Defending America's Individually & Family Owned Businesses

September 17, 2024

Rep. Lloyd Smucker
Chair, Main Street Tax Team
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U.S. House of Representatives
Washington, D.C. 20515

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Dear Chair Smucker and Members of the Main Street Tax Team:

The United States is unique among developed countries in the emphasis it places on pass-through business structures – S corporations, partnerships (including Limited Liability Companies), and sole proprietorships. Pass-through businesses make up 95 percent of all U.S. businesses, they employ 62 percent of private sector workers, and they contribute the majority of business income to our Gross Domestic Product (GDP).[1]

This reliance on pass-through businesses is not an accident. It was done purposefully by successive Congresses seeking to strengthen the role of small- and family-owned businesses in the American economy. These deliberate actions date back to the creation of the S corporation rules in 1958 and they have worked to the benefit of the businesses themselves, the people they employ, and the communities they serve. America has more jobs, higher wages, and a more diverse economy because of the strength of its pass-through business sector.

It is critical for Congress to understand this history as it seeks to address the expiration of provisions under the Tax Cuts and Jobs Act (TCJA), including the Section 199A deduction, next year.

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[1] Robert Carroll and Gerald Prante, *The Flow-Through Business Sector and Tax Reform*, Ernst & Young (April 2011). Available at: http://www.s-corp.org/2011/04/13/links-to-s-corp-study-and-press/

The Correct Way to Tax Businesses

One reason the pass-through business structure has been so successful is that it is the correct way to tax business income. If Congress were to start from scratch, the pass-through treatment of business income, particularly how S corporations are taxed, would be the starting point. As Eric Toder of the Tax Policy Center told the Senate Finance Committee in 2011:

> *I would… note that the ideal way to tax business income is the way we tax S corporations. We would like to attribute the income to the owners and the only reason we have a corporate tax is for large and frequently traded companies – very hard to do that and identify the owners who would pay the tax. So where you can do that, we should do that, and that is the right treatment.*[2]

Pass-through taxation reduces opportunities for gaming and it ensures a more progressive outcome for business owners – those with modest means pay lower rates while wealthy owners pay higher rates.

For public corporations, pass-through treatment may not be feasible. But allowing all closely-held businesses the option to use the pass-through structure improves tax administration, progressivity, and simplicity while making the U.S. more competitive.

Economic Footprint & 199A

As noted, pass-through businesses are the dominate form of business organization in the United States. They comprise 95 percent of all businesses, they employ six out of ten private sector workers, and they contribute the majority of business income to our national economy. Any discussion of economic competitiveness should begin with the pass-through sector, including the pending expiration of the Section 199A small and family business deduction.

As recent study by EY highlights this point. According to EY, Section 199A supports 2.6 million jobs, contributes $161 billion to employee compensation, and adds $325 billion to the national economy.[3] This table summarizes the study's findings:

Table 1. Total economic activity supported by, and related to, the Section 199A deduction, 2024
Thousands of jobs; billions of dollars

	Directly supported economic activity	Related supplier activity	Related consumer spending	Total
Employment	1,118	590	853	2,561
Employee compensation	$65	$43	$53	$161
GDP	$132	$87	$106	$325

Note: Employee compensation includes all labor income (i.e., employee cash compensation and benefits). Employee compensation is a component of GDP. Figures are rounded.
Source: EY analysis.

[2] Hearing entitled *How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?* Response to a question before the Senate Committee on Finance, March 30, 2011.
[3] Robert Carroll, *Economic activity supported by the Section 199A deduction*, EY (August 2024)

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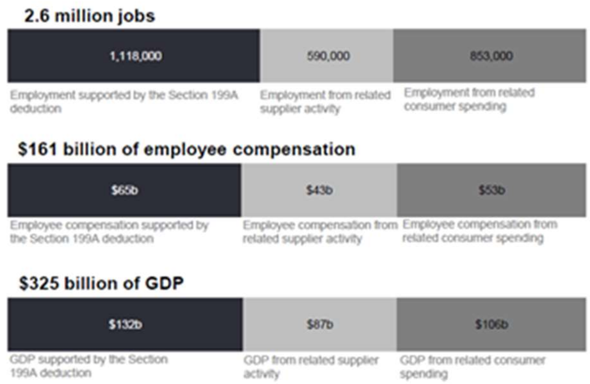
Regarding jobs, the study finds Section 199A supports 1.1 million jobs directly, 590 thousand jobs through increased employee compensation, and another 853 thousand jobs from related consumer spending increases:

Figure ES-1. Total economic activity supported by, and related to, the Section 199A deduction, 2024



These results highlight the importance of Section 199A to the economy and how the expiration of the deduction threatens these jobs. Absent congressional action, 2.6 million jobs will be at risk.

