S-Corp Monthly Member Call

October 17, 2017

S CORP

DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES

S-Corp Monthly Member Call

S Corporation Association Member Calls

- Welcome to the October 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, November 14th at 2pm Eastern Time
  - Tuesday, December 12th at 2pm Eastern Time
- Today's agenda is tax reform and its implications for S corporations and the rest of the pass through business community
- S-Corp President Brian Reardon will walk through the issues, followed by a period for questions and comments

S-Corp Monthly Member Call

The BIG Picture

- As Tax Reform progresses, don't lose sight of the BIG Picture!
- One year ago, S-Corp was fighting the 2704 family valuation regulations proposed by the Obama Treasury on August 4^{th}, 2016:
  - These proposed rules had the potential to increase estate and gift taxes by 30% or more
  - They literally threatened the succession plans of every sizable S corporation in the country
- In response, S-Corp:
  - Organized the broader business community
  - Drafted and submitted extensive comments opposing the rule
  - Testified before the IRS in opposition
- That was one year ago..

S-Corp Monthly Member Call

The BIG Picture

- Today, the 2704 regulations are dead
- Treasury announced that it was going to withdraw the proposed rules as part of a broader review of harmful Treasury regulations
  - The change in administrations has resulted in a complete change in approach on regulatory matters
- The same goes for tax policy –
  - One year ago, we were fighting over tax hikes and corporate-only tax reform
  - Now we're engaged in a reform that, done correctly, promises to reduce tax rates on C corps and pass through businesses alike
- It's a significant improvement, but there are still many challenges confronting the pass through community
- Here's an overview of the tax reform effort, and what S-Corp is doing to protect the interests of its members and the broader pass through community

S-Corp Monthly Member Call

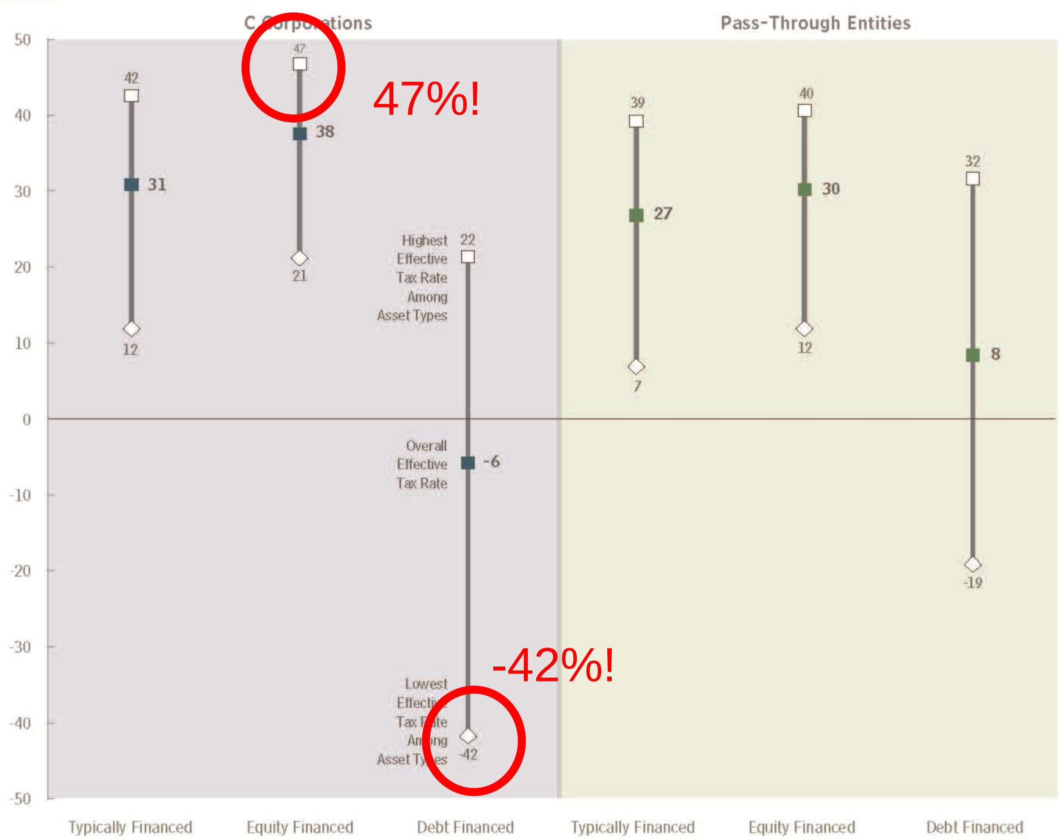
Business Tax Reform – The Basic Challenge

