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Small Business and Passthroughs Tax Reform Working Group
Ways and Means Committee
United State House of Representatives
Washington, DC 20515

Grant Thornton LLP appreciates the opportunity to share its views with the members of the Small Business/Passthroughs Working Group of the House Ways and Means Committee. Grant Thornton LLP is the U.S. member firm of Grant Thornton International Ltd, one of the world's leading independent audit, tax, and advisory firms. We work with dynamic organizations, many of which are organized as partnerships or S corporations (passthroughs) to address their accounting, tax and other business issues.

We applaud the Ways and Means Committee's efforts to reform our income tax system in a manner that will promote the competitiveness of U.S. businesses and contribute to the growth of our economy, and we thank the members of the working group for their particular consideration of the issues faced by small businesses and passthroughs.

Grant Thornton believes it is essential that tax reform ensures all businesses, whether organized as C corporations, S corporations, partnerships or sole proprietorships, are taxed at the same current rate. Otherwise, those businesses facing higher current tax rates will be placed at a competitive disadvantage.

Passthroughs represent one of the fastest growing and most important segments of the economy. More than 80% of all business entities are now organized as passthroughs, and passthroughs are responsible for more than 34% of all business receipts.

Beginning in 2013, passthrough entities owned by individual taxpayers, such as S corporations and partnerships, along with sole proprietorships, face a higher current marginal rate on their business income than their C corporation competitors. This disparity limits the ability of these businesses to match the prices offered by their C corporation competitors and can lead to higher prices for customers than might otherwise be the case. Should tax reform further reduce the rates on C corporations without restoring the rate equivalency that existed between C corporations and other business organizations before 2013, this competitive disadvantage, with its potential to adversely affect prices, will only increase.

The simplest solution would be to set the top individual rate at a level no higher than the top rate applicable to C corporations. If this is not possible, a "business equivalency rate" should be established so that income earned through an active business that operates in sole proprietorship, partnership, or S corporation form is not taxed at a higher statutory rate than would be charged on the same income earned through a C corporation. Such a business equivalency rate could be administered in the same manner as the capital gains rate or as a separate calculation that would isolate the business income and prevent its inclusion from indirectly increasing tax liability through its effect on phase outs and other tax computations.

Structuring a business equivalency rate

Should the committee determine it is not possible to set the top individual rate at a level no higher than the top rate applicable to C corporations, two solutions could be explored. A business equivalency rate applicable to income earned through an active trade or business could be established to ensure all business income is subject to the same rates. A business equivalency rate could be designed using the same methodology that is currently employed for capital gains of individuals. Alternatively, a business equivalency rate could be established by excluding income earned through an active trade or business from the normal calculation of Federal income tax and applying a separate tax to such income.

Capital gains methodology

If the capital gains methodology is adopted, qualified active business income would be included in an individual's computation of adjusted gross income and taxable income. All items, including phaseouts and limitations, that are affected by adjusted gross income and taxable income would continue to be affected in the same manner as under present law. After the calculation of regular tax liability for the year, including the application of the capital gains rate, but before the calculation of alternative minimum tax, a calculation modeled on the current Qualified Dividends and Capital Gains Tax Worksheet would be performed with qualified active business income taxed at a rate equivalent to the top corporate rate. Alternative minimum tax, if any, would then be determined using a rate no higher than the top corporate rate as the rate applicable to qualified active business income. This ordering should preserve the existing policies behind both the capital gains rate and the alternative minimum tax, while providing appropriate relief from the over taxation of qualified active trade or business income.

The capital gains methodology provides substantial, but not complete, equivalency between the current taxation of qualified active business income in a passthrough and such income earned in a C corporation. Because qualified active business income is included in both adjusted gross income and taxable income, numerous phaseouts and limitations (including phaseouts of itemized deductions, both regular and alternative minimum tax exemptions and such credits as the American Opportunity Credit for higher education expenses) can be affected, resulting in a higher marginal rate on the income earned by the passthrough.

Separate tax approach

More complete rate equivalency in taxation of qualified active business income earned in a C corporation and in a passthrough can be accomplished by excluding such income from the calculation of Federal income tax entirely and subjecting it to a separate calculation at a flat rate equal to the top corporate rate. This approach prevents backdoor tax increases attributable to the qualified active business income through phaseouts and limitations. If this approach is followed, it should be made elective on an annual basis; so that taxpayers who would otherwise be taxed at a rate equal to or lower than the top corporate rate will not be disadvantaged by the business equivalency rate.

It is possible that taxpayers with substantial qualified active business income, but little other income, could use this methodology to qualify for tax provisions such as the zero rate on capital gains for taxpayers in the lowest income tax bracket and the earned income credit. If the separate tax approach is followed, it may be appropriate to deny the use of provisions like the zero rate on capital gains and the earned income credit to taxpayers electing to use the business equivalency tax.

Definition of qualified active business income

The business equivalency tax provides equivalency in taxation only for qualified active business income. Qualified active business income would be defined to include ordinary income earned by a business not organized as a C corporation in the ordinary course of its trade or business. It would not include capital gains or other investment income and would only include interest in situations where the entity is actively engaged in a financing business. Section 162 would be controlling in determining whether an activity is a trade or business for purposes of this definition. Since there is no requirement that an investor be active in a C corporation, it is important that whether a business is active be determined at the business level and not at the individual investor level in order to provide equivalency.