Rate Parity

The pending expiration of the individual TCJA provisions also poses a fairness challenge to the pass-through community. Section 199A was designed to bridge the gap between the new, 21-percent corporate rate and the higher individual rates that apply to pass-through income. But Section 199A sunsets at the end of 2025 as do the lower rates that apply to pass-through income. The result will be a significant rate hike on pass-through businesses:

	TCJA		**Post Fiscal Cliff**	
	Active	Passive	Active	Passive
Individual Rates	37.0%	37.0%	39.6%	39.6%
NIIT	NA	3.8%	NA	3.8%
Pease	NA	NA	1.2%	1.2%
Section 199A	-7.4%	-7.4%	NA	NA
	29.6%	**33.4%**	**40.8%**	**44.6%**

Note: The Net Investment Income Tax (NIIT) applies to S corporation income attributed to passive owners only. The Pease deduction limitation caps allowable itemized deductions, including pass-through business deductions.

These higher rates will apply to a larger base of income. The TCJA reduced or eliminated many deductions and credits that pass-through businesses use to calculate their taxable income, including the new state and local tax (SALT) deduction cap, the Section 163(j) cap on interest deductions, the amortization of research and experimentation (R&E) expenses, the repeal of the Section 199 manufacturing deduction, etc. Most of these base-broadeners will remain in place post-fiscal 2025.

The result will be higher rates applied to a broader base of income -- not just compared to today's levels but compared to their pre-TCJA levels as well.

What About the Double Tax?

Critics argue corporate tax rate calculations should include both entity level and shareholder level taxes. These arguments fail to account for the changing profile of today's public company shareholders, however. As former the Chief of Staff of the Joint Committee on Taxation Ken Kies has argued[4]:

> *The notion that corporate income is subject to double-taxation is one of the great myths of tax policy. In fact, very little corporate income is ever… subject to a second level of tax….*
>
> *First, the myth of the double-taxation of corporate income ignores the fact that the imposition of the tax is generally optional. For corporations that choose not to pay dividends and instead retain their earnings, the second-level of tax can be deferred in perpetuity.*
>
> *Second, the myth of the double-taxation of corporate income ignores the fact that in many cases, dividends from a corporation are not subject to current tax. The majority of corporate shares are held by tax-exempt (e.g., non-profits, foreign investors domiciled in a country with a zero-withholding tax treaty with the U.S., the beneficiary of a 529 account) or tax preferred entities (e.g., pension funds, owners of a 401(k), owners of an IRA)….*
>
> *[I]t is likely that the amount of U.S. corporate earnings paid as dividends to currently taxable accounts is no higher than 9 percent, and the amount eventually subject to a second layer of tax in later years is likely no greater than 14 percent.*
>
> *In contrast, owners of a pass-through business are always currently subject to full, current taxation at a maximum rate significantly higher than the corporate rate.*

Our EY analysis takes into account all these nuances, as well as the fact that a significant portion of pass-through income does not qualify for Section 199A.[5] As detailed in that analysis:

[4] Ken Kies, *Congress' Worst Tax Idea Ever? Hardly*, The Hill (April 28, 2019).

[5] Robert Carroll, *Relative Tax Treatment of Pass-Throughs and C Corporations*, EY (June 6, 2023). Available at: https://s-corp.org/wp-content/uploads/2023/06/EY-S-Corporation-Association-Pass-through-C-corp-parity-analysis-June-2023.pdf

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%

Taking all that into account, the result is rough parity now but no rate parity without Section 199A. Failure to extend Section 199A would hurt millions of small and family-owned businesses, increasing the advantage public companies have over private businesses.

Can't pass-throughs just convert and access the 21-percent corporate rate? No. Whereas public C corporations largely avoid the double tax through deferral and having shareholders who don't pay taxes, by definition nearly all S corporation shareholders are tax-paying individuals or trusts. These business owners *would* pay the full double tax.

Moreover, public C corporation shareholders can monetize their ownership easily by selling shares on the public exchanges. That option is not available to closely held businesses, where the typical means of rewarding their shareholders is to pay dividends. If forced into the C corporation structure, those dividends would be fully taxable.

So, no, they can't just convert as they will end up paying more either way.

S Corporation Modernization

Ensuring rate parity is not the only way Congress can help S corporations. Since their creation in 1958, S corporations have grown to become the dominant form of private business in the United States. Despite their popularity and commensurate contribution to investment and jobs, the S corporation structure is extremely rigid. It limits the number of shareholders, the types of shareholders, and the classes of stock an S corporation may have. None of these limitations apply to partnerships or limited liability companies.

