

# **S-Corp Monthly Member Call**

## **February 20<sup>th</sup>, 2018**



# S-Corp Monthly Member Call

## S-Corp Housekeeping

- New Parity for Main Street Employers Website, Executive Director
  - Visit the site at: <http://mainstreetemployers.org/>
- S-Corp PAC has hosted one event already this year, with another scheduled for next week
  - If you have questions about the PAC or would like to contribute, send us a note and we'll be happy to help
- S-Corp invoices for 2018 dues have been sent
  - If you didn't receive your invoice or have questions about the new dues structure, email Christine at [cwalizer@s-corp.org](mailto:cwalizer@s-corp.org)
- Next S-Corp Member Call will be Tuesday, March 27<sup>th</sup> at 4pm Eastern

# S-Corp Monthly Member Call

## Latest on Tax Reform

- The tax overhaul continues to dominate policy in DC
  - New NYT poll shows support for tax overhaul is above 51 percent
  - Three new small business surveys show renewed small business confidence
- But there's room for improvement!
- As a reminder, S-Corp's five key concerns with the new law are:
  1. The 20% 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!
- Today's call will focus on the first two and two specific steps S-Corp is taking to address them

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## Pass-Through Deduction Challenges

- The new deduction poses many challenges for pass-throughs:
  - Its too small
  - Its temporary
  - Its guardrails are uneven and can penalize real businesses with real employees and real investments
- In response, S-Corp is communicating with the Hill and the Administration
  - You can read our full list of technical concerns [here](#)
  - Many of these concerns can be resolved with rules out of Treasury
- First among these technical concerns is ensuring that owners have the ability to group multiple businesses together to calculate the new deduction

# S-Corps & Section 199A

## Grouping vs. “Trade or Business”

- Section 162 allows deductions for all ordinary and necessary expenses paid in carrying on a “trade or business”
  - Section 162 does not, however, define “trade or business”
  - Recent Court Decision, “The Code does not define the term ‘trade or business’. Deciding whether the activities of a taxpayer constitute a trade or business requires an examination of the facts in each case.”
- How to determine a “trade or business”? Courts have applied a three factor test:
  1. Whether the taxpayer undertook the activity intending to make a profit;
  2. Whether the taxpayer was regularly and actively involved in the activity; and
  3. Whether the taxpayer’s business operations had actually commenced.

