Pass-Through Businesses & Tax Policy

Pass-Through Businesses & Tax Policy

Business Tax "101" – Intro

- The Section 199A Small Business Deduction is critical to Main Street businesses
  - It bridges the gap between the corporate and individual rates
  - It reduces the cost of capital for pass-through businesses, resulting in increased growth and job creation
  - It helped avoid a tax hike on Main Street
- Challenge: 199A Small Business Deduction sunsets at the end to 2026 along with the other individual and pass-through provisions in the TCJA
- This briefing is designed to:
  - Build understanding of how pass-through businesses are taxed
  - Explain why the pass-through taxation is the superior approach to taxing business income, and
  - Highlight the challenge to Main Street if the 199A deduction expires

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Business Tax “101” – Two Models

- Classic C Corp Model features two layers of tax:
  - First Layer: Corporate tax of 21% at the entity level
  - Second Layer: Tax on cap gains and dividends of 23.8%
  - Key points:
    - Second layer can be deferred indefinitely
      - Not all C corp profits are paid out in dividends
      - Shareholders choose when to sell their stock
    - Profile of C corp shareholders has changed dramatically
      - Most public company shareholder pay little or no tax today
  - Combined Marginal Rate: Between 21% and 39.8%

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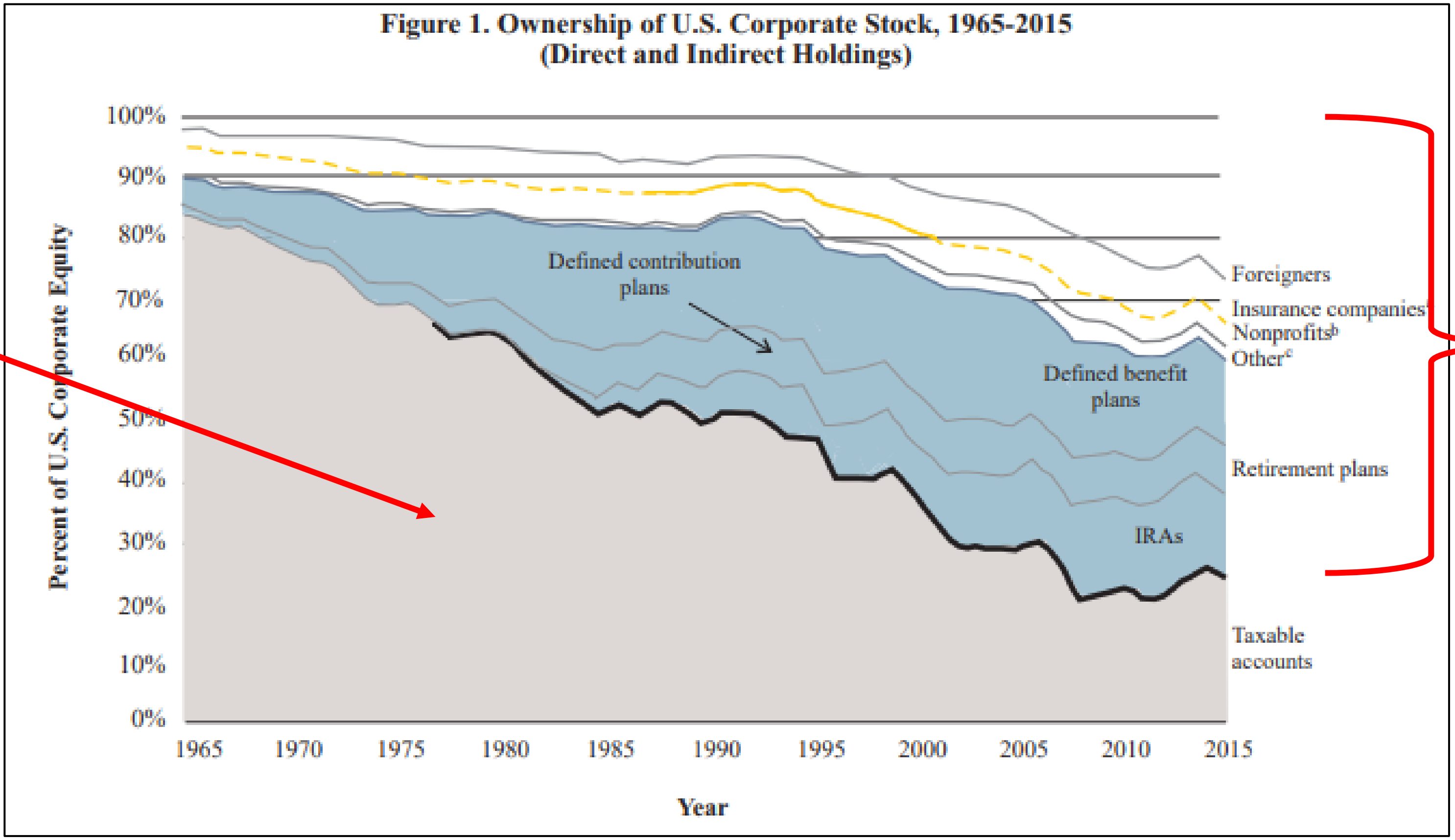
Business Tax "101" – Two Basic Models

