S CORP
DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES
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S-Corp Concerns with Senate Tax Reform Bill

Top Line

The Framework and rhetoric leading up to its release indicated that Senate Leadership and the Finance Committee were committed to treating the millions of companies organized as pass-through businesses fairly in relation to C corporations. The Framework explicitly called for a rate differential of five percentage points, while previous Finance Committee work focused on leveling the playing field between C corporations and pass-through businesses by eliminating the double corporate tax and moving the entire business community towards a single, reasonable level of tax on all businesses.

Unlike much of the business community, S-Corp fully supported *both* efforts and expressed that support publicly.

The tax bill released Thursday night falls well short of these promises and policies. It abandons any notion of equity for pass-through businesses. Under the plan, no successful pass-through business will receive the promised 25 percent rate or anything close to it, while the new, larger tax rate gap between pass-through businesses and C corporations will result in a migration of business activity out of the correct, single layer tax approach and into the harmful, double corporate tax. The economy will suffer as a result – there will be fewer jobs and less investment than if pass-through businesses could continue as a viable alternative for family businesses.

The new disparity of rates between individuals and C corporations will turn the C corporation into the tax avoidance vehicle of choice for wealthy taxpayers, returning the Tax Code to the pre-1986 Tax Reform Act days when C corporation rates were sharply lower than individual rates and tax gaming within the corporate structure was rampant.

Below are specific concerns and questions we have regarding the Senate bill. It was released late Thursday evening, so this is not a comprehensive list or review. S-Corp will continue to work with the Committee and members of the Senate to seek improvements and restore some semblance of parity between the tax treatment of C corporations and S corporations.

Specific Concerns

Rate Differential: The bill reduces the top rate on C corporations to 20 percent. The bill reduces the top rate on S corporations to 38.5 percent, 18.5 points higher and 13.5 points above the promised rate in the Framework. The bill does include a deduction for pass-through businesses, if they have sufficient employees and payroll costs, of up to 17.4 percent, bringing the effective rate on qualifying pass-through businesses down to 32 percent, or 12 points above the C corporation rate. That is not the rate most S corporations will pay, however:

- SALT: The bill repeals the State and Local Tax Deduction for individuals and pass-through businesses. C corporations will continue to deduct SALT. Depending on which state(s) an S corporation resides in, the repeal of this business expense will increase the marginal rate of S corporations by as much as 5 percentage points. S corporations operating in California, therefore, will pay a marginal rate of 37 percent. The average S corporation will pay a marginal rate of around 34 percent, or 14 points above the C corporation rate.

- NIIT: Republican leadership promised to repeal the Net Investment Income Tax (NIIT) following the election of President Trump. This tax applies to income from S corporations earned by inactive shareholders. The failure of health care reform, coupled with the decision by leadership to not repeal the NIIT in tax reform, means marginal rates on S corporation income for inactive shareholders will be even 3.8 percentage points higher, resulting in a top marginal rate for S corporations of 40 percent or more.

- Revenues: The reason the pass-through rate is so much higher than the C corporation rate is the Committee chose to devote relatively more revenues to reducing the corporate rate. The JCT reports that the 20 percent corporate rate reduces revenues by $1,326 billion, whereas the pass-through deduction reduces revenues by just $460 billion, or 26 percent of the total revenue pool devoted to business rate relief. By way of comparison, pass-through businesses employ the majority of workers and earn the majority of business income. They represent approximately one-third of the American economy, not one-fourth.

- Fix: The Committee should devote a proportional amount of revenue to reducing the pass-through rate as it does to reducing the C corporation rate. At the very least, it should set as a goal maintaining the current maximum rate differential of approximately 9 percentage points between the two entity types.

Base Broadening: The Senate bill includes extensive base broadening, much of it affecting both C corporations and S corporations. But many of these base broadening provisions apply to pass-through businesses only, while all the base broadening will hurt S corporations more, since their marginal rate is so much higher than the C corporation rate. The loss of a $1 deduction will cost C corporations just 20 cents, whereas it will cost an S corporation up to 40 cents or more. Here are some of the significant base broadening provisions that will affect S corporations:

- Loss Limitation Rules: The Senate bill includes a wholly new limitation on "excess business losses of a taxpayer other than a C corporation…" There is little explanation as to why this provision is needed, necessary or even good policy. It would apply to active pass-through business income (not passive income) and it raises $176 billion over ten years. By way of background, the JCT references an existing limitation on losses by farmers who receive federal crop subsidies, yet this provision appears to have nothing to do with farms or subsidies. When you net this extra tax against the cost of the 17.4 percent deduction, the rate relief targeted at pass-through businesses drops to $284 billion, or just one-fifth the cost of the 20 percent corporate rate.