Accordingly, we strongly support implementation of H.R. 8619, the S Corporation Modernization Act (the "Act"), as introduced by Representative Brad Wenstrup (R-OH). This legislation would:

- <u>Modify Passive Income Rules</u>: The excess passive investment tax is a corporate-level penalty levied against S corporations on their passive income (e.g. rents, royalties, interest and annuities) that exceeds 25 percent of the S corporation's gross receipts. The bill would raise this threshold to 60 percent of gross receipts and eliminate the accompanying "three strikes and you're out" penalty, consistent with recommendations made by the Joint Committee on Taxation.

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- Expand Allowable S Corporation Shareholders: The S corporation rules restrict who is an eligible shareholder, limiting the ability of S corporations to attract capital. H.R. 8619 would expand the pool of eligible shareholders in the following three areas:

    - A 2017 provision allowed nonresident aliens to invest in S corporations indirectly through an ESBT. Some countries do not recognize the taxes paid by the ESBT, however, resulting in the potential of a double tax. This provision would expand the options of foreign ownership of S corporations to mirror the current partnership rules.

    - Many private companies offer their workers stock ownership options but those employee-owners count against the 100 shareholder limit that applies to S corporations. Faced with this limitation, companies must stop offering ownership opportunities or convert to C. This provision would allow S corporations to count all employee-owners as a single shareholder.

    - The Act would allow IRAs to hold the stock of S corporations. Consistent with the current law treatment for qualified retirement plans, the IRA would be subject to UBIT on its share of the S corporation's income and on any gain from the disposition of S-corporation shares.

- Suspended Loses: Under current law, if a shareholder leaves their S corporation stock to their children, any suspended losses would be forfeited. This treatment is at odds with the general step up in basis rule at death. The Act would allow suspended losses to transfer on death and ensure the loss is treated as an ordinary loss when there is sufficient S corporation income. Any suspended losses attributable to third-party indebtedness incurred by an S corporation will transfer to the children of the S corporation shareholder at death, ensuring that such losses are treated as ordinary losses when the third-party indebtedness is repaid.

- Inside Basis Step-up: Upon the death of an S-corporation shareholder, the basis of the decedent's stock is adjusted to fair market value, but the inside basis of the business' assets is not. The provision would allow an election to adjust the inside basis of the S corporation's assets to fair market value upon the death of an S corporation shareholder, as is allowed for partnerships.

- Repeal Section 409A: Section 409A creates an unnecessary impediment to offering employees deferred benefits. This provision would repeal Section 409A and allow S corporations to offer their employees deferred compensation without unnecessary complexity.

Such reforms would increase the ability of S corporations to grow and raise capital, as well as to ease their transition from one generation to the next and to improve day-to-day management of the business.

S CORP

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The NIIT and S Corporations

As noted, the Net Investment Income Tax (NIIT) applies to S corporation earnings attributed to passive owners -- but not those attributed to active earners. Some argue this is a "loophole" and the NIIT should be expanded to include all S corporation (and pass-through) income. These arguments are incorrect and Congress should reject calls to expand the NIIT tax.

The NIIT's legislative history is clear – the provision was added to the Affordable Care Act after both the House and the Senate had passed their respective health care reforms and, from the beginning, it excluded the business income of active owners. Here's how National Journal reported at the time:

> *President Obama's $950 billion healthcare reform plan released Monday exempts income derived from running a small, closely held business from a proposed new payroll tax on investments. The carve-out is a concession to a range of business groups and advocates for the self-employed.*

Congress made several key changes to the Administration's proposal before it was enacted. They removed its connection to Medicare (the revenue goes into the general fund, not Medicare) and they increased the rate to 3.8 percent, but they retained the exclusion on income of active business owners. As S-Corp Advisory Board Chair Tom Nichols summarized in his testimony back in 2012:

> *This net investment income tax is generally imposed on interest, dividends, annuities, royalties, rents and gains, with one very important exception. Congress recognized that this new imposition should not apply to income derived by owners directly involved in active businesses. Therefore, Congress excluded from the tax base all income derived from a trade or business unless the income was reported by a person who did not "materially participate" under the passive activity rules or the trade or business consisted of trading in financial instruments or commodities.*

In short, exempting the business income of active owners from the NIIT was a planned feature of the tax from the start and is no way a "loophole." The tax treatment of S corporation income attributed to active owners is correct and justified, and Congress should resist calls to expand the NIIT when it considers the TCJA sunsets next year.

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Conclusion

The TCJA set the foundation for a more competitive business tax system. Next year's fiscal cliff is an opportunity to build on that foundation and continue the rough balance that exists between the tax treatment of pass-through businesses and public corporations. It is also an opportunity to improve upon the rules that govern S corporations, making them more flexible and less of an impediment to raising capital and operating the business.

The S Corporation Association appreciates the opportunity to offer these suggestions and welcomes the chance to discuss these issues further.

Sincerely,

Brian Reardon
S Corporation Association