April 2015

Comments to the U.S. Senate Committee on Finance
Business Income Tax Working Group
On the Impact of Tax Reform Proposals on
S Corporations and Other Pass-Through Businesses

Senator Thune, Senator Cardin and Members of the Senate Committee on Finance Business Income Tax Working Group, the Small Business Legislative Council (SBLC) appreciates this opportunity to share its insights on the impact that certain tax reform proposals could have on the success of S corporations and other pass-through businesses.

S corporations and other pass-through businesses play a vital role in the American economy. Yet, all too commonly, tax reform proposals focus on C corporations, at best, placing S corporations and pass-through businesses at a disadvantage vis-à-vis C corporations and, at worst, leaving S corporations and pass-through businesses paying for the more favorable tax treatment for C corporations.

The Discussion Draft of the Tax Reform Act of 2014, released on February 26, 2014, by former House Ways & Means Committee Chairman Dave Camp (R-MI) (the "Camp Proposal"), contained both constructive technical improvements to the S Corporation tax rules as well as a number of far-reaching changes that could prove to have a much greater, and negative, impact on S corporations and other pass-through entities (including partnerships and limited liability companies treated as partnerships). Although Congressman Camp retired in January, 2015, his proposal is the most detailed tax reform proposal that we have seen in the last few years and provides an excellent vehicle for highlighting the types of proposals that would be particularly harmful to S corporations and other pass-through businesses.

The Small Business Legislative Council urges Congress to reject those proposals, like those set forth in the Tax Reform Act of 2014, that would disproportionally benefit regular C corporations, including large multinationals, at the expense of small and midsize pass-through companies, whose owners will pay for the C corporations' tax reduction.

Historically, start-up businesses, the vast majority of which are organized as pass-through entities, have accounted for a disproportionate share of new jobs in this country, a trend that appears to be dropping off since 2008. If Congress desires to do something positive for the future of American business, it is critical that it address the needs of all businesses, ranging from large publicly-held C corporations to closely-held S corporations, partnerships and sole proprietorships. Partnerships, S corporations and LLCs are not subject to tax, but their owners

are, and their rates are now higher than the corporate tax rate – 35% versus 39.6 %. Tax rates on business income are important. Therefore, if Congress wants to encourage more investment and jobs in the U.S., then it has to focus as much on the individual rates that are applicable to pass-through entity owners, as it does on the rate for C corporations.

Expansion of Self-Employment Tax to S Corporations

Many family and other entrepreneurs own and operate capital intensive businesses through S corporations. Under current law, and assuming those owners pay themselves reasonable compensation for the services they provide (and there are no published cases suggesting that unreasonably low wages are ever a concern for these capital intensive businesses), entrepreneurial profits earned by those owners, whether retained by the S corporation or paid as dividend distributions, are subject to income tax but not the Federal Insurance Contribution Act ("FICA") or Self-Employment Tax ("SE Tax"). This is consistent with the policy behind the FICA/SE Tax structure, which is a payroll-based system whereby employees and employers are required to set aside income during the employees' working years to meet the employees' retirement income and health care needs. In this respect, the S corporation tax structure also meshes well with the C corporation tax structure, which does not impose any FICA or SE Tax on profits earned at the corporate level, whether retained or paid to shareholders as dividends.

The Camp Proposal would dramatically change this. **It would force all pass-through businesses, including S corporations, into a rigid system, whereby 70% of their income would be subject to the SE Tax.**[1] *See* Camp Proposal § 1502 [amending I.R.C. §1402(a), creating new § 1402(m)]. This would result in a significant reduction in FICA/SE Tax for many existing partnerships, which have voluntarily chosen the current partnership tax treatment. However, this revenue loss would be more than offset by a substantial increase in the SE Tax liability of S corporation owners using the simpler, but less flexible, S corporation structure. The bottom line is that the owners of closely-held pass-through businesses would no longer have any vehicle available to them in order to avoid paying FICA/SE payroll-type taxes on their entrepreneurial profits,[2] even when they are paid reasonable wages that are subject to the FICA

[1] The Executive Summary for the Camp Proposal indicates that this change is designed to close the John Edwards/Newt Gingrich tax "loophole" whereby a sole shareholder of an S corporation tries to treat what is essentially wage/compensation income as business income not subject to the SE Tax. *See* House Ways and Means Committee, *The Tax Reform Act of 2014 (Executive Summary)* at 23 (available at: http://waysandmeans.house.gov/uploadedfiles/tax_reform_executive_summary.pdf). However, the Proposal's impact is much broader than that, and would apply to all S corporations, even those operating capital intensive businesses where the Edwards/Gingrich "loophole" has no application.

[2] Some have suggested that such entrepreneurs should simply elect C corporation status in order to avoid this result. However, policymakers have recognized that the double-tax C corporation system produces arbitrary results and is subject to manipulation. As a consequence, the Tax Code has encouraged and fostered a dramatic movement toward the single-tax S corporation/partnership structure ever since the Tax Reform Act of 1986. *Testimony of Thomas J. Nichols Before Committee on Ways & Means, United States House of Representatives* at pgs. 4-5, (March 7, 2012).

tax. President Obama addressed a similar issue in his 2016 Budget Proposal. Under the President's proposal owners of an S-Corp, partnership or LLC who materially participate in the business would be subject to SE Tax on their distributive shares of the business' income. However, unlike the Camp Proposal which would apply to all types of businesses, the President's proposal would only apply to professional service businesses.

Unequal Treatment of C Corporations and Pass-Through Businesses

Unlike S corporations, regular C corporations separately report their taxable income and pay income tax on that taxable income. Under current law, the top marginal rate for C corporations is 35%, whereas the top marginal rate for income earned through S corporations, partnerships and sole proprietorships is 39.6% (passive investors are also subject to an additional 3.8% "Medicare tax" on net investment income exceeding a specified annual threshold). Prior to calendar year 2013, the top marginal rate for both individuals and corporations was 35%. That placed pass-through businesses, which constitute the large majority of business enterprises and employ over half of the employees in the United States,[3] on the same footing as publicly-held and private C corporations.

An expansion of the current percentage point gap between the C corporation and pass-through top marginal rates would significantly undermine the viability and competitiveness of many small businesses which are organized as S corporations or closely-held businesses.[4]

A consideration of overall effective tax rates further bolsters the proposition that a reduction in tax rates for C corporations alone is not warranted. The effective tax rate (i.e., the rate on all income, rather than just the top marginal rate applicable on net additional income earned) is 31.6% for S corporations, whereas the effective rate for C corporations is between 17.8% and 27.1%, depending upon various factors, such as foreign earnings.[5] While the Small Business Legislative Council favors eliminating genuine loopholes and reducing marginal rates for all taxpayers (including C corporations), substantially increasing the current disparity between the top marginal and overall effective tax rates for C corporations versus S corporations and other pass-through entities would put entities in the latter category who retain and reinvest earnings at a substantial disadvantage vis-à-vis their C corporation counterparts, many of which are publicly held.

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[3] Drs. Robert Carroll and Gerald Prante, *The Flow-Through Business Sector and Tax Reform* at pg. 5, Appendix B, Ernst & Young (April, 2011).

[4] Under the Camp proposal, virtually all C corporation taxable income would be taxed at a flat 25% corporate rate. However, pass-through businesses would be subject to a 25% or 35% top marginal rate, depending upon the nature of the business.

[5] Quantria Strategies, LLC, *Entity Choice and Effective Tax Rates*. This study took into account the double-tax on C corporation dividends. However, the investigators were unable to adjust for the basis adjustment attributable to income/loss passed through from S corporations and other pass-through businesses due to lack of available data. *Id*. at n.9.

Complicated Rate Structure for Pass-Through Businesses

The Camp Proposal encompassed several changes that would constitute significant steps forward toward the goal of tax simplification. This would include the repeal of the corporate alternative minimum tax [Camp Proposal § 2001], the individual minimum tax [*id.*] and the deduction for domestic production activities [*id.* at § 3122 (amendment to I.R.C. § 199)].