- Tax Policy Center on Public Company Shareholders

Taxable Accounts



Tax Advantaged Accounts

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Business Tax "101" – Two Basic Models

- Pass-Through Model features single tax applied at the owner level
  - Business income "passes through" to the owner's tax return at a top rate of 37 percent
  - Income is taxed regardless of whether its distributed – there is no "avoiding" the pass-through tax
  - Some pass-through income qualifies for the 20% 199A deduction, resulting in an effective top rate of 29.6%
- Single tax system is better – there's less distortion and business income is taxed at progressive rates
- Why is this important? -- Pass-throughs are a big part of the economy

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Importance of Pass-Throughs

- Most businesses are pass-through:
  - C Corp: 2.3 million
  - S Corp: 5.6 million
  - Partnership/LLC: 4.6 million
  - Sole Prop: 29 million
- Pass-through businesses employ a majority of private sector workers – 62% in 2018
- Private companies – the combination of pass-throughs and private C corporations – employ 8 out of 10 workers

Employment/business owners by organizational form, 2018

	Employment & owners	% of total
C corporation	52,907,321	37.7%
Pass-through	87,544,667	62.3%
S corporation	38,533,460	27.4%
Partnership	18,131,976	12.9%
Sole proprietorship	30,879,231	22.0%
Total	**140,451,988**	100.0%

Employment/business owners by ownership structure, 2018

	Employment & owners	% of total
Publicly-traded corporations	27,385,869	19.5%
Privately-held entities	113,066,120	80.5%
Total	**140,451,988**	100.0%