These long lines are the problem…

S-Corp Monthly Member Call

Business Tax Reform – The Basic Challenge

Range of Effective Tax Rates by Form of Organization and Source of Financing

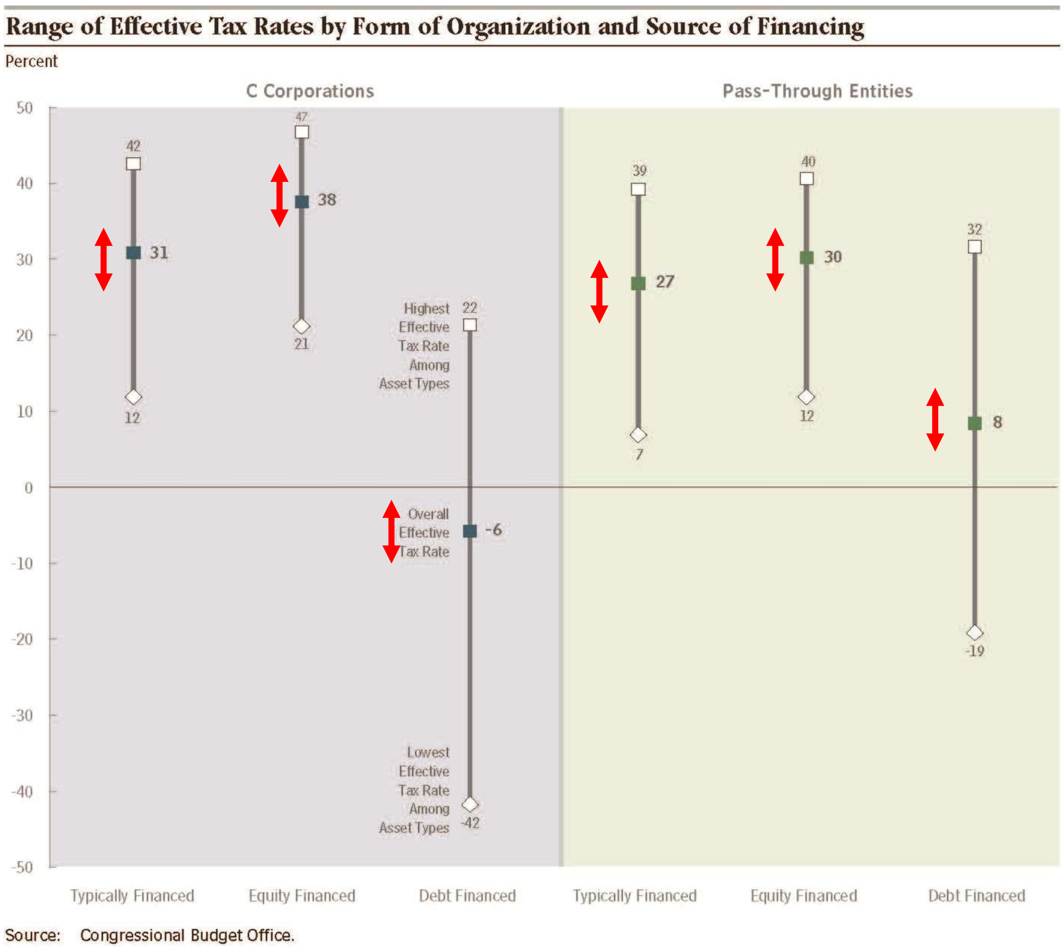


Source: Congressional Budget Office.

They are all over the place! One asset faces an effective tax rate of 47%, while another is negative 42%!