However, the Camp Proposal would also introduce a new bifurcated tax system for upper income individuals under which most categories of income would be subject to a 35% marginal tax rate (without the benefit of many deductions currently available), but under which "qualified domestic manufacturing income" would be subject to only the 25% regular income tax without the additional 10% "surtax." *Id.* at § 1001 [amendment to I.R.C. §§ 1(a)(3); 2(b)(1)(B)(ii), (c)(1), (4)]. While the phase-out and repeal of the deduction for income attributable to "domestic production activities, this new two-level tax structure for pass-through entities would require their owners to distinguish between "qualified domestic manufacturing income" and all other income. Any such attempt to "pick winners and losers" unavoidably involves some arbitrary and random line drawing. It also triggers the diversion of resources from productive activities into corporate structuring and other tax planning designed merely to procure the benefit of the favored tax status.

In addition to the complications caused by this bifurcated tax system, the Camp Proposal introduced even more complexity when the new SE Tax provisions described above are taken into account. This arises because domestic manufacturing gross receipts eligible for the favored 25% top rate "shall not include any amount which is properly allocable to the taxpayer's net earnings from self-employment (determined after any reduction provided under Section 1402(m))." *Id.* at § 1001(b) [amending I.R.C. § 2(c)(5)]. Proposed new subsection 1402(m) provides that individuals who materially participate in a pass-through business will be able to deduct 30% of the net earnings from that business in determining their SE Tax, but that a passive investor will be entitled to exclude 100% of such income for purposes of the SE Tax. *Id.* at § 1502 [amending I.R.C. § 1402(a)(1), creating § 1402(m)]. The 100% exclusion for passive investors makes sense, because such taxpayers are subject to the new 3.8% "Medicare Tax" under Section 1411 of the Tax Code on net investment income above the annual income threshold.[6]

This interaction between the SE Tax provisions and the regular tax provisions cited above creates the anomalous result whereby the top marginal tax rate for individuals materially participating in a manufacturing business is substantially higher than that for passive investors in the same manufacturing business. Under the rules explained above, none of the manufacturing income of the passive investor is subject to the SE Tax, which means that all of that income is subject to the tax-favored 25% rate plus the 3.8% "Medicare Tax," for a top combined marginal

[6] The net effective rate for the new "Medicare Tax" is actually slightly higher because, in contrast to the SE Tax, no portion of it is deductible for income tax purposes. In order to avoid unnecessarily confusing the analysis, this paper does not illustrate the slightly varying rates resulting from this integrated deductibility system.

rate of 28.8%. However, only 30% of the active owner's income will be eligible for the tax-favored 25% rate (and exempt from the 3.8% top SE Tax), while the remaining 70% will not only be subject to the 35% rate, but also the 3.8% Medicare Tax. This results in a rate of 34.66% [(30% x 25%) + (70% x [35% + 3.8%]) = 34.66%]. This policy does not seem to be consistent with the concept of promoting the development, and even the repatriation, of manufacturing business within the United States.

<u>Closing "False Loopholes"</u>

A fundamental principle of most of the tax reform proposals to date is to eliminate unwarranted tax benefits for taxpayers and use the additional revenue generated thereby to lower rates for all taxpayers (or to raise revenue). As a general proposition, the SBLC supports the goal of reducing tax rates. However, it is absolutely critical to distinguish between "loopholes" that constitute genuinely unwarranted tax benefits and those provisions that are solidly based in fundamental tax policy.

There are many examples of loophole elimination in the Camp Proposal, such as the repeal of percentage depletion, whereby taxpayers may deduct an amount in excess of the amount actually paid for mineral properties. Camp Proposal at § 3130 [repeal of current I.R.C. §§ 613; 613A]. However, there are a number of other provisions in the Camp Proposal that are aimed at closing tax "loopholes" that are not unwarranted tax treatment and thus are not loopholes that should be reformed ("False Loopholes").

One obvious example of a False Loophole is the Section 409B structure set forth in the Camp Proposal. *Id.* at § 3801. This new provision would require all employees to include deferred compensation in their taxable income as soon as there is no substantial risk of forfeiture, notwithstanding the fact that the deferred compensation has not yet been paid and may not be paid for many years or may never be paid if the business becomes insolvent. Forcing employees to pay tax on money that they have not received does not appear to serve any policy purpose. Instead, it is punitive and unfair. The nonabusive nature of the current tax treatment of deferred compensation is made more obvious by the fact that current law already clearly provides that the employer in these circumstances is not entitled to deduct any such deferred compensation unless and until the employee is paid and includes the compensation in income. *See* I.R.C. § 404(a)(5).[7] Thus, the net effect of this part of the Camp Proposal would further (1) complicate the Tax Code and compliance and (2) punish many unsuspecting taxpayers who are engaging in perfectly legitimate business activities that are not abusive. In fact, the SBLC contends that Section 409A should be modified so it does not apply to closely held businesses.

We understand that even true tax loopholes have their defenders, and we are not suggesting that true tax loopholes should not be eliminated. The SBLC generally supports the

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[7] In this respect, new Section 409B would suffer form the same infirmities as Section 409A, a similar "loophole" closing provision enacted in 2004. American Bar Association Tax Section, *Letter re I.R.C. Section 409A* (July 31, 2006); Small Business Council of American Section 409A Whitepaper.

proposition that all tax "loopholes" that benefit a select few without any meaningful policy justification for the disparate treatment should be eliminated and the revenue generated should be used to reduce tax rates for *all* taxpayers. But we also support the proposition that a more competitive corporate rate for America's largest businesses should not be paid for by America's vital small business sector.

S Corporation Improvements

The above critique is not to say that recent proposals, including the Camp Proposal, do not contain any recommendations that would be positive for S corporations or pass-through businesses. The Camp Proposal, for example, does contain a number of changes to the S corporation rules that would be clear improvements from the standpoint of both tax policy and administration. These include the following:

1. Making permanent the reduction in the built-in gains tax recognition period (a time period after a C corporation becomes an S corporation) from ten years to five years amending I.R.C. § 1374(d)(7)]. This serves to free up capital for S corporations, which is important because S corporations, unlike publicly-held C corporations, do not have the ability to raise capital in the public markets. Moreover, the five-year period is clearly sufficient for whatever policy justifications there are, if any, for discouraging S corporations from selling assets that appreciated during any period prior to the election of S stats. Most recently, a proposal to reduce the built-in gains tax recognition period from ten years to five years was included as part of the America's Small Business Tax Relief Act of 2015 (H.R. 636) which passed the House on February 13, 2015.

2. Increasing the passive investment income tax floor from 25% to 60% and repealing the provision triggering termination of S corporation status as a result of excess passive investment income [amending I.R.C. §§ 1375(a); 1362(d)]. This change would conform the S corporation passive income tax rules with the personal holding company rules for C corporations. Both sets of rules are intended to reduce the incentive for "incorporated pocketbooks," and it makes sense for comparable rules to apply to both types of corporations.

3. Expansion of qualified beneficiaries for electing small business trusts to include nonresident aliens [amending I.R.C. § 1361(b)(1)]. This provision would allow S corporations to access an additional source of capital by enabling nonresident aliens (in addition to U.S. citizens and resident aliens) to invest in S corporations. Given the fact that any income allocable to such newly eligible owners would automatically be taxed at the highest applicable individual income tax rate, this change should cause little, if any, revenue loss to the government. In fact, for this reason, it makes sense for any individual or entity to be able to qualify as a shareholder in this fashion, i.e., subject to the top individual rate. This would

facilitate S corporation access to new sources of capital with little or no cost to the government in terms of lost revenue.

4. Allowing corporations to make their S corporation election on their initial tax returns [amending I.R.C. § 1362(b)]. Under current law, S corporations must make their S election within the first 2½ months of their initial taxable year. However, many corporations, especially start-up entities, may not consult their tax accountant until it is time for them to prepare and submit tax returns for the year. This reform provision would enable corporations to make that intital S election as part of the tax return preparation process, rather than having to wait at least one additional year and potentially having to deal with cumbersome calculations, including the built-in gains tax, as a consequence.

Each of these changes would be consistent with good tax policy. However, although each of them could have a substantial impact on the specific S corporations to which they apply, these changes would not impact the vast majority of S corporations, whereas the rate and other changes described in the earlier sections of this paper would have a substantial and negative impact on the entire pass-through community.

The SBLC thanks this Committee for its consideration of these issues and would welcome the opportunity to discuss these comments further.

The SBLC is a 35 year old permanent, independent coalition of over 50 trade and professional associations that share a common commitment to the future of small business. SBLC members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. SBLC policies are developed by consensus among its membership.

For more information, please feel free to contact:

Paula Calimafde, President and General Counsel
301-951-9325
calimafd@paleyrothman.com

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