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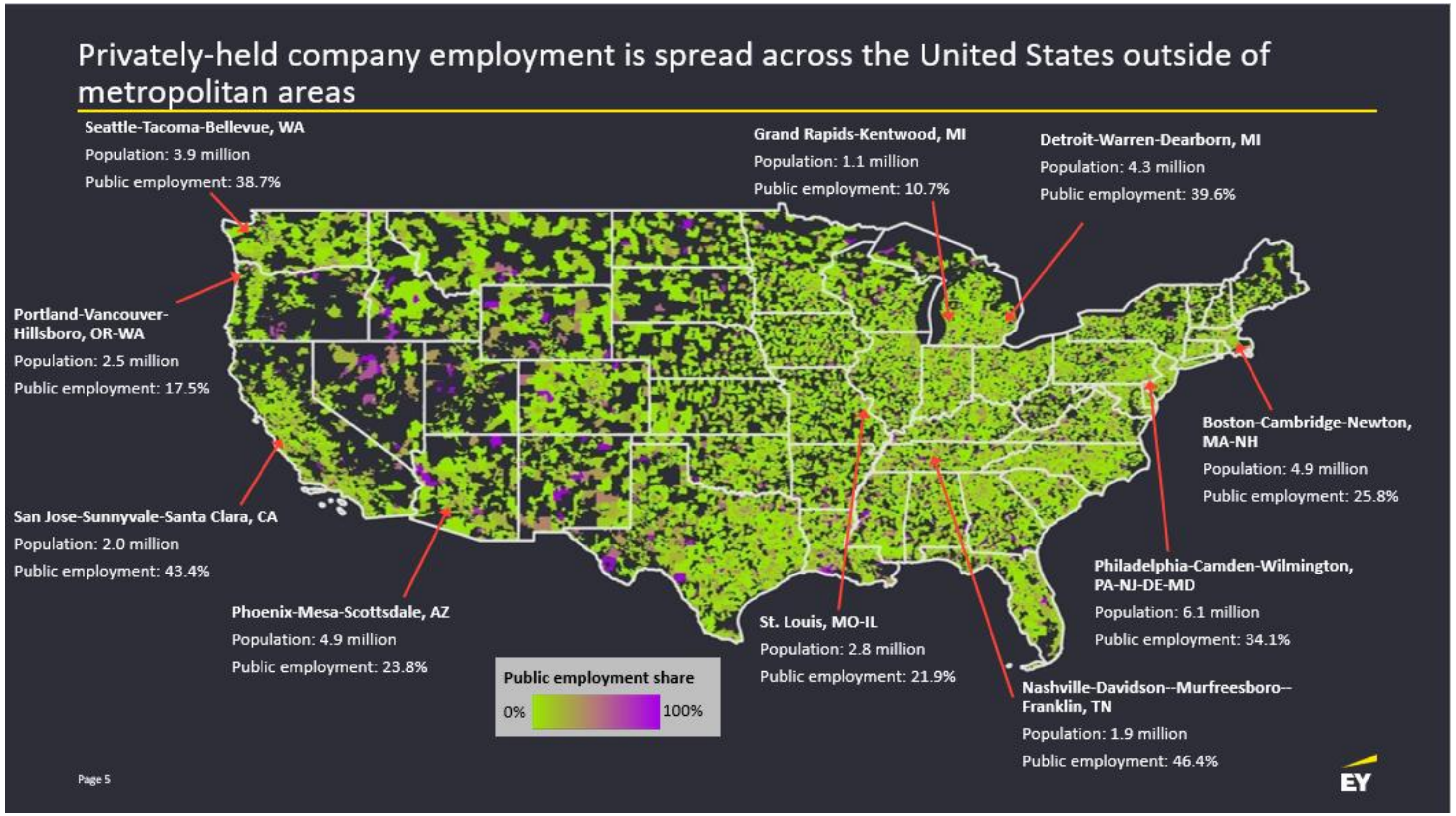
Importance of Pass-Throughs

- Private employers are geographically diversified



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Business Tax "101" – Case for 199A

- The 199A Small Business Deduction closes gap between individual and corporate rates

	SSTB	**Non-SSTB**
Below Threshold ($384k)	• 20% deduction on all Qualified Business Income • Must be a trade or business • Owner wages and guaranteed compensation excluded	
Between Thresholds	• Deduction is phased out for SSTBs	
Above Threshold ($484k)	• Service businesses disqualified from 199A (Lawyers, Doctors, etc.)	• Wage & Capital guardrails apply

Pass-Through Businesses & Tax Policy

Business Tax "101" – Case for 199A

- 199A was necessary to prevent a massive tax hike on pass-through businesses
- TCJA base-broadening affecting pass-through businesses:
  - SALT Cap ($668B)
  - Excess Loss Limitation Rules ($150B)
  - 163(j) Limitation on Interest Deductions ($253B)
  - 174 Amortization of R&E ($120B)
  - Section 199 Manufacturing Deduction Repeal ($98B)
  - Section 212 Deductions Repeal
- By example, in 2018 the SALT cap raised taxes on individuals making more than $1 million by $33 Billion vs. $17 billion of relief for the 199A deduction

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199A Pass-Through Deduction

Business Tax "101" – Solution

- 199A is essential for Parity, Economic Growth, and avoiding a massive tax hike on Main Street
- The Main Street Certainty Act
  - House – HR 4721: Lloyd Smucker (PA) (171 Cosponsors)
  - Senate – S. 1706: Steve Daines (MT) (32 Cosponsors)
- Business community letter
  - Signed by 160+ national trade groups, including NFIB, Farm Bureau, NAW, Real Estate Roundtable, National Grocers Association, etc.
- Support Main Street Certainty!

