S-Corp Monthly Member Call

November 14, 2017

S CORP

DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES

S-Corp Monthly Member Call

S Corporation Association Member Calls

- Welcome to the November S Corporation Association Member Call
- We host these calls once a month to keep our membership informed on issues of specific importance to the S corporation community
- Be sure to put future calls on your calendar – we will be hosting our next two calls on:
  - Tuesday, December 12th at 2pm Eastern Time
  - Tuesday, January 9th at 2pm Eastern Time
- Today's agenda is the Senate tax reform bill its implications for S corporations and the rest of the pass through business community
- This legislation will make significant changes to pass through tax rules, so S corporations need to pay attention!

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House & Senate Bills

- Both the House and Senate bills make significant changes to the taxation of US businesses – for C corporations, the bills offer:
  - A top rate of 20%
  - 5-years for full expensing
  - Territorial tax treatment on international income
  - Numerous base broadening provisions, including limits on interest deductibility and the elimination of numerous deductions and credits
- For pass through businesses, the Senate bill is a little more complicated:
  - The new top rate would range from anywhere between 32% and the mid-40s
  - Pass throughs are precluded from territorial treatment
  - Pass throughs are subject to the base broadening provisions applying to C corporations, but to several additional ones as well

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Senate Pass Through Deduction

- The Senate Bill would cut the rate paid by C Corporations from 35% to 20%, effective 2019
- For Pass through businesses, the Senate bill would 1) lower the top individual rate to 38.5 percent and 2) include a new business deduction equal to 17.4%, resulting in a possible top rate for some pass through businesses of 31.8%
- Several limitations apply –
  - A broad definition of personal services businesses would be able to access the deduction, but only up to $150,000 for married couples – personal service business owners with incomes above $200,000 would not get the deduction
  - The deduction is limited to 50% of the firm's payroll
- How does the deduction work?

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Deduction Example

- Deduction limited by 50% of total W-2 wages paid by the entity
- Assume an S Corp has $3000 net income with $900 in total W-2 wages paid and owner A holds 33% of S Corp stock
- With Owner A's $1000 share of the pass-through income, his preliminary deduction is $174. That is weighed against 50% of his share of the total W-2 wages, which is $300 * 0.5 = $150
  - The wage limit is lower than the preliminary deduction, so Owner A may claim a pass-through business deduction of $150.
  - Instead of a 31.8% rate, this taxpayer would be subject to a 34.2% rate
- If S Corp had $1500 in total W-2 wages, Owner A's preliminary deduction of $174 would be weighed against 50% of his share of the total W-2 wages, which is now $500 * 0.5 = $250
  - In this case, Owner A would be able to deduct the full $174.

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Effects of Deduction on Pass Thru Rates

- Other changes in the bill would help drive up the rate from 31.8%
- The loss of the state and local income tax deduction and the 3.8% NIIT on inactive shareholders results in a remarkable variety of top rates applying to S corps:

Non-Personal Service	**S Corporation**			**C Corporation**
S Corporation	No Income Tax State	Average Income Tax State	High Income Tax State	
Active Shareholder	31.8%	34.3%	36.8%	20.0%
Inactive Shareholder	35.6%	38.1%	40.8%	20.0%

- Personal service S corps face even higher rates:

Personal Service	**S Corporation**			**C Corporation**	
S Corporation	No Income Tax State	Average Income Tax State	High Income Tax State	House	Senate
Active Shareholder	38.5%	41.0%	43.5%	25.0%	20.0%
Inactive Shareholder	42.3%	44.8%	47.3%	25.0%	20.0%

- These rates are then applied to a broader base of business income

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Base Broadening Provisions

- The Senate bill includes extensive base broadening, much of it affecting both C corporations and S corporations
- But many of these base broadening provisions apply to pass-through businesses only:
  - Loss of State & Local income tax deductions
  - Pass Through Loss Limitation
  - Prohibiting deductions of investment related expenses
  - DISC Repeal
- Moreover, *all* the base broadening will hurt S corporations more, since their marginal rate is so much higher than the C corporation rate. The loss of a $1 deduction will cost C corporations just 20 cents, whereas it will cost an S corporation up to 40 cents or more
- Here are some of the major base broadening provisions in the bill

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Base Broadening Provisions: Active Business Loss Limitation

- The Senate bill includes a $176 billion limitation on excess pass through business losses. Target is individuals active in their business and whose business throws off relatively large losses
  - Passive losses of individuals already are limited under the current-law passive loss rules
  - Limits losses to $250,000 for singles and $500,000 for married filing jointly (indexed)
  - Losses below the limits can offset current-year non-pass-through income (i.e., investment income and wage income)
  - Losses above the limits are carried forward and treated as part of the taxpayer's net operating loss carryforward in subsequent taxable years, just like a C corporation
- This provision is wholly new with no explanation for why its in the bill
  - One possible explanation is to put pass through businesses on an equal footing with C corporation treatment of NOLs
  - This "leveling the playing field" approach is missing from the rest of the bill

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Base Broadening: State & Local Income Tax Deduction

- Both the House & Senate bills appear to preclude pass through businesses from deducting state and local income taxes owed on their pass through income – C corporations would continue to deduct these taxes
- The write up on the House & Senate bills is wholly unclear on this point:
    - State and local taxes incurred in a trade or business remain deductible for all types of entities (Hatch's mark, p 23)
- Our reading (we have asked many times with no response) is that state & local property and sales taxes paid at the entity level are deductible, but business-related taxes deductible at the shareholder level are not
- As noted previously, disallowing state & local income tax deductions has a significant impact on the marginal rates paid by pass throughs
- This remains a problem in both the House and the Senate

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Base Broadening: Interest Deductibility Limitation

- Interest exceeding 30% EBI would not be deductible for businesses with gross receipts above $15 million under the Senate bill
- Here's how it works:

	House (EBITDA)	Senate (EBI)
NBI	5000000	5000000
Depreciation & Amortization	6000000	NA
Interest	4000000	4000000
Total	15000000	9000000
Interest Cap (30%)	4500000	2700000
Adjusted Business Income	5000000	6300000
Effective Marginal Rate	0%	26%

- Provision has the potential to raise effective marginal rates of affected businesses dramatically, even above 100 percent of earnings
- Provision is pro-cyclical, hurting businesses in bad years

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Base Broadening Provisions: Section 199 Deduction ($81b)

- Section 199 allows producing businesses to deduct up to 9% of their qualified production income, limited to 50% of the business' payroll
  - Qualified production activities are defined to include manufacturing, mining, electricity and water production, film production, and domestic construction, among other activities.
- The vast majority of businesses in these industries are organized as pass through businesses
  - For example, there are about 400,000 pass through manufacturers, compared to about 80,000 C corporation manufacturers
- The repeal of 199 has the effect of raising effective marginal rates on affected businesses by up to 3 percentage points.

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Territorial & DISC Repeal

- Finally, the bill moves C corporations into a new territorial international tax regime, but it precludes S corporations from taking part
- It also repeals the IC-DISC tax benefit closely-held exporters rely on
- This repeal has little effect on C corporations, as the new territorial system taxes C corporation income almost exactly as the IC-DISC system does now
  - The foreign earnings would be subject to foreign tax, and then a single additional layer of tax at the dividend rate when dividends are paid to the shareholder
  - The only difference would be that the dividends can be paid directly to the shareholder, rather than through the DISC
- Since S corporations are excluded from the new territorial system, they will be harmed by this repeal. They lose the benefit of the DISC, but also are precluded from the benefits of territorial

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Other Tax Relief

- To be fair, there are significant tax relief provisions in the bill, including:
- Estate Tax Relief: Senate bill doubles the estate tax exclusion to $10 million (indexed)
- AMT Repeal: The bill repeals the individual (and corporate) AMT, benefiting a large number of pass through businesses
  - This benefit is muted, if no fully overset by the fact that the bill also eliminates most of the deductions disallowed under the AMT (personal exemptions, SALT, investment expenses, etc.)
  - The result is under the Senate bill, the tax code generally replicates AMT treatment, only at higher marginal rates
- Expensing: Five years of full expensing is another benefit under the bill, particularly for those businesses not eligible for 179 expensing

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Asks

- So those are the challenges – the Senate bill offers C corporations a clean, 20 percent rate on all active C corporation income but for pass through businesses, it's a bit of a mess
- What are our asks?
    1. Increase the pass through deduction to restore parity with C corporations!
    2. Allow pass throughs to deduct State and Local income taxes – they are legitimate business expenses and the disallowance results in higher effective marginal rates
    3. Allow pass throughs territorial treatment, or at the least preserve the DISC for pass through businesses -- the net result is basically the same
- These changes would go a long way towards leveling the treatment of pass through businesses and C corporations, and bring it into alignment with the Framework endorsed by the Senate and House

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Action Items

- What can you do to help?
- Good news! We have allies in the Senate willing to fight for a better deal for pass through businesses, but they need your support
  1. Calculate what the Senate bill means to your business
  2. Communicate your concerns to your Senators!
  3. Let us know, so we can follow up with sympathetic offices and add them to the team
- S-Corp is only as effective as its membership, so we need you involved and informed!
- And time is short! The Finance markup ends this week, so your Senators need to hear from you now!

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