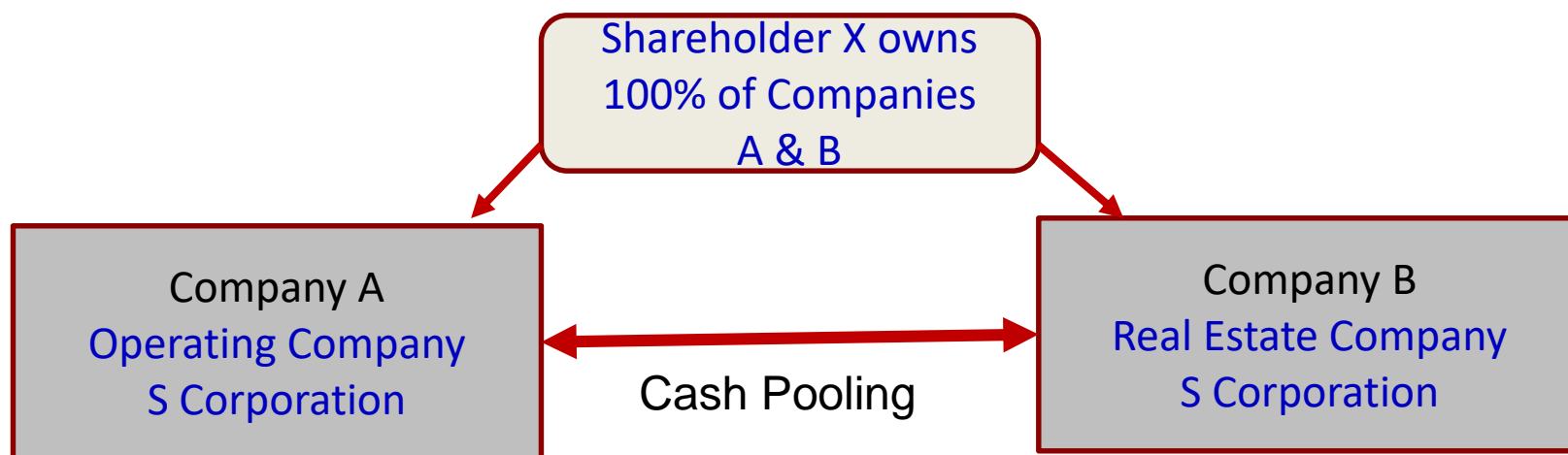
# S-Corps & Section 199A

## Grouping vs. “Trade or Business”

- Challenge – Section 199A deduction uses “trade or business” as basis for calculating the 20% pass-through deduction
  - It doesn’t define the term either
  - Nor does it address the question of businesses with multiple separate entities
- So the new law is unclear how the deduction would be calculated – at the entity (or sub-entity) level, or whether owners would be able to “group” multiple businesses together to calculate the deduction, as under Section 469
- **This is a BIG deal!**

# S-Corps & Section 199A

## Example #1 – Brother-Sister Company



- Typical “Brother-Sister” company with common shareholders and cash pooling
- Company A has operations and employees – Company B has capital assets
- Grouping under 469 would allow Shareholder X to group all income, payroll, etc from Companies A and B to determine 199A deduction

# S-Corps & Section 199A

## Grouping vs. “Trade or Business”

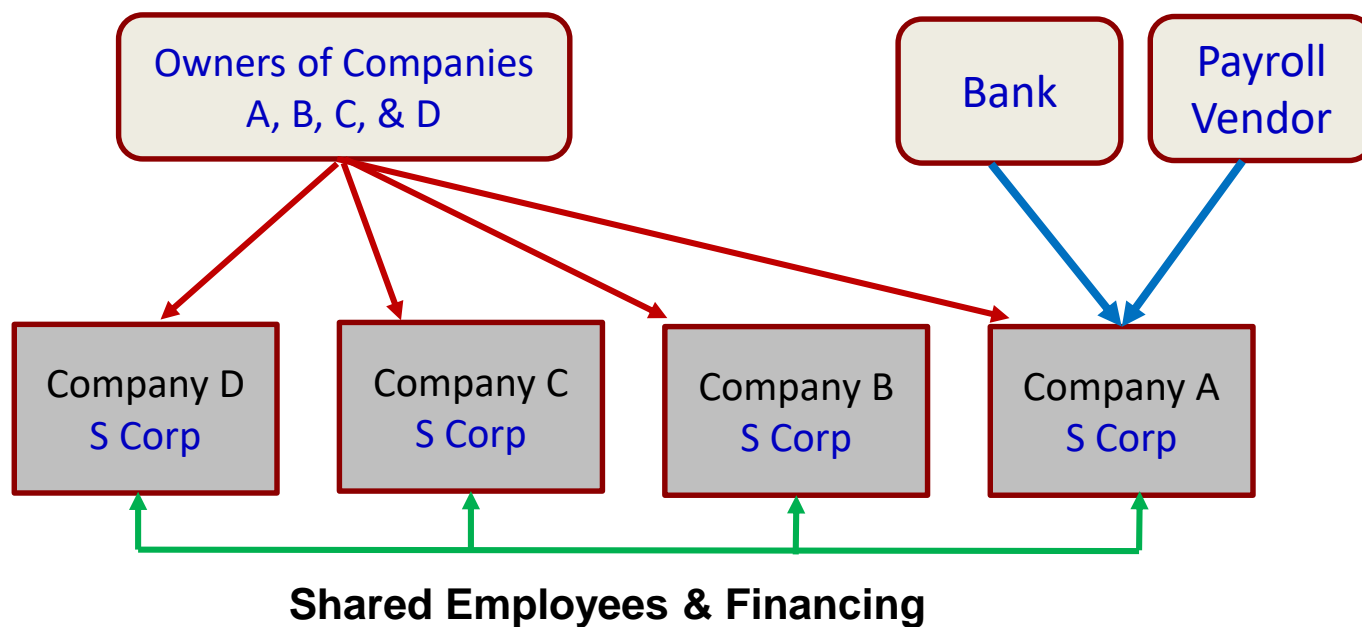
- Grouping “Brother-Sister” Companies reduces overall tax payment by 6 percent