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Parity - Relative tax treatment of pass-throughs and C corporations

Presentation for the Small & Family Business Tax Lunch & Learn

Robert Carroll, Quantitative economics and statistics (QUEST) group

April 15, 2024

EY
Building a better working world

Changes in 2026 present significant challenges for pass-though businesses

Key changes confronting pass-throughs

- Section 199A provision sunsets
- Top individual tax rate reverts to 39.6%
- SALT limitation sunsets
- “Pease” limit on itemized deductions for high income taxpayers returns

Key question: How do these changes affect the relative tax treatment of businesses organized as pass-throughs versus C corporations (parity)

EY

2019 and 2023 EY parity analyses

Analyses consider tax policies affecting entity choice from several from several perspectives:

- What is the relative tax treatment between the pass-through versus C corporation form?
- Overall, within the economy, what is the relative taxation of pass-through businesses versus C corporations?
- Does the relative taxation depend on the size of the pass-through business: Large S corporations versus the average pass-through business

How parity is assessed

Evaluate relative tax treatment of pass-throughs and C corporations using two tax rate measures:

Effective tax rates (ETRs)

- Average tax rate for hypothetical business earnings received through a pass-through business and a C corporation; useful for comparing the relative burden on existing operations
- Plans, including choice of organizational form, often based on overall average taxes based on existing rules and changes can have significant impacts

Marginal effective tax rates (METRs)

- Measures taxes on the additional increment of income from a new breakeven investment
- Forward-looking measure that reflects the burden of taxes on a new investment; is a measure of the impact of the tax system on the incentive to undertake a new investment
- Include METRs for a business choosing between the pass-through versus C corporation business form and METRs that reflect the overall burden of taxation on the pass-through and C corporation business sectors

Compare tax rates under TCJA law in 2019 to those in 2026; also report tax rates under pre-TCJA law in 2016.

Comparison of simple effective tax rates

- Tax treatment of corporate shareholders matters:
  - In 2026, rough parity between pass-throughs and C corporations if corporate shareholders are fully taxable.
  - Large S corporations disadvantaged somewhat before 2026, but especially after the sunsets in 2026.
  - As the fraction of tax-exempt corporate shareholders rises, pass-through business fare relatively less well, especially under the TPC assumption.

Effective tax rates	**Pre-TCJA (2016)**	**Post-TCJA (2019)**	**Post-TCJA (2026)**
Large S corporations	41.2%	34.0%	41.2%
Pass-through businesses	32.9%	27.4%	32.9%
C corporations:			
Closely-held, fully taxable shareholders	43.7%	32.0%	31.6%
38% of corporate shareholders nontaxable (CBO)	42.5%	30.5%	30.1%
75% of corporate shareholders nontaxable (TPC)	38.0%	24.8%	24.7%

Note: Effective tax rates are for hypothetical business earnings received through an S corporation, pass-through business, and a C corporation. The ETR for the C corporation reflects both the corporate income tax and investor level shareholder taxes.

Source: EY analysis.

- What is the question: Is there parity for a business choosing between business forms? How do businesses in the pass-through sector generally compare to those in the C corporate sector? Do the results vary by ownership structure or industry?

Comparison of marginal effective tax rates

- S corporations/pass-throughs versus fully taxable corporate shareholders reflects a business choosing between business forms.
- Tax advantage associated with S corporation / pass-through forms relative to a C corporation with fully taxable shareholders.
- Economy-wide, parity depends, in part, on the degree to which shareholders are tax-exempt:
  - Under the TPC assumption that 75% of corporate shareholders are tax exempt, pass-through business are disadvantaged.
  - And, large S corporations are very disadvantaged.

Economy-wide METRs	Pre-TCJA (2016)	Post-TCJA (2019)	Post-TCJA (2026)
Large S corporations	21.4%	14.6%	25.1%
Pass-through businesses	18.1%	12.8%	21.3%
C corporation: Fully taxable shareholders	37.6%	31.5%	34.7%
C corporation: Partially taxable shareholders:			
38% of corporate shareholders nontaxable (CBO)	28.5%	21.2%	24.9%
75% of corporate shareholders nontaxable (TPC)	19.2%	10.7%	15.0%

Note: The METR estimates reflect bonus depreciation (50% in 2016, 100% in 2019, and 20% in 2026). The economic characteristics of a corporate versus pass-through investment differ in economy-wide METRs. For example, there are different compositions of investment (e.g., share of equipment versus structures versus intangibles) in the corporate versus pass-through sector, as well as differences in the amount of debt versus equity used to fund an investment.

Source: EY analysis.

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