S-Corp Monthly Member Call

Business Tax Reform – The Basic Challenge

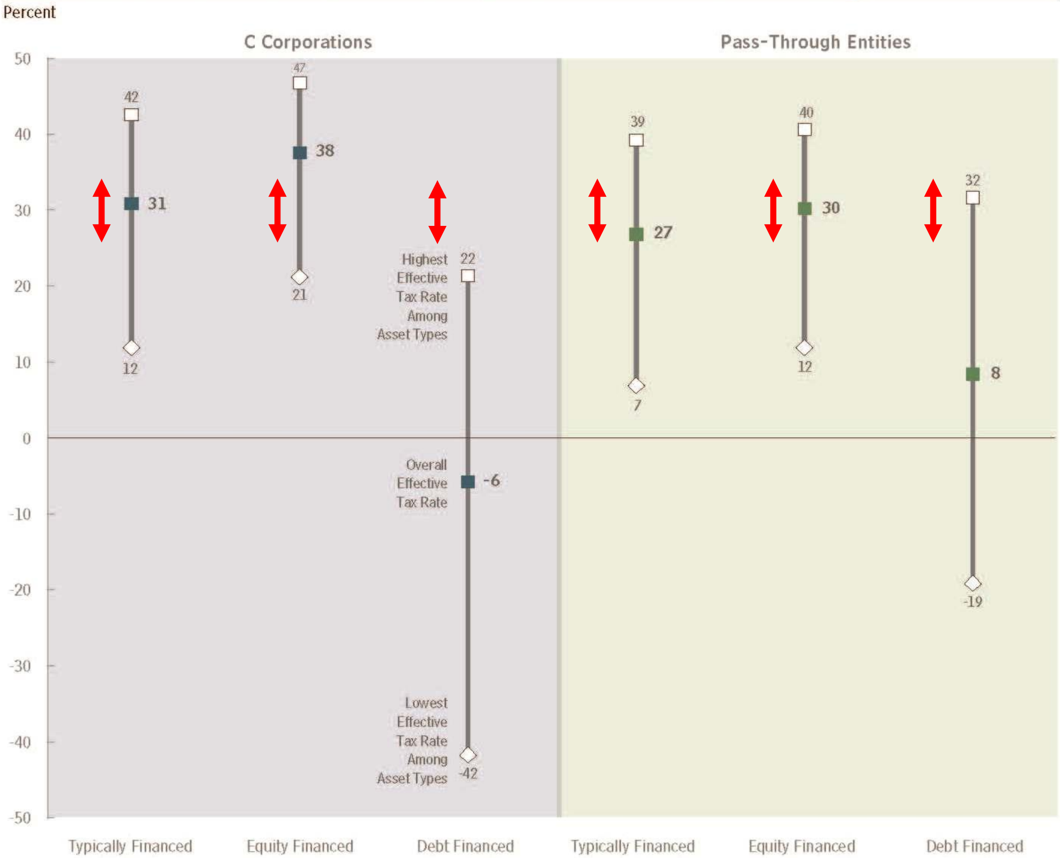


Done correctly, tax reform would shorten the lines…

S-Corp Monthly Member Call

Business Tax Reform – The Basic Challenge

Range of Effective Tax Rates by Form of Organization and Source of Financing



Source: Congressional Budget Office.

…and level out tax burdens so that all investments face a similar level of tax.

S Corporations & Tax Reform

Tax Reform – The Basic Challenge

- So how do you level the effective rates?
- The optimal reform would apply the same, reasonable tax rate to all forms of income – corporate, pass through, individual – while eliminating the double tax on corporate income
  - The result would be a profoundly simpler Tax Code and a leveling of the tax burden on equity verses debt
  - This would eliminate a huge amount of economic diversion and distortion caused by the current Code
- Since 2011, the pass through community has argued for reform that 1) is comprehensive, 2) restores rate parity, and 3) eliminates the double corporate tax
  - In 2016, 120 business groups signed onto these principles
- Unfortunately, that's not on the table so we are on to Plan B

S Corporations & Tax Reform

Tax Reform – Framework

- The Framework creates a new, lower pass through rate five percentage points above the C corporation rate
- Here's a simple example of the result:

Tax Reform Example -- $80m Manufacturer

Framework on S Corps	S Corp	C Corp	Framework - S	Framework - C
Income	3500000	3500000	3500000	3500000
Section 199	*315000*	*315000*		
State Tax	*175000*	*175000*		*175000*
Local Tax	*70000*	*70000*		*70000*
Taxable Income	2940000	2940000	3500000	3255000
Tax Rate	39.6%	35%	28.8%	20%
Tax	1164240	1142705	1008000	805938

* Assumes 25 percent of C corporation shareholders are fully taxable

* S corporation has non-active Shareholder in the top rate

S Corporations & Tax Reform

Pass Through Businesses v. C corps

- Difference in effective rates for C corps and pass through businesses on the chart is 31 percent v. 27 percent – that's pretty close
- Reality is its closer – the chart groups sole props with S corps and partnerships, dragging down their effective tax:
  - Sole Prop: 15%
  - C corps: 27%
  - Partnerships: 29%
  - S Corporations: 32%
- Conventional wisdom is that C corps pay the highest effective tax rates – this is simply not true! Large S corps pay the highest effective rate: 35 percent
- What about the double corporate tax?

