



## TESTIMONY BEFORE THE JOINT ECONOMIC COMMITTEE

### Hearing On: *Small Business, Big Taxes: Are Taxes Holding Back Small Business Growth*

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#### History of the S Corporation

Before Congress created S corporations, entrepreneurs had two choices. They could form a traditional C corporation and enjoy liability protection, but they would face two layers of federal tax at the corporate and individual level. Or they could choose a partnership or sole proprietorship and enjoy a single layer of taxation at the individual level, but sacrifice the umbrella of liability protection.

Neither choice was optimal for closely-held and family owned businesses. In 1946, the Department of Treasury suggested a third option – merging a single layer of federal tax with comprehensive liability protection. President Eisenhower embraced the Treasury proposal and in 1958, led by Democratic Finance Chairman Harry Byrd, Congress acted to create subchapter S of the tax code.

Creation of the S corporation was a huge step forward in reducing the harmful effects of the double corporate tax and encouraging closely-held and family business creation in the United States. Reducing an oppressive level of tax was an essential part of the legislation. As the Finance Committee noted at the time of passage, “permitting shareholders to report their proportionate share of the corporate income, in lieu of a corporate tax, will be a substantial aid to small business.”

Over a half century later, policies embraced by Democratic and Republican Congresses alike have made the S corporation rules more flexible while also reducing the marginal tax rates these businesses pay. In return, S corporations have made the American economy more flexible, dynamic, and diverse, helping to create much needed jobs while providing an essential economic anchor to communities around the country.

Despite this success, the recent debate over reforming business taxation has almost exclusively focused on C corporations and their challenges. This narrow focus has persisted even though S corporations and the larger pass through business community employ the majority of workers, contribute more to our national economy, and face exactly the same pressures and challenges as C corporations.

The rate on C corporations should come down as part of a larger package of tax reforms, but so shouldn't the top tax rate on pass through businesses, including S corporations. This is an argument we have been making for more than four years now, and during that time we have developed a number of



themes that help explain both the importance of the pass through community to investment and jobs here in the United States, and the reasons why Congress should enact comprehensive tax reform that reduces rates for pass through businesses and C corporations alike.

### Use S Corporations as the Model

Simply put, the S corporation structure is the correct way to tax business income. If Congress were starting its tax policy from scratch, it would start with the S corporation model to tax business income. There are three key reasons why this is true.

First, S Corporation income is taxed once, and only once. Everybody knows multiple layers of tax raise the total effective rate paid by businesses, but the double corporate tax also has the effect of distorting business behavior. There is a reason why only a small minority of C corporations pay dividends – they are adjusting their behavior to avoid that second layer of tax. Business income should be taxed once at a reasonable rate and then that's it.

Second, S corporation income is taxed when the business earns the income, and it is taxed regardless of whether the income is “distributed” to shareholders. There is no election or deferral in paying tax on S corporation income.

Finally, S corporation income is taxed at progressive rates tied to the shareholder's income. Wealthy S corporation shareholders pay high marginal rates while lower income shareholders pay lower rates. This contrasts with the C corporation model, where with few exceptions most C corporation shareholders shoulder the same tax burden, regardless of their income.

### S Corporations are Doing What Congress Intended

Congress created S corporations to encourage private enterprise and it worked. Today there are 4.6 million S corporations.<sup>1</sup> They are in every community and they are engaged in every type of industry.

Since their inception, Congress has proactively amended S corporation rules to make them more attractive to entrepreneurs. Reforms enacted in 1982, 1986, 1996, 2001, 2003, 2004, and since have made the S corporation structure more flexible and competitive with C corporations and the newer LLC's. Of these changes, the two that stand out are the broad tax reforms of 1986 and the Jobs and Growth tax package of 2003.

