualify	No	Yes	Yes
Permanent?	Yes	No	Yes

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<u>S-Corp's Top Five Concerns with Tax Reform</u>

- So the final law is much improved, but many challenges remain
- From S-Corps perspective, the top five remaining issues with the new law are:
  1. The 20-percent deduction is inherently unstable and falls well short of rate parity
  2. S corporations are precluded from deducting SALT
  3. The international provisions exclude S corporations
  4. The 3.8 percent NIIT remains in place
  5. Pass-through provisions are temporary!
- For today's call, we will focus on the first two – challenges with the new deduction and the new SALT limitation

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Pass-Through Deduction

- Why is the new deduction “unstable”?
  1. First, it’s a deduction and not a rate
     - Deductions are different than rates – they are viewed as loopholes and they have a tendency to be limited by industry, income, etc.
  2. Second, the proposed enforcement is uneven and could result in abuse by taxpayers under the new income thresholds
  3. Third, its temporary!
     - We have another fiscal cliff on our hands
- So we begin the year with a deduction that’s going to need some help. How does it work?

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Pass-Through Deduction

- Section 199A creates a new 20% deduction on "qualified business income" (QBI). What qualifies as QBI?
- For all pass-through business owners, QBI excludes compensation-like payments, including:
  - Any "reasonable compensation" or other payments paid to an owner for services rendered, including guaranteed payments paid to a partner for their services to the firm
- Approach is similar to the existing "reasonable comp" rules
  - Problem: "Reasonable Compensation" rules are not considered effective
  - Increased enforcement relies on a "substantial understatement" penalty for understating income by 5% points or more

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Pass-Through Deduction

- For business owners above the taxable income threshold (315k for joint filers), certain industries are excluded:
  - The law includes a new “specified service business” definition that includes a list of disqualified industries plus where the businesses’ “principle asset is the reputation or skill of a single employee”
  - The specified service business definition is similar to the “personal services corporation” definition, but its expanded to include athletes, brokerage services, etc.
- We expect this new definition to be highly contentious and litigated endlessly

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<u>Pass-Through Deduction</u>

- Owners above a new income threshold who are not “specified service businesses”, the deduction is limited to:
  - 50% of company payroll; or
  - 25% of company payroll plus 2.5% of qualified capital
- These “guardrails” are not perfect but they do have the advantage of tying the deduction to jobs and investment
  - They also do not rely on distinctions based on industry or income – if you create jobs and invest, you get the deduction
  - It’s a more straight-forward approach and its tied to the underlying goal of the tax bill – to promote jobs and investment

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Pass-Through Deduction Challenges

- The new deduction poses many challenges to the pass-through community, but S-Corp is going to focus on two key issues:

1. Gaming: Taxpayers under the income thresholds have a strong incentive to game the system
   - S-Corp intends to work with tax writers to ensure the deduction is reserved for real businesses and real profits
2. Consolidating or Grouping: Taxpayers with multiple businesses are able to group those businesses together on one return to ease reporting and tax compliance
   - S-Corp plans to work with tax writers to ensure that owners have the ability to use grouping with regard to the new deduction as well

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Pass-Through Businesses & SALT

- Despite assurances that "State and local taxes incurred in a trade or business remain deductible for all types of entities," the new law ends deduction for most state and local income taxes on pass-through business income
- The simple way to think about it is this:
  - If the business pays the tax, it remains deductible
  - If tax is paid by the owner, it is not deductible
- Because most state and local taxes paid on S Corporation income are paid at the shareholder level, they would not be deductible under this language

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<u>Pass-Through Businesses & SALT</u>

- The confusion arises because some states tax income at the entity level
- For example, one of our members operates in 36 states
- Of those, 28 have income taxes levied at the individual level
  - These taxes average 5.7% and would not be deductible under the law
  - A 37% top rate means they add 2.1% to the company's average effective tax rate
- Meanwhile, eight states tax income at the entity level
  - Those taxes remain deductible, but they average just 1.8%
- Bottom Line: The new law allows S corporations to deduct some state and local income taxes, but the vast majority of these taxes would NOT be deductible

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Pass-Through Businesses & SALT

- This is a big deal! As noted, the inability to deduct most state and local income taxes significantly increases the effective rate on these businesses
  - It also creates a huge disparity in effective rates based on where a business is located and/or operates
- To address this new issue, S-Corp has a two-step plan:
  1. First, work with friendly Hill offices and our association allies to introduce a legislative fix. C corporations continue to deduct all state and local taxes – pass-through businesses should get that too
  2. Second, work with State legislatures to adjust their rules – under the new law, taxes paid at the entity level are deductible. States should give their businesses the option of paying taxes at the entity level to get the deduction

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Action Items

- Bottom Line: Many challenges remain for pass-throughs and S-Corp will be working on those issues moving forward
- Today, we wanted to focus on the two at the top of our list:
  1. Making sure the new deduction is real, workable, and sustainable; and
  2. Leveling the playing field for pass-through businesses on SALT deductions
- For next steps, we are:
  1. Working with our Parity for Main Street Employers coalition to educate Congress as to the tax bill's realities and how it effects pass-through businesses; and
  2. Meeting with key Hill and Administration offices to work through the implementation challenges of the deduction and how to best treat pass-through businesses

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Action Items

- Finally, we want to say thanks to our S-Corp members
- Over the past three months, we called on you repeatedly to speak up for the pass-through community, and you responded:
  - Our congressional allies were able to win improvements to the bill because every member of the tax committees heard from multiple businesses in their states and districts
  - This outreach meant the difference between failure and success
- So lots of challenges remain, but with the support of our membership, I'm confident we will continue to succeed in making the world safe for family businesses and S corporations

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