Testimony before the Senate Committee on Small Business

"Tax Reform: Removing Barriers to Small Business Growth"

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Congress created S corporations over fifty years ago explicitly to encourage private enterprise -- and it worked. Today there are 4.7 million S corporations.[1] They are in every community and they are engaged in every type of industry. Their emergence has made the US economy larger and more flexible, resulting in more employment, more investment, and a stronger safety-net against economic downturns like the recent financial crisis.

Despite this success, the debate over reforming business taxation has focused primarily on C corporations and their challenges. US-based C corporations pay some of the highest tax rates in the world, and they are hamstrung by an outdated worldwide system that chases their income wherever it is earned. As a result, the tax code encourages our public companies to shift jobs, investment, and even their headquarters overseas. To address this, Congress needs to enact reforms that fix the tax code for C corporations.

But pass through businesses, including S corporations, face the same challenges as C corporations. The C corporation tax rate may be among the highest in the world, but the tax rate paid by S corporations is even higher. Moreover, pass through businesses have a bigger economic footprint than C corporations – they employ more people and they contribute more to national income. So any reform needs to be permanent, comprehensive, and treat pass through businesses as equal partners.

This is an argument we have been making for several years, 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 permanent, comprehensive tax reform that reduces tax rates for pass through businesses and C corporations alike.

1. Start with S Corporations

The S corporation structure is the correct way to tax business income. If Congress were starting from scratch, it would begin with the S corporation as the base model. There are three key reasons why this is the case.

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[1] IRS SOI

- First, S Corporation income is taxed just once, which is the correct way to tax business income. Multiple layers of taxation raise effective tax rates and they distort 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 it is earned 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 a 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 pay the same marginal tax, regardless of their income.

Congress should keep these advantages in mind as it tackles tax reform. Tax reform should move the tax code towards the pass through model, not away from it.

2. The Business Tax Base is Growing, Not Shrinking

We often hear observation that the corporate tax base has shrunk since 1986, usually as a prelude to calling for expanding the reach of the corporate tax. The reality, however, is that the overall business tax base is growing, not shrinking. Businesses play a bigger role in the American economy today than they did prior to 1986, entirely due to the contributions of pass through businesses, including S corporations.

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, C corporations contribute 5 percent of GDP while pass through businesses add 6 percentage points – a total of 11 percent of GDP. [2] That bigger share of the overall economy means more jobs and more investment.

So instead of decrying the "erosion" of the corporation tax base, the tax community should be celebrating the growth of the "business" tax base. It's a good news story.

3. The Business Community Has Voted for a Single Layer of Tax

This shift away from the traditional corporate form is reflective of a broader theme, where the business community is migrating away from the harmful double corporate tax. For example,

[2] http://taxfoundation.org/article/america-s-shrinking-corporate-sector?mc_cid=275125da58&mc_eid=8aee3da63d

the Tax Foundation found that in 2012 that pass through businesses earned nearly 60 percent of business income (single layer) while C corporations earned only 40 percent (double taxation).[3] These income numbers suggest a majority of business income today is not subject to the double tax.

The shift to a single layer of tax is even more profound than those numbers suggest. The Tax Policy Center[4] recently reported that only one-quarter of US corporate stock today is owned in taxable accounts, down from four-fifths back in 1965. The rest is held by qualified plans, endowments, charities, foreign accounts, etc. This suggests that about 90 percent of all business income (pass through income plus three-quarters of C corporation income) is subject to a single layer of tax.

Congress may be seeking ways to improve the tax code and reduce the double tax on corporate America, but the business community is already there. Proposals to integrate the corporate tax, as suggested by Chairman Hatch (R-UT) and the Bush Treasury Department, would help the tax code catch up to the reality of business taxation today.

4. Pass Through Business Employ Most Workers

While businesses organized as S corporations, partnerships and sole proprietorships are generally labeled "small," their cumulative contribution to the economy is large, starting with employment.

The most recent numbers from the Tax Foundation found that 57 percent of private sector workers were employed at pass through businesses, with S corporations employing one in four[5]. According to the Tax Foundation:

- Pass Through Businesses – 73 million (57 percent)
- S corporations – 33 million
- Partnerships – 14 million
- Sole Proprietorships – 26 million
- C Corporations – 54 million (43 percent)

States with the highest levels of pass through employment include Montana, South Dakota, Idaho and Vermont. Only Hawaii has pass through employment levels below 50 percent. Large pass through businesses are also a significant source of employment, with more than 10 million people working at pass through businesses with more than 500 employees.

[3] https://taxfoundation.org/pass-through-businesses-data-and-policy/
[4] http://www.taxpolicycenter.org/taxvox/only-about-one-quarter-corporate-stock-owned-taxable-shareholders
[5] https://taxfoundation.org/pass-through-businesses-data-and-policy/

5. Pass Through Businesses Pay Their Fair Share of Tax

A critique of S corporations is that they "avoid" the corporate tax, with the implication being that they either don't pay taxes at all or pay insufficient levels of tax. This critique is simply untrue. S corporations pay taxes on their business income when it is earned, and often at higher rates than C corporations.

In 2013 we asked an econometric firm to measure[6] 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 effective tax rates while partnerships and S corporations tend to be larger and more formal, so they tend to have higher effective tax rates.

And while effective rates on C corporations have been studied extensively with varying results, the point here is that pass through businesses, and in particular S corporations, already pay their fair share and then some. Policymakers should keep this in mind as they seek to reform how businesses pay tax.

6. Pass Through Taxes Just Went Up

Finally, it is important to remind policymakers 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. 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.

[6] http://www.s-corp.org/wp-content/uploads/2013/08/Quantria_Study_ETR_8-6-13_Final_pm.pdf

The cumulative effect of these changes was to raise the top marginal rate on S corporation shareholders and other pass through business owners from 35 to more than 44 percent.

The resulting high rates drain working capital from these businesses. One of our members, McGregor Metal Working, testified back in 2015[7] that prior to 2013 they were able to retain up to 66 cents of every dollar of after-tax earnings for working capital and hiring new workers. Post 2013, they only are able to retain up to 59 cents, a decrease of 16 percent in retained earnings potential. That is a huge reduction, and it means fewer jobs and less investment.

Pass Through Businesses and Tax Reform

Beginning in 2011, the Treasury Department began to push the idea of "corporate-only" tax reform. Under this plan, the business tax base would be broadened by eliminating certain deductions and tax credits with the resulting revenue used to pay for lower rates for C corporations.

The challenge this approach poses to pass through businesses is obvious. They use the same deductions and credits as C corporations, but unlike C corporations, their rates just went up, not down. The result would be pass through businesses paying top tax rates 15 to 20 percentage points higher than C corporations. This disparity would be simply unsustainable.

To assess how harmful this approach would be to pass through businesses, we asked Ernst & Young to study[8] the effect of corporate-only tax reform. They found that corporate-only reform would increase the tax burden on pass through businesses by about $27 billion per year. Industries most affected would include agriculture, construction, and retail.

Consider the impact on McGregor. The fiscal cliff raised their effective tax rate (including federal, state and local) from 34 to 41 percent. 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 50 percent.

No amount of small business expensing or cash accounting could help to offset that tax hit.

Pass Through Principles for Tax Reform

So the pass through community opposes corporate-only tax reform. What do we support? In 2016, more than one hundred trade groups, including the National Restaurant Association, the National Federation of Independent Business, and the American Farm Bureau, signed a letter articulating the following three principles for tax reform:

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[7] https://smallbusiness.house.gov/uploadedfiles/4-15-2015_mcgregor_testimony.pdf
[8] EY reference

1. Reform needs to be comprehensive and improve 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.

The difference between a "corporate only" approach that treats pass through businesses as an afterthought and true comprehensive reform that treats them as equal partners 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.

Capping Pass Through Rates

One option to achieve this parity is to create a special, lower rate for pass through businesses. The House "Blueprint", the plan outlined by Senators Rubio (R-FL) and Lee (R-UT), and the Administration's tax reform outline all call for a new, lower top pass through rate. But separating pass through business and individual rates brings its own challenges – defining the new pass through tax base and including enforcement provisions to prevent cheating.

For the first, the tax base for pass through businesses should mirror the tax base for corporations and include all the active business income earned by S corporations and other pass through businesses. Provisions to limit the new rate's application based on shareholder status or the size of the business are inappropriate. Senators Susan Collins (R-ME) and Ben Nelson (D-FL), along with Representative Vern Buchanan (R-FL), have introduced legislation that demonstrates how the pass through tax base can be defined effectively.

For the second, establishing a separate rate for pass through business income creates an enforcement challenge by taxing active pass through business income at a lower rate than individual wage and salary income. The bigger the difference in rates, the bigger the enforcement challenge.