The 1986 tax reform opened the door to the broad growth of the pass through business sector. Prior to 1986, the top rate on corporate income was 46 percent, while the top rate on individual income was 70 percent. As a result, the vast majority of business activity was done under the C corporation umbrella and tax planning, avoidance and gaming was rampant as business owners attempted to avoid the higher

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<sup>1</sup> Internal Revenue Service Data Book, 2014



individual rates. As S Corporation Association Advisor Tom Nichols testified before the Ways and Means Committee in 2013<sup>2</sup>:

*When I first started practicing law in 1979, the top individual income tax rate was 70 percent, whereas the top income tax rate for corporations taxed at the entity level (“C corporations”) was only 46 percent. This rate differential obviously provided a tremendous incentive for successful business owners to have as much of their income as possible taxed, at least initially, at the C corporation tax rates, rather than at the individual tax rates, which were more than 50 percent higher.*

*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.*

The second major event in pass through taxation was the adoption of the Jobs and Growth tax package in 2003. This package included two major improvements in business taxation. First, it significantly reduced the double tax on corporate income, moving corporate taxation closer than ever to the pass through structure we should adopt.

The President’s initial proposal was for full integration of the corporate code so that, like S corporations, C corporation income would have faced a single layer of tax. Far from being unachievable as some have argued, that proposal came within a few votes of becoming law. As it was, Congress adopted a plan that significantly reduced the double tax by cutting dividend and capital gains taxes to 15 percent.

Second, the 2003 reforms resulted in rate parity among C corporations, pass through businesses, and individuals. This meant that a business making a dollar faced the same 35 percent rate, regardless of how it was structured, on its initial earnings.

In return for these reforms, S corporations have rewarded Congress by making the US economy larger and more flexible than if all business activity were conducted under the C corporation structure. As Ernst & Young noted in 2011:

*“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*

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<sup>2</sup> Statement of Tom Nichols before the Ways and Means Select Revenue Measures Subcommittee (May 15, 2013)



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.”<sup>3</sup>

There is more employment and capital investment in the United States than if all businesses were organized as C corporations because of the existence and success of pass through businesses.

#### Pass Through Business Employ Most Workers

The higher growth rates resulting from pass through taxation includes employment. Both Ernst & Young<sup>4</sup> and, more recently, the Tax Foundation<sup>5</sup> have found that more than half of private sector workers are employed at pass through businesses, while S corporations employ nearly one in four. According to the Tax Foundation numbers:

- Pass Through Businesses – 66 million (55 percent)
- S corporations – 29 million
- Partnerships – 13 million
- Sole Proprietorships – 23 million
- C Corporations – 52 million (45 percent)

States with the highest levels of pass through employment include Montana, South Dakota, Maine, Rhode Island, New York, Idaho and Wyoming. Only Hawaii and Delaware have pass through employment levels below 50 percent.

The Tax Foundation reports that large pass through businesses also are a significant source of employment. According to their analysis, more than 10 million people work at pass through businesses with more than 500 employees.

#### The Business Tax Base is Growing, Not Shrinking

Moreover, while observers frequently note that the corporate tax base has shrunk since 1986, it's rarely pointed out that the business tax base overall has grown in that time. Business plays a bigger role in the American economy today than it did prior to 1986, entirely due to the growth of pass through businesses, including S corporations.

According to the Tax Foundation<sup>6</sup>, in the decades prior to 1986, traditional C corporation income made up approximately 8 percent of GDP while pass through income, including S corporations, made up just one percent, for a total of 9 percent. Today, following the 1986 reforms and subsequent improvements in business taxation, C corporations contribute 5 percent of GDP while pass through businesses add 6 percentage points – a total of 11 percent of GDP

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<sup>3</sup> Robert Carroll and Gerald Prante, The Flow-Through Business Sector and Tax Reform (Ernst & Young, 2011)

<sup>4</sup> Ibid., 4.

<sup>5</sup> Kyle Pomerleau, An Overview of Pass-through Businesses in the United States (Tax Foundation, 2015)

<sup>6</sup> William McBride, "America's Shrinking Corporate Sector," Tax Foundation, last modified January 6, 2015



Instead of decrying the “erosion” of the corporation tax base, policymakers should be celebrating the growth of the business tax base. The pass through approach to business taxation is superior in many respects, and businesses are making that clear by migrating, when they are able, into the more efficient structure.

#### S Corporations Pay Their Fair Share of Tax

Another critique of S corporations is that they “avoid” the corporate tax, with the implication being that they either don’t pay taxes or pay insufficient levels of tax. This is simply untrue. While it’s correct that S corporations do not pay the corporate tax rates, as noted above they do pay taxes on their business income when it is earned, and often at higher rates than C corporations.

To get a better sense of how much tax S corporations pay, two years ago we asked the econometric firm Quantria<sup>7</sup> to measure the effective tax rates of businesses by type – C corporation, S corporation, partnership, and sole proprietorship. They found that S corporations, and particularly large S corporations, pay the highest effective federal tax rate:

- Sole Proprietorships: 15 percent
- C corporations: 27 percent
- Partnerships: 29 percent
- S corporations: 32 percent
- Large S corporations: 35 percent

For pass through businesses, these results show what you might expect. Sole proprietorships are generally informal smaller enterprises with lower incomes while partnerships and S corporations tend to be larger and more formal, so they have higher effective tax rates. And while effective rates on C corporations have been studied extensively, with results sometimes varying from the level found by Quantria, the key point here is that pass through businesses, and in particular S corporations, pay significant amounts of tax. Policymakers should keep this in mind as they seek to reform how businesses pay tax.

#### Rates on Pass Through Businesses Just Went Up

Finally, it is important to point out that, as a result of the resolution of the fiscal cliff and the implementation of a new Affordable Care Act tax, marginal tax rates on pass through businesses went up sharply beginning in 2013.

First, top marginal rates on pass through businesses rose from 35 to 39.6 percent. Second, the restoration of the Pease limitation on itemized deductions has the effect of increasing marginal rates by another 1.2 percent.<sup>8</sup> And finally, the implementation of the new ACA Investment Surtax adds another 3.8 percent on S corporation shareholders who do not work at the business. The cumulative effect of

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<sup>7</sup> Entity Choice and Effective Tax Rates. Quantria Strategies, LLC, 2013

<sup>8</sup> Kyle Pomerleau, " The Pease Limitation on Itemized Deductions Is Really a Surtax," Tax Foundation, last modified October 6, 2014



these changes, all taking effect beginning in 2013, raised the top marginal rate on S corporation shareholders and other pass through business owners from 35 to more than 44 percent.

The effective of this increase is to drain working capital from these businesses. The Chairman of McGregor Metalworking, an S Corporation Association member testified earlier today<sup>9</sup> that the combined local, state, and federal tax distributions he makes to his shareholders increased from 34 percent in 2012 to 42 percent in 2013. Prior to 2013 he was able to retain up to 66 cents of every dollar his business made for working capital and hiring new workers. Post 2013, he only is able to retain up to 58 cents.

#### Pass Through Businesses and Tax Reform

Beginning four years ago, we became aware of a move by the Treasury Department to push for reforming the business tax code, but for corporations only. Under this plan, the business tax base would be broadened by eliminating certain deductions and tax credits and then the revenue raised from that base broadening would be used, at least in part, to pay for lower rates for C corporations.

The challenge of this approach to pass through businesses is obvious. Pass through businesses use the same deductions and credits as C corporations to determine their taxable income, but unlike C corporations, their rates just went up, not down. The result would be C corporations facing an initial layer of tax 15 to 20 percentage points less than the pass through business they compete against. This disparity in rates is simply unsustainable.

To assess how harmful this approach would be to pass through businesses, in 2011 we asked Ernst & Young to study<sup>10</sup> the effect of corporate-only tax reform. They found that corporate-only reform would increase the tax burden on pass through businesses by 8 percent, or about \$27 billion per year. Industries most affected include agriculture, construction, and retail. This estimate was done prior to the rate hike starting in 2013, so the impact on pass through businesses today would likely be higher.

For a company specific example, consider again McGregor Metal Working. As noted previously, their effective tax rate (including federal, state and local) increased from 34 to 42 percent as a result of the fiscal cliff and the implementation of the ACA investment surtax. According to McGregor, if Congress enacted corporate-only reform that lowered the corporate rate while eliminating McGregor's access to LIFO, section 199, and the R&E tax credit, their effective rate would rise to over 46 percent.