	<u>S Corporation A</u>	<u>S Corporation B</u>	<u>A &amp; B NOT Grouped</u>	<u>A &amp; B Grouped</u>
Income	\$ 100.00	\$ 100.00	\$ 200.00	\$ 200.00
W-2 Wages	\$ 70.00	\$ 10.00		\$ 80.00
Capital	\$ 25.00	\$ 200.00		\$ 225.00
Deduction (20%)	\$ 20.00	\$ 20.00		\$ 40.00
W-2 Limitation	\$ 35.00	\$ 5.00		\$ 40.00
Capital Limitation	\$ 18.13	\$ 7.50		\$ 25.63
Allowed Deduction	\$ 20.00	\$ 7.50	\$ 27.50	\$ 40.00
Taxable Income	\$ 80.00	\$ 92.50	\$ 172.50	\$ 160.00
Effective Tax Rate	29.6%	34.2%	31.9%	29.6%



# S-Corps & Section 199A

## Example #2 – Domestic Manufacturing Company



- Company A houses *ALL* payroll, insurance & financing to reduce costs – Company A has no revenue
- If 199A is calculated at a “trade or business” level without grouping, Manufacturer would need to completely reorganize operations or get little deduction whatsoever
- That result makes no sense!

# S-Corps & Section 199A

## Grouping vs. “Trade or Business”

- S-Corp is working with our Main Street Coalition to educate lawmakers and the Administration on the importance of allowing grouping under Section 469 for the new pass-through deduction
- As the examples show, it is a more sensible and efficient way to calculate the deduction
- It is also a better way to ensure that real businesses with real profits and investment get the full pass-through deduction

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## Pass-Through Businesses & SALT

- 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:
  - 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
- 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

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## Pass-Through Businesses & SALT

- To address this, S-Corp has a two-step plan:
  1. Work with friendly Hill offices and our association allies to introduce a legislative fix. C corps continue to deduct state and local taxes – pass-through businesses should too
  2. Work with State legislatures to adjust their rules – Taxes paid at the entity level are deductible, so states should give businesses the option of paying tax at the entity level
- In recent weeks, Connecticut has embraced this approach
- The Connecticut plan would:
  1. Impose a tax on pass-through businesses equal to the individual state income tax of 6.99%
  2. Give pass-through owners a refundable tax credit equal to protect them being double taxed on their business income
  3. Include rules to recognize tax credits from other states to business owners living in Connecticut

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## Pass-Through Businesses & SALT

- How does the math work on the CT plan?

	<u>Prior Law</u>	<u>New Law -- No deduction</u>	<u>CT Proposal</u>
Income	\$ 100.00	\$ 100.00	\$ 100.00
State Tax Rate	6.99%	6.99%	6.99%
Entity Tax	\$ -	\$ -	\$ 6.99
Income Attributed to Shareholder	\$ 100.00	\$ 100.00	\$ 93.01
Credit	\$ -	\$ -	\$ 6.50
Shareholder State Tax (6.99%)	\$ 6.99	\$ 6.99	\$ -
Income for Federal Tax	\$ 93.01	\$ 100.00	\$ 93.01
Federal Tax (39.6%)	\$ 36.83	\$ 37.00	\$ 34.41
Effective Federal Marginal Tax Rate	39.6%	39.8%	37.0%

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## Pass-Through Businesses & SALT

- So the Connecticut Governor has embraced our idea of shifting tax incidence to preserve the SALT deduction
- What are the next steps?
  1. Work with our Main Street coalition to support and perfect the CT plan
  2. Work with tax attorneys to develop model language based on the Connecticut bill that works in other states
  3. Building out teams of businesses and advocates in key states to push this issue
  4. Highlight the effort in the press to make this a national issue
- This approach is a win-win for states and their businesses – it makes the state more business friendly without costing it revenue

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## Action Items

- Today's action item is on SALT – Our goal is to get our legislative fix moving in half-a-dozen states initially
- To do that, we need your help
- If you live in an income tax state, let us know if you can help push the SALT plan at the state level. Can you:
  - Put your state-level relationships to work?
  - Have the ability to pen an op-ed?
  - Work with other interested S-Corps?
- If so, please let us know and we'll put you to work
- Restoring parity on SALT is a priority for the Main Street business community, but it won't happen without your help!

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