Focus on Current Taxation

The business equivalency tax focuses on maintaining equivalency in the current taxation of income between sole proprietorships, passthroughs and C corporations. It is our experience as accountants for many passthrough entities that current taxation is the most important consideration in their business planning and in the economic decisions that will affect how much additional economic activity can be obtained from a reduction of income tax rates. Most business decisions, particularly in the case of small and medium sized businesses, are made on a cash flow basis and current taxes are the element that must be considered.

We are aware that other proposals exist that would exclude sole proprietorships from the benefits of a corporate tax rate cut and would share those benefits with passthroughs only to the extent that the passthrough does not distribute earnings. We believe these proposals are inadequate to fully address the issue of business equivalency. As noted above, our experience is that business decisions among small and medium sized businesses are typically made on a cash flow basis, and that current taxes are the appropriate measure of taxes for that purpose. It is also our experience that the small and medium sized businesses that operate as passthroughs are rarely in the same position to retain earnings compared to their larger C corporation competitors. Attempting to address equivalency by focusing only on retained earnings will benefit the large to the detriment of the small and medium sized.

Requiring passthroughs to become C corporations is not the answer

Some may suggest that an alternative answer to the problem of rate disparity would be to simply have all sole proprietorships and passthroughs incorporate, become C corporations, and make themselves eligible for any reduction in corporate tax rates included as part of tax reform. There are a number of reasons we believe this to be an inadequate answer.

As we have noted, most small and medium sized passthroughs do not have the same ability to retain earnings that their larger C corporation competitors enjoy. It is inappropriate to condition the availability of equivalent tax rates on the willingness to retain earnings in order to defer double taxation. It should also be noted that many non-tax reasons such as ease of governance, succession planning and natural family structures may have gone into the choice of the partnership form. These legitimate business considerations should not be disregarded in order to achieve a particular tax goal.

We also believe that it is bad tax policy to subject additional taxpayers to double taxation and question whether that is an appropriate goal of tax reform. Prior tax reform efforts have often focused on the need to eliminate double taxation, most recently in 2003 when Treasury presented proposals that would have exempted dividends paid by C corporations from further taxation at the shareholder level. Current law includes a number of provisions specifically designed to ameliorate the effects of double taxation, including a dividends received deduction for C corporations and reduced tax rates for qualified dividends received by individuals. The proposed shift to a territorial system, frequently associated with lower corporate tax rates as part of tax reform proposals, is itself an attempt to prevent the double taxation of income.

<u>Disparate rates create a competitive disadvantage that could result in increased prices for U.S. consumers</u>

Business tax cuts for all businesses can benefit the overall economy through lower prices, increased supplies, and greater competition. Classic economic theory teaches that prices are set at the intersection of the supply and demand curves; the point at which the price customers are willing to pay for a marginal unit meets the price at which sellers are willing to supply an additional unit. While a disparity in business tax rates may have little effect on the demand price point, it is expected to have a significant effect on the supply price point. The supply curve is largely determined by the after-tax profit that can be made on the sale of a unit at a particular price. The higher the after-tax profit, the more units sellers are willing to provide at a particular price. This upward shifting of the supply curve due to tax reform is expected to result in a new intersection point, with a greater number of items being provided at a lower price.

The benefit to be derived from cutting business taxes as part of tax reform will be limited where only some, but not all, suppliers are eligible for the rate cut. Where a significant number of suppliers are excluded from the rate cut, only those suppliers that are included in the rate cut will voluntarily change their supply curve and be willing to offer more items at lower prices, since they will still be able to enjoy the same after-tax income. Those suppliers excluded from the rate cut may be forced to reduce prices in order to respond to the actions of their competitors who do enjoy a rate cut, but will do so only at the cost of earning a lower-after tax return than their competitors, making it more difficult for them to remain in, much less to expand, their business. Further, those suppliers who do receive the rate cut will have less incentive to adjust their prices downward, taking advantage of their less fortunate passthrough competitors to keep prices higher and pocket the increased after-tax profits. The net result is that fewer items are sold and at higher prices than would be the case if the tax cut were provided to all suppliers, and there is less benefit to the overall economy from the tax cut than should have been available.

It may be argued that this effect is not important in those industries where sole proprietorships, partnerships and S corporations represent only a small portion of domestic economic activity. But these passthrough businesses represent a majority of the domestic

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receipts in a number of key industries; including entertainment (75%), construction (72%), real estate (68%), agriculture (64%), professional services (62%), hospitality (60%), health care (59%) administration (56%) and education (53%).[1] A failure to provide equivalent tax rates for all active businesses without regard to their form will result in less economic activity than would otherwise be the case.

Summary

Tax reform should not result in placing any business at a competitive disadvantage, especially the dynamic passthrough businesses that are so important for U.S. economic success. Tax reform should be used as an opportunity to restore rate equivalency for all businesses.

Thank you for your consideration of these issues. We look forward to the opportunity to continue this dialogue during the consideration of tax reform.

[1] IRS Statistics of Income, 2008.