#### Pass Through Principles for Tax Reform

So the pass through community opposes corporate-only tax reform. What do we support? Two years ago, dozens of trade groups representing hundreds of thousands of pass through employers signed a letter articulating the following three principles for tax reform:

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<sup>9</sup> Statement of Dan McGregor before the Small Business Committee (April 15, 2015)

<sup>10</sup> Carroll and Prante, The Flow-Through Business Sector and Tax Reform, Ernst & Young, 2011.





1. Reform needs to be comprehensive and reform the code for individuals, pass through businesses, and corporations alike;
2. Reform should reduce rates on individuals, pass through businesses, and corporations and seek to restore the rate parity that existed from 2003 to 2013; and
3. Reform should continue to reduce or eliminate the double tax on corporate income.

This week, we released an updated version of this letter with more than 100 trade groups signing on, including the National Federation of Independent Business, the National Restaurant Association, and the American Farm Bureau.

The message is simple – when it comes to reforming the tax code to make American businesses more competitive, the difference between a “corporate only” approach that treats pass through businesses as an afterthought and true comprehensive reform that treats them as an equal partner is rate reduction. Tax reform needs to reduce rates on corporations and pass through businesses alike and seek to restore the rate parity that existed prior to 2013.

#### Why Can't They Just Convert?

One question that gets asked repeatedly is why S corporations who oppose corporate only reform don't simply convert to C corporation status to access the lower rates. If the Administration's approach to reform were adopted, the short answer is that many would convert, but they wouldn't be better off, and neither would the tax code or the economy. The result would be a step backwards for business taxation, not an improvement.

Here are three reasons policymakers should reject the “they can just convert” argument:

1. **Anti-Tax Reform:** The 1986 Tax Reform Act ended the decades-long era of taxing corporate income at lower rates than individuals and pass through businesses. As noted above, that approach discouraged the creation and growth of closely-held and family businesses while encouraging gaming and tax sheltering. Corporate-only reform would effectively return us to the pre-1986 world where most businesses were structured as C corporations and business decisions were driven by tax considerations, not business considerations.
2. **Strengthens the Double Tax:** Most observers agree that the double tax on corporate income retards investment and jobs creation, yet those arguing that S corporations can just “convert” are suggesting that we should increase the reach of the double tax to include family businesses currently structured as S corporations. That makes no sense. Tax reform should move business taxation away from the double tax, not towards it.
3. **Penalizes Business Sales:** For many business owners, the sale of their business is their retirement plan. The tax code recognizes this reality by taxing any gain from the sale of a pass-through business at the capital gains rate of 24 percent. The sale of a closely-held C corporation, on the other hand, is taxed twice at a combined rate of 50 percent. This double tax punishes entrepreneurs who have spent a lifetime building their businesses.



The goal of tax reform should be to promote closely-held and family-owned businesses, not punish them.

### Conclusion

Congress has a unique opportunity to dramatically improve how we tax all businesses. This reform effort should build on the remarkable success of the experiment begun 50 years ago when Congress created the S corporation. With that legislation, Congress sought to improve the American economy by encouraging the creation of closely-held and family owned businesses and to diversify economic decision making across the country.

Today, America's 4.6 million S corporations come in every size imaginable and are in every industry, every state and every community. Combined with partnerships and sole proprietorships, the pass-through community employs the majority of American workers and generates more than half of all business income. This diversity of industry, size and location strengthens our economy by spreading out economic power and decision making away from the financial centers and into the local communities where the business resides.

By adopting reforms that fit within the three pass through principles articulated above, Congress can help Main Street businesses succeed by continuing to shift business activity away from the harmful, less competitive double corporate tax and towards the more efficient, competitive pass through model. These businesses have been at the forefront of America's economic growth since their inception, and have acted as a backstop for economic insecurity, most recently during the 2008 financial crisis. The resiliency of S corporations and other pass-through businesses is vital to our nation's economy, and Congress should make them a centerpiece of any tax reform effort.