- SALT: The bill would repeal the State and Local Tax (SALT) deduction for individuals and pass-through businesses but not for C corporations. As noted above, this has the effect of raising marginal rates of pass-through businesses by up to 5 percentage points, exacerbating the rate differential between S and C corporations.

- Section 199: The bill would repeal the Section 199 deduction for production income, utilized by manufacturers and other producers. Four out of five manufacturers are organized as pass-through businesses. The deduction is up to 9 percent of production income, so it has the potential to reduce effective marginal tax rates by more than 3 percentage points. While the 199 repeal applies to both C corporations and pass-through businesses, the rate disparity between C corporations and pass-through businesses means it will hit S corporations up to twice as hard.

- Repeal of Miscellaneous Deductions: These are a series of deductions that are only limited for individuals and pass-through businesses, including indirect and miscellaneous deductions from a pass-through business and deductible investment expenses from a pass-through entity. Preventing a partnership from deducting investment expenses can result in the partners paying taxes exceeding the returns on the investment. Needless to say, C corporations may continue to deduct their investment expenses.

- AMT: The Senate bill would repeal the individual Alternative Minimum Tax (AMT). This is a large benefit to pass-through businesses, since much of their income is taxed under the AMT rather than the regular code. The effect is muted if not fully offset, however, by the fact that the bill repeals many of the deductions restored by the AMT repeal. For example, pass-through businesses lose the SALT when their shareholders pay the AMT. Repealing the AMT restores their ability to deduct the SALT. The bill then repeals the SALT, but only for individuals and pass-through businesses, not C corporations. Combined, the base broadening in the Senate bill has the effect of turning the regular Tax Code into a new AMT, only at higher marginal rates.

- Fix: Strike the new limitation on active pass-through business income and allow pass-through businesses to deduct SALT.

International: The bill moves the tax code from a world-wide system to a modified territorial system (subject to the new GILTI regime). This new territorial system is reserved for C corporations only. S corporations and other pass-through entities are not included. This exclusion puts S corporations with overseas operations at a distinct disadvantage.

- Example: Under the bill, a C corporation with a CFC operating in the UK would pay the 20 percent UK corporate tax. Assuming no further inclusions under the GILTI regime, it would be able to pay the remainder back to the US with no additional tax. When the C corporation pays that income as a dividend to its shareholders, they would be taxed at 23.8 percent, but only those shareholders who pay taxes. Seventy-five percent of C corporation shareholders are tax advantaged - charities, endowments, qualified plans, foreigners, etc.

- S Corporations with branch operations in the UK would pay the 20 percent tax to the UK and then the US tax of 32-41 percent immediately (see section above) at the new pass-through tax rates. They would be allowed a Foreign Tax Credit for the taxes paid in the UK against their personal income, but this would be subject to limitations. There would be no opportunity to defer paying the US tax.

- Alternatively, an S corporation with a CFC would pay the 20 percent UK tax and its shareholders would be taxed at 23.8 percent on 100 percent of the dividend income when that is repatriated, regardless of whether the dividend was distributed to the shareholders. In other words, an S corporation with a CFC is treated worse than a C corporation CFC under the new territorial system.

- IC-DISC: The bill repeals the IC-DISC. This repeal has little effect on C corporations, as income qualifying for the new territorial system is taxed almost exactly as the IC-DISC system does now. The foreign earnings would be subject to foreign tax, and then a single additional layer of tax at the dividend rate when dividends are paid to the shareholder. The only difference would be that the dividends can be paid directly to the shareholder, rather than through the DISC. Since S corporations are excluded from the new territorial system, they will be harmed by this repeal. They lose the benefit of the DISC, but also are precluded from the benefits of territorial.

- Fix: The Senate bill should allow S corporations with CFCs to participate in territorial. The result would be IC-DISC-like treatment for all types of business operating overseas, with all of them having equal treatment. An alternative fix would be to preserve the IC-DISC for pass-through businesses.

Bottom Line

If enacted as introduced, the Senate bill would result in a large migration of business activity from the pass-through tax and into the double corporate tax. This migration would not result in better economic performance – the transition costs, the double tax imposed on a broader base of business income, and the change in behavior it would require on the part of converted family businesses will hurt economic growth, not help it.

Pass-through businesses employ the majority of workers, they earn the majority of business income, and they pay higher effective tax rates than C corporations, yet they are literally being treated as an after-thought in this legislation.

The fix is for the Senate (and the House) to pursue tax reform that balances the importance of the pass-through community with the legitimate need to reduce the C corporation rate. S-Corp and its allies are willing and eager to work with the Committee and the full Senate to affect these changes.