In addressing this challenge, Congress needs to make sure it doesn't undermine the value of the lower rate to business owners. Separating the return on owner's labor from the return on their investment in the business is not easy, but guidelines to reinforce the new pass through rate should include:

1. Exempting non-active owners from the enforcement provisions. If an owner of a pass through business does not materially participate in the operation of the business, then there is no issue.
2. Recognizing the investment pass through businesses make in their capital and employees. The new rule needs to recognize that some businesses make significant

investments in both capital and employees and that much of the business' profits derive from these investments.

3. Ensuring the new rules are easier to comply with -- and enforce -- than the existing "reasonable compensation" rules the IRS uses today.

S Corporation Modernization

Beyond tax reform and rate reduction, there are other ways Congress can encourage the creation and growth of Main Street businesses. Since its inception, the S Corporation Association has promoted legislation to improve the rules that govern S corporations, some of which date back over half a century. This Congress, the S Corporation Modernization Act (H.R. 1696 and S. 711) was sponsored by Senators Thune (R-SD) and Cardin (D-MD) and Representatives Reichert (R-WA) and Kind (D-WI).

Key provisions in the bill would enable S corporations to attract foreign investment, reduce the bite of the so-called "Sting Tax" on excessive passive income, and ensure that S corporation assets passed on from one generation to the next are treated similarly to assets held by a partnership. The S Corporation Association is working with our sponsors to include these provisions in the tax reform legislation to be considered by Congress later this year.

Withdraw Section 2704 Rule

Finally, not all tax issues critical to S corporations fit under the umbrella of tax reform. Last August, the Treasury Department proposed changes to Section 2704 that would, if left intact, result in increased estate and gift tax valuations of family-controlled businesses of 30 percent or more.

The S Corporation Association has vigorously opposed these rules since their publication, submitting extensive comments, speaking at the public IRS hearing held in December, and organizing a trade association letter to congressional leadership requesting their assistance in defeating the rules.

Most recently, we released a critical study sponsored by the S Corporation Association and several other trade groups. Authored by Clinton Administration economist Robert Shapiro, the study quantifies the economic harm the pending rules would have on employment and economic output. As the study concludes, over the next decade the rule would:

- Reduce GDP by $154 billion; and
- Reduce employment by 105,990 jobs.

The Trump Administration supports estate tax repeal and has asked Treasury to list out those existing and pending regulations that should be repealed or, in the case of pending rules,

withdrawn. The S Corporation Association has encouraged Treasury to include the 2704 rules on that list and intends to continue to press this issue until they are withdrawn.

Conclusion

Constructed correctly, tax reform can literally take us from one of the worst tax codes in the world to one of the best, but only if Congress pursues permanent, comprehensive reform that builds on the remarkable success of the S corporation.

By adopting reforms that conform to the three pass through principles articulated above, Congress can completely redo how we tax business activity in the United States, helping to ensure that all businesses, public and private, large and small, are able to compete and grow on a level playing field.

In turn, those businesses and the people who run them will respond with more investment, more jobs, and higher wages than if Congress did nothing. Tax reform is a generational opportunity, and like the S corporation, it needs to start on Main Street.

Employment by Business Form and State (2014)

	C Corporations		Pass-Through Businesses		Sole Proprietorships		Partnerships		S Corporations	
State	Share	Employment	Share	Employment	Share	Employment	Share	Employment	Share	Employment
Alabama	42.1%	728,300	57.9%	1,003,534	20.0%	347,124	11.3%	194,876	26.7%	461,534
Alaska	40.3%	114,853	59.7%	169,812	22.6%	64,441	10.9%	31,000	26.1%	74,371
Arizona	43.6%	1,062,382	56.4%	1,373,429	18.1%	440,937	13.9%	339,144	24.4%	593,348
Arkansas	43.2%	453,349	56.8%	596,660	19.5%	204,844	11.4%	119,401	25.9%	272,415
California	43.1%	6,600,068	56.9%	8,729,622	22.2%	3,406,213	10.4%	1,591,356	24.3%	3,732,053
Colorado	40.5%	969,705	59.5%	1,422,209	18.7%	447,853	13.9%	332,792	26.8%	641,564
Connecticut	43.7%	643,274	56.3%	828,756	20.9%	307,921	16.1%	237,400	19.3%	283,435
Delaware	49.1%	195,702	50.9%	203,009	13.7%	54,655	14.7%	58,509	22.5%	89,845
District of Colur	43.9%	161,660	56.1%	206,418	17.0%	62,430	22.6%	83,082	16.5%	60,906
Florida	41.2%	3,557,508	58.8%	5,082,343	20.1%	1,739,731	10.4%	901,517	28.3%	2,441,095
Georgia	42.7%	1,707,995	57.3%	2,295,527	21.6%	865,048	10.5%	421,969	25.2%	1,008,510
Hawaii	50.1%	272,212	49.9%	271,486	21.0%	114,377	10.5%	57,021	18.4%	100,088
Idaho	34.6%	202,031	65.4%	381,233	21.0%	122,439	15.4%	89,817	29.0%	168,977
Illinois	44.3%	2,436,213	55.7%	3,068,390	17.5%	963,753	10.6%	581,334	27.7%	1,523,303
Indiana	40.3%	1,056,015	59.7%	1,565,634	16.4%	431,261	12.6%	331,351	30.6%	803,022
Iowa	45.1%	577,921	54.9%	704,151	17.4%	222,456	9.5%	122,062	28.1%	359,633
Kansas	45.1%	539,954	54.9%	656,641	17.9%	214,777	11.8%	140,886	25.2%	300,978
Kentucky	43.6%	694,931	56.4%	897,393	19.2%	305,141	12.2%	194,488	25.0%	397,764
Louisiana	38.3%	710,963	61.7%	1,143,685	20.5%	380,761	14.9%	276,817	26.2%	486,107
Maine	35.2%	174,319	64.8%	320,459	24.3%	120,135	9.6%	47,503	30.9%	152,821
Maryland	40.8%	947,363	59.2%	1,374,460	21.2%	492,043	11.4%	265,562	26.6%	616,855
Massachusetts	45.0%	1,307,633	55.0%	1,595,143	18.5%	537,166	10.5%	304,834	25.9%	753,143
Michigan	42.5%	1,551,151	57.5%	2,101,314	16.4%	599,519	13.0%	474,439	28.1%	1,027,356
Minnesota	42.3%	1,042,923	57.7%	1,424,426	17.1%	421,802	9.4%	231,374	31.3%	771,250
Mississippi	41.9%	412,954	58.1%	572,713	23.4%	230,761	11.9%	117,517	22.8%	224,435
Missouri	44.7%	1,075,740	55.3%	1,333,424	18.6%	448,452	11.1%	266,543	25.7%	618,429
Montana	31.4%	119,781	68.6%	262,148	22.9%	87,424	12.0%	45,757	33.8%	128,967
Nebraska	40.7%	345,809	59.3%	504,854	16.2%	137,454	9.4%	80,119	33.8%	287,281
Nevada	44.4%	550,067	55.6%	688,633	17.5%	216,355	15.6%	192,972	22.5%	279,306
New Hampshire	41.0%	233,811	59.0%	335,830	21.4%	121,836	11.6%	66,017	26.0%	147,977
New Jersey	41.7%	1,561,231	58.3%	2,181,255	18.3%	686,265	15.8%	593,047	24.1%	901,943
New Mexico	39.8%	254,204	60.2%	384,459	21.1%	135,060	13.9%	88,465	25.2%	160,934
New York	39.4%	3,101,935	60.6%	4,762,703	21.0%	1,648,990	13.8%	1,085,864	25.8%	2,027,849
North Carolina	44.7%	1,682,836	55.3%	2,084,595	19.6%	739,213	9.8%	370,051	25.9%	975,331
North Dakota	38.0%	127,520	62.0%	208,473	17.1%	57,442	11.1%	37,157	33.9%	113,874
Ohio	44.5%	2,074,729	55.5%	2,590,348	18.0%	841,177	11.8%	548,201	25.7%	1,200,970
Oklahoma	40.4%	589,800	59.6%	868,975	20.1%	293,582	14.3%	208,895	25.1%	366,498
Oregon	40.0%	594,809	60.0%	893,557	20.0%	297,526	12.1%	180,411	27.9%	415,620
Pennsylvania	43.2%	2,167,764	56.8%	2,855,287	18.2%	913,043	11.3%	565,105	27.4%	1,377,139
Rhode Island	37.3%	151,488	62.7%	254,172	18.8%	76,184	9.6%	38,964	34.3%	139,024
South Carolina	43.6%	766,549	56.4%	989,824	19.4%	341,492	11.3%	198,321	25.6%	450,011
South Dakota	33.7%	112,436	66.3%	221,168	20.2%	67,386	12.2%	40,623	33.9%	113,159
Tennessee	46.8%	1,224,105	53.2%	1,391,440	21.9%	573,331	16.4%	429,666	14.9%	388,443
Texas	44.4%	4,954,767	55.6%	6,197,271	21.1%	2,357,804	15.4%	1,717,186	19.0%	2,122,281
Utah	41.0%	502,640	59.0%	722,886	15.3%	187,055	15.7%	191,879	28.1%	343,952
Vermont	34.8%	90,263	65.2%	168,826	27.2%	70,585	9.3%	24,212	28.6%	74,029
Virginia	44.5%	1,477,090	55.5%	1,840,105	17.9%	593,351	11.1%	367,790	26.5%	878,964
Washington	43.0%	1,109,811	57.0%	1,470,607	18.5%	477,960	11.6%	298,092	26.9%	694,555
West Virginia	46.2%	258,872	53.8%	301,326	19.5%	109,046	12.7%	71,038	21.6%	121,242
Wisconsin	42.1%	998,866	57.9%	1,374,710	16.4%	390,412	10.1%	238,566	31.4%	745,732
Wyoming	36.9%	88,775	63.1%	152,126	19.0%	45,798	13.8%	33,157	30.4%	73,171

Source: Tax Foundation calculations based on Census County Business Patterns (2014) and Non-Employer Statistics (2014)

Note: Due to data constraints, some employees may be counted more than once

Combined Top Marginal Tax Rate on Pass-through Businesses by State, 2016

State	Sole Proprietors and General	Active S Corporation	Passive S Corporation Shareholders
Alabama	45.62%	42.64%	46.44%
Alaska	42.58%	39.60%	43.40%
Arizona	46.51%	43.53%	47.33%
Arkansas	47.93%	44.96%	48.76%
California	51.80%	48.82%	52.62%
Colorado	46.56%	43.58%	47.38%
Connecticut	47.93%	44.96%	48.76%
Delaware	47.80%	44.83%	48.63%
District of Columbia	49.17%	46.19%	49.99%
Florida	42.58%	39.60%	43.40%
Georgia	47.39%	44.41%	48.21%
Hawaii	48.75%	45.77%	49.57%
Idaho	48.24%	45.26%	49.06%
Illinois	46.03%	43.05%	46.85%
Indiana	45.97%	42.99%	46.79%
Iowa	47.08%	44.10%	47.90%
Kansas	42.58%	39.60%	43.40%
Kentucky	47.79%	44.81%	48.61%
Louisiana	45.96%	42.98%	46.78%
Maine	48.09%	45.11%	48.91%
Maryland	48.06%	45.08%	48.88%
Massachusetts	46.85%	43.87%	47.67%
Michigan	46.40%	43.42%	47.22%
Minnesota	49.72%	46.74%	50.54%
Mississippi	46.79%	43.81%	47.61%
Missouri	47.46%	44.48%	48.28%
Montana	47.93%	44.96%	48.76%
Nebraska	47.90%	44.92%	48.72%
Nevada	42.58%	39.60%	43.40%
New Hampshire	42.58%	39.60%	43.40%
New Jersey	49.18%	46.21%	50.01%
New Mexico	46.73%	43.75%	47.55%
New York	49.55%	46.57%	50.37%
North Carolina	47.24%	44.26%	48.06%
North Dakota	45.71%	42.73%	46.53%
Ohio	47.25%	44.28%	48.08%
Oklahoma	46.94%	43.96%	47.76%
Oregon	49.75%	46.77%	50.57%
Pennsylvania	46.04%	43.07%	46.87%
Rhode Island	47.38%	44.41%	48.21%
South Carolina	48.00%	45.02%	48.82%
South Dakota	42.58%	39.60%	43.40%
Tennessee	42.58%	39.60%	43.40%
Texas	42.58%	39.60%	43.40%
Utah	46.79%	43.81%	47.61%
Vermont	49.17%	46.19%	49.99%
Virginia	47.24%	44.26%	48.06%
Washington	42.58%	39.60%	43.40%
West Virginia	47.69%	44.71%	48.51%
Wisconsin	48.39%	45.41%	49.21%
Wyoming	42.58%	39.60%	43.40%
U.S. Average	**47.13%**	**44.15%**	**47.95%**
Note: Many states also apply gross receipts, margin, and franchise taxes to pass-through business income. In addition, some states			
Source: Tax Foundation			