DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES

April 15, 2013

The S Corporation Association Comments to the House Committee on Ways and Means Pass-Through Business Working Group

The S Corporation Association commends the House Committee on Ways and Means and the Pass-Through Tax Reform Working Group for their commitment to comprehensive tax reform that would lower top tax rates for individuals and employers. We particularly appreciate the Committee's willingness to be transparent in this process and the opportunity to weigh in on these matters.

The comments below should be viewed as a friendly effort to recommend areas where we believe the Committee can make changes to improve the tax code and make all businesses, regardless of how they are structured, more competitive.

Pass-Through Business Community Principles

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 the majority of private sector workers and they contribute the majority of business income to our GDP.[1]

This reliance on pass-through businesses is not an accident or a byproduct of other priorities. Rather, it was done purposefully by successive Congresses seeking to strengthen the role of private businesses in the American economy. These deliberate actions date back to the creation of the S corporation structure 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 tackle tax reform in the coming months. One reason the pass-through business structure has been so successful is that it is, fundamentally, the correct way to tax business income. If Congress were in a position to start from scratch, the pass-through treatment of business income, particularly how S corporations are taxed, should be the starting point. As Eric Toder of the Tax Policy Center told the Senate Finance Committee last Congress:

> *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]

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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/

[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.

For publicly-owned companies with thousands of shareholders, pass-through treatment is simply not feasible. But for everyone else, allowing closely-held businesses to pay their taxes using the pass-through structure would be an improvement in tax administration and tax simplicity while helping to make U.S. business more competitive globally.

Starting with the premise that S corporation taxation is the correct way to tax business income, we encourage the Working Group to consider the following broad principles (supported by 47 business trade groups – see attached letter) as it considers how to best reform the tax code and tax business income:

1. Tax reform needs to be comprehensive. Most workers in the United States are employed at pass-through businesses that pay taxes at the individual rates, not the corporate rates. To ensure that we avoid harming a large segment of American employers, tax reform needs to include both the individual and the corporate tax codes.
2. Congress needs to keep the tax rates paid by individuals and corporations at similar, low levels. Excessive marginal rates discourage investment and hiring, while splitting business income and taxing it at significantly different rates encourages planning to circumvent the higher rates, ultimately resulting in wasted resources and lower growth. To ensure that tax reform results in a more simple and competitive tax code, Congress needs to keep top tax rates low, and it needs to keep them at similar levels.
3. Congress should continue to reduce the incidence of double taxing business income. A 2011 study on tax reform by Ernst & Young made clear that the predominance of pass-through businesses in the United States, and the single layer of tax they face, results in higher levels of investment and employment in the U.S. A key goal of tax reform should be to continue this progress towards taxing all business income only once.

The third priority here is particularly important. If the goal of tax reform is to improve incentives for domestic job creation and investment, it needs to address the burden of the double tax on American corporations. Congress has proactively worked to reduce this burden for the past three decades, and that progress should continue in any future tax reform. As the 2011 Ernst & Young study noted:

> *In addition, the flow-through form helps mitigate the economically harmful effects of the double tax on corporate profits, in which the higher cost of capital from double taxation discourages investment and thus economic growth and job creation. Moreover, double taxation of the return to saving and investment embodied in the income tax system leads to a bias in firms financing decisions between the use of debt and equity and distorts the allocation of capital within the economy. As tax reform progresses, it is important to understand and consider all of these issues with an eye towards bringing about the tax reform that is most conducive to increased growth and job creation throughout the entire economy.*[3]

[3] 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/

Tax reform will, by definition, include many, many details -- far too many to be addressed here. But if Congress successfully enacts tax reform that remains consistent with these three principles, the resulting tax code is more likely to encourage more investment and job creation while reducing the complexity of both paying and collecting taxes. It will create a code that raises the revenue the federal government needs in the manner that is more conducive to economic growth.

Recent Rate Hike on S Corporations and Other Pass-Through Businesses

Consistent with the second priority, one task of tax reform should be to reverse the recent rate hike on pass-through businesses. From 2003 through 2012, the top rate on individuals, pass-through businesses, and C corporations was effectively the same – 35 percent. This parity meant that taxpayers had little incentive to move income from one source to another, which meant business owners made decisions based on their business needs and not on the tax code.

That parity is now gone. Rates on pass-through businesses have gone up sharply starting January 1. These rate hikes mean that a dollar earned by an S corporation is subject to federal taxes totaling nearly 45 cents, whereas a dollar earned by a C corporation is still subject to a top tax of only 35 cents.

	2013	2012
Income Tax Rate	39.6%	35%
Pease Limitation	1.2%	NA
ACA Investment Tax	3.8%	NA
Total Marginal Tax	44.6%	35%

For pass-through businesses, the net effect of these higher marginal rates is to drain capital from the business. This is an important point that needs to be emphasized. S corporation taxes must be paid when the income is earned, and they are due regardless of whether the business distributes the earnings to its shareholders. To accommodate these taxes, most S corporations make quarterly distributions to shareholders sufficient to cover the taxes owed. For example, in 2012, an S corporation making $100 would have distributed $35 to its shareholders in order to cover the federal tax. Today, that same business would have to distribute $45. In other words, the retained earnings of the business just declined from $65 to $55. That $10 decline means less money to invest and hire new workers.

Tax reform should seek to reduce marginal tax rates and restore the rate parity between C and pass-through businesses on the initial layer of business tax.

S Corporation Modernization

Reducing marginal rates is not the only way tax reform can help S corporations. Since their creation in 1958, S corporations have grown to become the dominant form of private business. Despite this popularity and commensurate contribution to investment and jobs, the S corporation structure is extremely rigid, especially when compared to the partnership rules. Subchapter S limits the number of shareholders, the types of shareholder, and the classes of stock an S corporation may have. None of these limitations apply to partnerships and limited liability companies. As noted in a recent letter signed by 16 trade associations (see attached):

These outdated rules hurt the ability of S corporations to grow and create jobs. Many family-owned businesses would like to become S corporations, but the rules prevent them from doing so. Other S corporations are starved for capital, but find the rules limit their ability to attract investors or even utilize the value of their own appreciated property. Well into the 21st century, America's most popular form of small-business corporation deserves rules adapted to today, not fifty years ago.

Accordingly, we strongly support implementation of H.R. 892, the S Corporation Modernization Act, as introduced by Representatives Dave Reichert (R-WA) and Ron Kind (D-WI) and (largely) incorporated into Option One of the Ways & Means Pass-Through Business Discussion Draft. This legislation would:

- Make Permanent the Five-Year Built-In Gains Holding Period: Prior to 2009, businesses converting to S corporation were required to hold on to any assets with built-in gains (BIG) for at least 10 years or face a punitive tax applied at the highest corporate rate. In 2010 and again in 2012, Congress reduced the holding period to five years, but this shorter holding period expires at the end of the year. The Act would make permanent the five-hear holding period for built-in gains.
- Modify Passive Income Rules: 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 Act would raise this threshold to 60 percent of gross receipts and eliminate the "three strikes and you're out" penalty, consistent with recommendations made by the Joint Committee on Taxation.
- Allow Nonresident Aliens to Own S Corporations Through an ESBT: Nonresident Aliens are not allowed to own S corporation shares, closing off foreign investment as a source of capital. This provision allows nonresident aliens to invest in S corporations indirectly as the beneficiary of an ESBT. The Act will not allow for tax avoidance. ESBT rules ensure that all taxes are paid at the trust level and at the highest applicable tax rate.
- Charitable Contributions for ESBTs: Current law does not allow electing small business trusts to deduct certain charitable contributions attributed to an S corporation, even though individual shareholders of the S corporation are eligible for the deduction. The Act would apply the rule for individual S corporation shareholders to electing small business trusts.
- Charitable Contributions of Property: Prior to the Pension Protection Act, if an S corporation donated appreciated property to charity, its shareholders' deductions were limited to their basis in the S corporation. The PPA temporarily removed this limitation and Congress has extended it several times. The current rule is set to expire at the end of 2013. The S Corporation Modernization Act would make this adjustment permanent.

In addition to these provisions, other reforms that would ease the governance of S corporations include increasing the current limit on the number of S corporation shareholders, removing limits on the types of S corporation shareholders, and allowing S corporations to have more than a single class of stock. 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.

Ways & Means Discussion Draft

The S Corporation Association intends to submit more comprehensive comments to the Ways and Means Committee on the Pass-Through Business Discussion Draft once we have had a chance to review it more thoroughly.

As a general reaction, the S Corporation Association strongly supports the direction offered by Option One as well as most of the specifics. Option One would help millions of closely-held businesses by making it easier for them to access capital, manage their businesses, and transition from one generation to the next.

Option Two also includes many valuable reforms that would move the tax code in a positive direction. For example, it embraces a new, superior line of demarcation between those businesses taxed under the pass-through structure and those subject to the C corporation tax. By adopting access to capital markets as the dividing line, the Chairman has chosen the simplest and most enforceable dividing line between pass-through and C corporation tax treatment.

On the other hand, the scale of the changes suggested under Option Two, together with the uncertainty and transaction costs they would impose on existing S corporations and partnerships, has the potential to outweigh whatever benefits the resulting unified pass-through regime offers. Applying the existing partnership aggregate approach to S corporations is a big change and needs to be fully explored, as do the transition rules necessary to get both partnerships and S corporations from point A to point B.

Moreover, while Option Two seeks to replace the current matrix of business structures and rules with a single, unified pass-through regime, we believe there is inherent value in offering entrepreneurs multiple structures in which to organize their businesses that needs to be taken into account. Not all businesses have the same capital and governance requirements, and allowing owners to pick and choose between several options to best fit their specific business model increases their ability to raise capital and operate.

More time, analysis, and detail will be necessary before we can be more specific about our position on Option Two.

One specific area of concern in the Core Provisions is the cash accounting provision, which would limit the ability of S corporations and partnerships with revenues exceeding $10 million to use cash accounting. Service sector businesses, particularly those engaged in personal services need to use cash accounting in order to avoid cash flow disruptions. These businesses work on multi-year projects where their compensation comes in large, lump sum payments. Forcing them to pay taxes on income accrued but not actually paid could put them in a serious cash-flow bind while serving no real tax policy purpose.

Anti-Tax Reform

As much as Congress should seek to tackle tax reform in a comprehensive and thoughtful manner, it should also seek to avoid making changes that would take the tax code in the wrong direction. The vast majority of policymakers are unified behind two fundamental goals for tax reform:

- Increase simplicity for both taxpayers and the IRS; and
- Lower marginal tax rates imposed on a broader base of income.

There are, however, outliers who disagree with these two goals and whose proposals put forward under the guise of "tax reform" would take us in exactly the opposite direction. Rather than simplify the tax code, they would make it more complicated; and rather than move towards lower rates and a broader base of income, they would selectively lower and/or raise rates based on priorities that have little to do with simplicity or overall economic growth. Below are a few examples of these "anti-tax reform" proposals and our concerns with each.

Corporate-Only Tax Reform: The business community is united behind the premise that tax reform should be comprehensive and address the tax treatment of individuals, pass-through businesses and corporations. Nonetheless, the Obama Administration and a small subset of public companies continue to push Congress to consider budget-neutral, "corporate only" tax reform instead.

Under this approach, Congress would eliminate some or all business "tax expenditures" and use the new revenue to offset lower rates on C corporations. The 2011 Ernst & Young study made clear the challenge corporate-only tax reform presents to pass-through businesses. According to E&Y, a broad policy of eliminating business tax expenditures while cutting only corporate rates would raise the tax burden on pass-through businesses by approximately $27 billion per year– and that doesn't include the additional hit to pass-throughs from their increased marginal tax rates beginning as of January 2013.[4] The most affected industries include agriculture and mining, followed by construction, retail trade, and manufacturing.

This shift in the tax burden happens because pass-through businesses use the same business deductions as their C corporation counterparts. By way of example, a simple reform package might eliminate the Section 199 manufacturing deduction in order to offset a reduction in corporate tax rates. A manufacturer organized as a C corporation would lose the use of that deduction, but it would get a lower corporate rate in return.

For the S corporation manufacturer down the street, however, there is nothing but downside. It too would lose the use of Section 199, but unlike its C corporation competitor, the resulting higher tax base is not offset by lower tax rates. Instead, the tax rates on the pass-through manufacturer just went up. Corporate-only tax reform represents a double whammy on pass-through businesses – higher tax rates imposed on a broader base of income.

To address this challenge, some advocates have suggested allowing pass-through businesses a deduction on their income, or even separating pass-through business income from individual income and taxing it at different rates. While these options might mitigate the adverse impact of corporate-only

[4] 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/

tax reform on pass-through businesses, they also inflict serious damage to the tax reform effort in general.

Prior to the 1986 Tax Reform Act, the tax rates on individuals and pass-through businesses were significantly higher than the tax rate imposed on C corporation income. Here is how tax attorney and SCORP Advisor Tom Nichols described the situation during his testimony before the Ways and Means Committee last year:

> *This tax dynamic set up a cat and mouse game between Congress, the Department of the Treasury and the Internal Revenue Service (the "Service") on the one hand and taxpayers and their advisors on the other, whereby C corporation shareholders sought to pull money out of their corporations in transactions that would subject them to the more favorable capital gains rates that were prevalent during this period or to accumulate wealth inside the corporations. Congress reacted by enacting numerous provisions that were intended to force C corporation shareholders to pay the full double tax, efforts that were only partially successful. These provisions included Internal Revenue Code (the "Code") Sections 302 (treating certain redemptions of corporate stock as "dividends") and 304 (treating the purchase of stock in related corporations as "dividends"), as well as Code Sections 531 (imposing a tax on earnings retained inside the corporation other than "for the reasonable needs of the business") and 541 (imposing a tax on the undistributed income of "personal holdings companies" deriving most of their gross income from investments).*

In other words, business owners began making decisions based on the tax code and not on the needs of their business. The 1986 Tax Reform Act ended this dynamic. Corporate-only tax reform would restore it. It is literally "anti-tax reform."

Buffett Rule: The Buffett Rule continues to come up in certain policy circles as an option for ensuring that the tax code is more progressive and fair. Despite the frequency with which President Obama and others talk about the Buffett Tax, the arguments in favor of the tax are uniformly weak.

Congressional Budget Office (CBO) analysis makes clear that the federal tax code is already strongly progressive. According to the CBO, the top 1 percent of taxpayers in 2009 paid an effective tax rate of 29 percent, or nearly three times the effective tax rate paid by moderate income taxpayers (11 percent).

Moreover, we already have *three* tax codes for individual income, not counting the payroll tax system used to finance Social Security and Medicare. That is, we already impose three distinct tax rate structures on three distinct definitions of income earned by individuals and pass-through business owners:

1. The Individual Income tax
2. The Alternative Minimum Tax (AMT)
3. The Affordable Care Act Investment Tax

By any reasonable standard, tax reform should seek to reduce rather than to increase the number of tax codes we impose on families and businesses. Yet proponents of the Buffett Tax would impose yet a fourth tax code, this time on families and shareholders earning in excess of $1 million dollars.

Under the Buffett Tax, families earning that much in income would need to calculate their taxes four different ways! First, they would calculate their taxes under the Individual Income tax, then under the new Investment Surtax, then under the AMT, and then, after adding all those taxes together, they would need to calculate their overall Buffett Tax liability and see if it is higher. On this basis alone, Congress should reject the Buffett Tax concept.

For S corporations, the most dramatic and unfair consequence of the Buffett Rule for closely-held business owners would occur in the context of a sale of the business. The current federal tax rate for sale transactions is 20 percent (before taking into account the 3.8 percent additional tax on net investment income). The Buffett Rule would increase this tax rate for taxpayers making more than $1 million, even if that higher income was triggered by a "once in a lifetime" transaction involving the sale of a business built up over decades, effectively punishing entrepreneurs for starting and building a successful business.

By definition, the Buffett Rule would make the tax code more, not less, complex. It is anti-tax reform and should be rejected by Congress.

Conclusion

The S Corporation Association appreciates the opportunity to comment on these issues and strongly supports efforts by the Ways and Means Committee to enact comprehensive tax reform that lowers rates and broadens the base.

Consistent with the principles listed above, we call on Congress to enact comprehensive reform that lowers the top rates on individuals, pass-through businesses, and corporations alike while continuing to reduce the harmful double tax on corporate income. Reform that is consistent with these principles and the other policies listed above will help achieve the goal of making the tax code more simple and fair, while helping to make American businesses more competitive.

About S-CORP

The S Corporation Association (S-CORP) is the only organization in Washington D.C. exclusively devoted to promoting and protecting the interests of America's 4.5 million S corporations. S-CORP was founded in 1996.