Source: Quantria Strategies, LLC

S Corporations & Tax Reform

Pass Through Businesses v. C corps

- Difference in effective rates for C corps and pass through businesses on the chart is 31 percent v. 27 percent – that's pretty close
- Reality is its closer – the chart groups sole props with S corps and partnerships, dragging down their effective tax:
  - Sole Prop: 15%
  - C corps: 27%
  - Partnerships: 29%
  - S Corporations: 32%
- Conventional wisdom is that C corps pay the highest effective tax rates – this is simply not true! Large S corps pay the highest effective rate: 35 percent
- What about the double corporate tax?

Source: Quantria Strategies, LLC

S-Corp Monthly Member Call

The Framework and the Pass Through Rate

- Some argue that the Pass Through rate should equal the double tax imposed on C corps:

C Corp Rate	20 percent
Shareholder Rate	23.8 percent
Combined Rate	39.4 percent

- But this calculation assumes all C corp earnings are subject to the double tax immediately – this simply isn't true:
  - Three-fourths of C corp shareholders are tax exempt or tax advantaged
  - The shareholder tax can be deferred indefinitely
- The double tax increases effective taxes on C corps, but only at a fraction of the statutory rate

S-Corp Monthly Member Call

Why is the C Corp Rate Lower?

- Lower Rates: C corps are taxed at lower top rates than S corps – 35 percent verses more than 40 percent
- Tax Exempt Shareholders: Tax Policy Center estimates 75% of C corp shareholders are tax exempt or tax advantaged
- Deferral: C corps can indefinitely defer repatriating oversea income. S corps would have to sacrifice foreign tax credits, so deferral isn't an effective strategy for them
- Base Erosion Practices: C corps can shift income overseas to avoid high US tax rates. For S corps, no deferral means no base shifting
- Less Aggressive AMT: The Corporate Alternative Minimum tax is not as aggressive as the Individual AMT that applies to S corporations

S-Corp Monthly Member Call

Tax Reform – The Basic Challenge

- The optimal reform would follow the S corp model
- It would apply the same, reasonable tax rate to all forms of income – corporate, pass through, individual – while eliminating the double tax on corporate income
  - The result would be a profoundly simpler Tax Code and a leveling of the tax burden on equity verses debt
  - This would eliminate a huge amount of economic diversion and distortion caused by the current Code
- Since 2011, the pass through community has argued for reform that follows this model
  - In 2016, 120 business groups signed onto these principles
- Unfortunately, that's not on the table so we are on to Plan B

S-Corp Monthly Member Call

Tax Reform – Framework

- Businesses do better under the Framework, but it is no giant giveaway. The base broadening provisions will offset much of the rate reduction
- Key Points:
  - Calculations take into account the second layer of tax on C corpss, using the national average of fully taxable C corps shareholders of 25 percent
  - They do not include expensing assumptions
  - Results assume the owner receives the full benefit of the lower, 25 percent rate for pass through businesses called for in the Framework.
- Enforcement provisions like the Camp 70/30 rule have the potential to completely eliminate the value of these lower rates
  - The combination of the 35 percent personal rate, retaining the 3.8% NIIT, and the recharacterization of profits has the potential to wipe out any tax benefit of the lower rate
- Getting enforcement right is the key to preserving the benefit of the pass through rate

S-Corp Monthly Member Call

Framework's Pass Through Rate and Enforcement

- The Framework's new pass through business tax rate requires the tax code to:
  1. Define the pass through business tax base appropriately; and
  2. Distinguish between income from an owner's labor and income from his or her ownership of the business
- The first challenge is easy –
  - Pass through rate tax base needs to be broad and include all forms of active business income. Legislation introduced by Rep. Buchanan (HR 116) does a nice job of defining the tax base:

    QUALIFIED BUSINESS INCOME.—The term 'qualified business income' means all items of income, deduction, loss, or credit properly attributable to the taxpayer from the ***active conduct of a trade or business…***
- Second challenge – not so easy

S-Corp Monthly Member Call

Questionable Rate Enforcement Ideas:

1. A fixed rate of return on a business's capital
   - Requires an accurate measure of capital (or more accurately, the arms-length appraisal of a business's worth); and
   - Requires an assumption of a reasonable rate of return
2. Excluding certain industries, like personal services corporations:
   - Requires a statutory definition of personal services corporations
   - Ignores variation within those industries
   - Ignores complexities like services businesses that also sell products
3. Reserving the lower rate for retained capital
   - Effectively applies the corporate double tax to S corporations
   - Tax reform should move away from the double tax, not towards it
4. Fixed 70/30 Ratio from the Camp Draft
   - Fixed ratio discriminates against capital intensive businesses and those with lots of employees

S-Corp Monthly Member Call

Proposed Three Step Process

- Our goal is something more flexible that targets those businesses with both the incentive and the ability to game the system
- Step One: Exclude Inactive Owners
  - Owners who do not participate in the business obviously earn all of their income from their ownership
  - None of their income would be subject to recharacterization as wages
- Step Two: Exclude Arms Length Compensation Structures
  - Businesses with both active and inactive owners (not in the same immediate family) and a requirement for pro-rata allocations of income (such as the S corporation single class of stock rule) should be treated separately
  - No active owner is going to forego a $1 worth of income in order to save 14 cents on their taxes

S-Corp Monthly Member Call

Step Three: Test for Active Owners

- Personal services corporations and other services businesses are characterized by owners who materially participate in the business and whose services are a significant source of the businesses revenues
  - John Edwards’ work as an attorney was responsible for 100 percent of his S corporation’s revenues
- The Framework could test for businesses that fit that description, and then apply more rigorous tests to ensure they pay reasonable wages
- Benefits of this approach –
  - Targets businesses without attempting to define personal services corporations
  - Distinguishes between businesses where all the revenues are due to the owner’s work from those with large investments in capital and employees

S-Corp Monthly Member Call

Tax Reform "Framework" Outlook

- So getting the enforcement challenge correct is key to making the Framework work for Main Street businesses and we're spending nearly all our time on the issue
- What is the outlook?
- Senate will take up the budget this week -- looks like they are may have the votes to move forward
- Goal is to move the bill through the Committee and the House after Halloween, leaving the Senate the rest of November to do the same
- Both bodies would work in December to resolve differences
- That's the "optimistic" outlook – what might get in the way?

S-Corp Monthly Member Call

Framework Challenges

- Senate Budget Resolution
- Messaging & Message Discipline
- Middle Class Tax Relief
- Revenue Raisers
- Rate Deterioration
- Rate Parity for Pass Throughs

S-Corp Monthly Member Call

Rate Parity

- Which brings us back to rate parity and the pass through challenge
- As Congress goes about making changes to the Framework, our focus is multi-fold:
  1. Making sure the enforcement provisions surrounding the new pass through rate are fair and do a good job of distinguishing wages from profits; and
  2. Making certain the other provisions in the bill are robust and helpful.
     - On the positive side, these include estate tax repeal and AMT repeal.
     - On the other hand, provisions to limit interest deductibility, LIFO repeal, and Section 199 repeal all threaten to undermine the value of the package to S corporations.
     - We will take a broad view of the overall bill, but its needs to be balanced and Main Street friendly!
  3. Pushing for the bill to include our S Corporation Modernization language – we've been working on these reforms for years, and this a great opportunity to see these reforms enacted into law

S-Corp Monthly Member Call

Action Items

- So those are the challenges – the Framework offers pass through businesses the lowest marginal tax rates in decades, but there's a risk
- S-Corp is working to ensure the lower rate is real and that we avoid all those other pitfalls
- What can you do to help?
    1. Contact your Senators and Representatives! Go to our Take Action Page on the S Corporation Association website and follow the instructions. Its easy and effective!
    2. Contact us with your story! Every family business has a great story, and we are here to help you tell it. Your story and our advocacy is a winning combination.
    3. Stay informed – make sure to read our Washington Wires and join our next Member Call scheduled for Tuesday November 14th
- S-Corp is only as effective as its membership, so we need you involved and informed!

S-Corp Monthly Member Call

October 17, 2017

DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES