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Individual Income Working Group
Senate Finance Committee
United States Senate
Washington, D.C. 20510

Grant Thornton LLP appreciates the opportunity to share our views with the members of the Senate Finance Committee Working Group on Individual Income. We commend the committee for undertaking the effort to make the tax code fairer, simpler, and better for U.S. businesses, and applaud the members of the Working Group on Individual Income for their consideration of the tax rates faced by pass-through businesses.

Grant Thornton is one of the six global accounting, tax and business advisory organizations, and we help thousands of the most dynamic businesses in America budget their business activities, report their earnings to creditors and shareholders, and fulfill their tax obligations. We write to urge you to ensure that any rate cut that comes as part of tax reform includes pass-through businesses. Any tax reform plan that eliminates tax preferences for all businesses but does not provide a rate cut for pass-throughs would raise taxes on four out of every five U.S. businesses.

If it is not possible to immediately cut individual rates as part of tax reform, then we urge you to consider a business equivalency rate (BER)[1] that would tax active business income on an individual owner's income tax return at a rate no higher than the top corporate rate. All business income, whether from C corporations, S corporations, partnerships, or sole proprietorships, should be subject to the same rate.

The importance of pass-through businesses

Pass-throughs represent one of the fastest-growing and most important segments of the economy. S corporations, partnerships, and sole proprietorships are called pass-throughs because the business income is not taxed at the entity level, but is instead "passed through" and taxed on the individual returns of the owners. More than 80% of all business entities are now organized as pass-throughs, and according to the publicly available statistics available from the IRS, pass-throughs are responsible for 38% of all business receipts and more than half of all net business income.[2]

Pass-through businesses also represent a majority of the domestic 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%).[3]

[1] *See generally* "Business Equivalency Rate: Fairness for Pass-through Businesses," *available at* https://www.grantthornton.com/issues/library/articles/public-policy/2013/policy-issues/business-equivalency-rate.aspx
[2] IRS Statistics of Income, Integrated Business Data (2008).
[3] Ibid.

These pass-through businesses are an integral part of the business landscape and represent a growing share of U.S. economic activity. They should not be asked to give up existing business tax benefits without a rate cut. Tax reform will not achieve its pro-growth objectives if it raises tax on four out of every five businesses.

Much of the tax reform effort has focused on addressing the competitive disadvantages faced by U.S. multinational businesses, which include pass-through entities. But lowering tax rates only for C corporations would put pass-throughs at an even greater disadvantage internationally, and treat them unfairly compared with their domestic C corporation competitors. Moreover, with C corporations relying on pass-throughs as suppliers, vendors, dealers, subcontractors and in other vital roles, the benefits of corporate-only reform will not be as great as expected. Any tax reform that fails to reduce rates for pass-throughs will ultimately be bad for the economy and, therefore, bad for C corporations.

Why pass-throughs need equivalency

Proponents of a corporate-only rate cut have suggested three false propositions:

- Pass-throughs can still benefit from business reform if given only targeted tax incentives;
- Pass-throughs do not need a rate cut because they already have a tax advantage over C corporations; and
- Pass-throughs could simply convert to a C corporation if they want the benefit of a rate cut.

Unfortunately, no targeted tax incentive can compensate for an actual reduction in rates. An enhanced Section 179 deduction could encourage businesses to accelerate investments, but it has major limits. Such a deduction would mostly benefit capital-intensive industries, while doing little for others. Since it is only a timing benefit, Section 179 does not affect how much tax these businesses ultimately pay. Similarly, an enhanced Section 199 deduction, which is targeted only to manufacturing income, would leave out all other industries.

Targeted tax incentives would provide meager consolation for pass-through businesses that are left out of a rate cut while also forced to give up other incentives along with C corporations. Enhancing targeted tax incentives also runs counter to the spirit of tax reform, which is aimed at lowering rates in exchange for eliminating less-efficient incentives and simplifying the tax code.

If pass-throughs give up tax incentives as part of tax reform, they deserve a rate cut. While it is true that C corporations face an additional layer of tax to the extent they distribute earnings, in reality such companies typically do not face the same need to distribute earnings as most pass-throughs. In fact, less than half of all public C corporations distribute dividends to shareholders.[4] Even among groups that traditionally do pay dividends, such as S&P 500 companies, on average, less than a third of earnings are actually distributed.[5]

C corporations already have a lower rate than pass-throughs, which face a top rate of 39.6% on all income regardless of how much is distributed (not including self-employment tax or the 3.8% tax on net investment

[4] S&P Dow Jones Indices, "U.S. Companies Slow Pace of Dividend Net Increases," April 2, 2015.
[5] S&P Dow Jones Indices, "Dividend Quarterly Release," March 17, 2015.

income). The price of a lower rate should not be giving up pass-through status, as there are compelling economic and business reasons for pass-through treatment.

Next to the sole proprietorship, a partnership of individuals is the most basic business structure, with two or more people coming together to share the operation and profits (or losses) of a business. It is also the most flexible way of organizing a business, allowing for an easier governing framework, more alternatives in raising capital, and greater opportunities to fine-tune the sharing of responsibility and profit within a direct and simple structure.

The S corporation was designed to combine the benefits of limited liability with pass-through treatment and a simple ownership structure. Although limited liability companies now offer another option for liability protection with pass-through treatment, S corporations — as evidenced by their ever-growing popularity — continue to provide an important and simplified governing framework for privately held businesses.

Both S corporations and partnerships provide for natural family structures that facilitate succession. They also make more sense for professionals who work in the business and have a greater need to distribute cash than do many investors in a corporation. C corporations can avoid tax on distributions by retaining earnings, but this is not an option for many professional businesses whose owners rely on distributions from the company for living expenses.

The current pass-through tax regime also benefits the economy. Because owners and partners in pass-throughs are taxed on all of their income regardless of whether it is distributed, there is no "lock in" effect that discourages distributions. This leads to a more efficient use of capital. Also, pass-through treatment does not distort investment incentives in favor of debt financing. Because dividend distributions are not deductible but interest is, C corporations have more incentive to finance investment with debt, resulting in an economic distortion that creates unnecessary risk and hinders efficiency and growth.

Capitalization agreements, compensation arrangements, benefit plans, and retirement plans have all been created under specific rules unique to pass-through entities. It would be very disruptive to business for pass-throughs to convert to C corporations, and therefore harmful to the economy. If corporate rates are lowered first and individual rates lowered later, the effect would be even more disruptive. Businesses could change their status initially only to be stuck in the wrong form when rates changed again, leading to complicated and costly restructuring and inefficient tax planning.

Ensuring fairness with a business equivalency rate

If business tax reform advances without an individual rate cut, it is still possible to ensure fairness for pass-throughs by adopting a BER. A BER would ensure all business income is taxed at the same rate, providing pass-throughs with the same benefits and burdens as their C corporation competitors.

Under the BER, qualified income from an active business pass-through or sole proprietorship would be taxed at a rate no higher than the maximum corporate rate. A BER is simple. It would mimic the well-understood and

long-standing concept of applying lower tax rates to certain kinds of income, such as capital gains and dividends. The BER is self-executing, so taxpayers would not be required to determine whether to elect in or out of the BER. Pass-through businesses would report the amount of qualified income for each owner on Schedule K-1. Individual taxpayers would use a new schedule similar to the existing capital gains Schedule D to report their qualified income and determine their tax.

The BER is easy to implement and resistant to abusive tax planning. There are existing, well-defined rules in the Internal Revenue Code for differentiating business income from investment income. The concept of trade or business income is used in more than two dozen separate code sections, including the following:

- Section 162 trade or business activities versus Section 212 for profit activities and Section 183 activities not engaged in for profit
- Section 1411 income derived in the ordinary course of trade or business
- Section 355 active conduct of a trade or business requirement for a tax-free spinoff
- Section 1362 passive investment income limits for S corporations

Lawmakers would have the option of leveraging these or many other existing well-developed concepts to achieve a definition for active business income that is consistent with policy decisions about which types of income should qualify.

The BER will not affect other individual incentives. The active income that qualifies for the BER would continue to be included in adjusted gross income, so it would be neutral to other tax policy decisions on phaseouts or deduction limits.

The BER would provide full rate parity for business activity conducted through an active trade or business while avoiding the full cost and political disagreement over an individual rate cut. The top rate on other ordinary individual income would remain 39.6%.

Conclusion

Grant Thornton salutes the Senate Finance Committee and the Working Group on Individual Income for their efforts to reform our antiquated tax code and for their transparent efforts to seek input from the business community. We firmly believe that all business income should be taxed at the same rate and that pass-throughs should not be asked to give up tax incentives without a cut in their tax rate. We would be happy to meet to further discuss the details of implementing a business equivalency rate in more depth, and we look forward to continuing this dialogue as you consider tax reform. Thank you for your consideration.

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