S CORP

DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES

Brian Reardon
President, S Corporation Association
Written Testimony before the Michigan State House Tax Policy Committee
December 4, 2018

Mr. Chairman Tedder and Members of the Committee:

My name is Brian Reardon and I am the President of the S Corporation Association. Today I am providing written testimony on behalf of the S Corporation Association and a coalition of Michigan-based trade groups -- including the Michigan Chamber of Commerce, the Michigan Manufacturers Association and the Small Business Association of Michigan -- all of whom strongly support legislation introduced by Senator Hildenbrand, SB 1170.

This legislation would benefit thousands of family businesses operating in Michigan by restoring their ability to fully deduct the State and local income taxes (SALT) they pay on their business income. *The Michigan Department of Treasury estimates restoring this deduction will save Michigan pass-through businesses $190 million per year on their federal taxes.* The bill is intended to be revenue neutral and its effect would be to make these businesses more competitive and Michigan a more attractive place to do business.

It's a win-win for Michigan the family businesses who operate here.

Pass-Through Businesses & Tax Reform

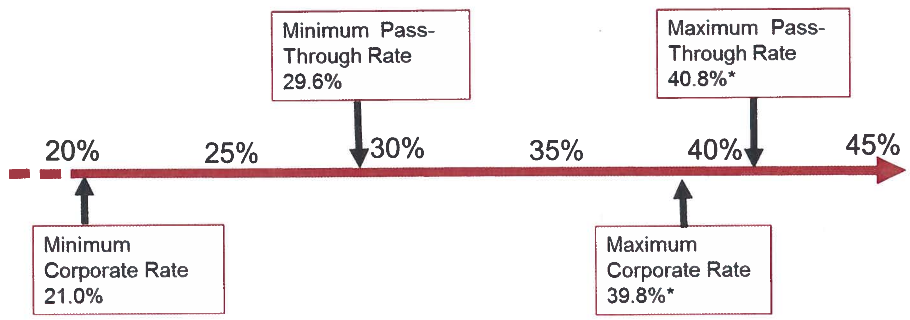
Many people believe that big, publicly-owned C corporations are the heart of the American economy. But while these businesses are important, the reality is that smaller pass-through businesses organized as S corporations, partnerships, and sole proprietorships represent over 95 percent of all businesses and they employ the majority of private-sector workers nationally. In Michigan, they employ 56 percent of the workforce, or just short of two million workers.

So pass-through businesses are critical to the economy and jobs, both in Michigan and nationally. How did they fare under last year's tax overhaul?

The answer is decidedly mixed. The cornerstone of the legislation was a reduction in the corporate tax rate from 35 to 21 percent. This new, lower rate was applied to all corporate income, regardless of industry or the location of the business.

For S corporations and other pass-through businesses, however, the new law was more complicated. These businesses received a slightly lower top rate and a new 20% deduction on qualified pass-through business income, but the 20% deduction was limited -- many industries were excluded and it was capped by a business' wages and levels of investment. And Congress left in place the place the 3.8 percent Net Investment Income Tax paid by passive shareholders.

The result was that the taxes an S corporation pays vary dramatically depending on what industry they are in, where they are located, and how active their shareholders are in the business. The effective tax rates they pay range from a low of 29.6 percent for those businesses residing in no-tax states and who get the full 20% deduction, to well over 40 percent for businesses in high-tax states and are precluded from the 20% deduction.



* Includes full double tax for C Corps and 3.8% NIIT for S Corps

The tax overhaul's treatment of SALT deductibility by S corporation further complicates these results.

SALT and S Corporations

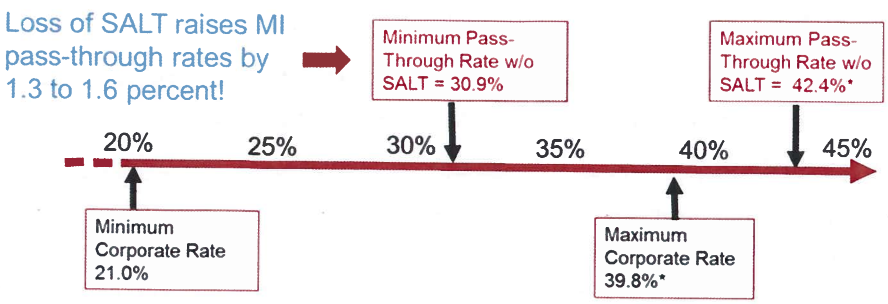
Like C corporations, S corporations are subject to SALT on their business income. Unlike C corporations, however, where SALT is always incurred *and* paid at the entity level, only a minority of states tax S corporations directly. Most, including Michigan, tax pass-through business profits at the shareholder level.

This disparity took on new significance with last year's tax overhaul. The legislative history of the Tax Cuts and Jobs Act makes clear that for S corporations operating in states that tax income at the entity level, those taxes remain deductible. In states like Michigan where pass-through profits are taxed at the shareholder level, however, those taxes and shareholder level property taxes are subject to the new, $10,000 cap on SALT deductions.

This new policy results in two disparities for family businesses residing in Michigan. First, they are disadvantaged compared to businesses operating in the state as C corporations. Under the new law, C corporations continue to fully deduct these taxes while pass-through businesses do not. There is no good policy rational for this disparity.

Second, these Michigan businesses are disadvantaged compared to businesses operating in other states or localities with 1) no State or local income taxes or 2) an entity-level tax that remains deductible.

How significant is the loss of SALT for Michigan S Corporations? It's equal to a tax hike of between 1.3 and 1.6 percentage points, or the loss of $1.30 to $1.60 in profits for every $100 of business income.



* Includes full double tax for C Corps and 3.8% NIIT for S Corps

How many Michigan businesses are affected? According to the IRS Statistics of Income, there are 138,915 S corporations residing in Michigan and another 107,675 partnerships. That adds up to nearly a quarter-million businesses at risk of losing their SALT deduction beginning in 2018.[1]

Senate Bill 1170

Senate Bill 1170 would address this disparity and help level the playing field between pass-through businesses organized as S corporations and partnerships and those organized as C corporations. Specifically, the bill would:

- Allow these Michigan pass-through businesses an annual election to pay their SALT at the entity level;
- Provide the owners of these electing businesses a credit for the taxes paid by the business to avoid double taxation; and
- Recognize the value of similar credits paid by other states to pass-through owners.

The bill would effectively restore the deductibility of SALT to Michigan pass-through businesses that make the election. Moreover, it is designed to be revenue neutral. The tax paid by the electing businesses would be equal to the tax otherwise paid by their shareholders or partners. The math works like this:

Proposed Pass-Through Business Entity Tax					
	Tax Cuts & Jobs Act		Pass-Through Business Entity Tax		
	Individual Taxpayer		S Corp or	Individual Taxpayer	
	Taxed at 37%	Taxed at 29.6%	Partnership	Taxed at 37%	Taxed at 29.6%
Taxable Income	100.00	100.00	100.00	100.00	100.00
State Tax Rate	4.25%	4.25%	4.25%	4.25%	4.25%
State Tax	4.25	4.25	4.25	4.25	4.25
Less Credit	0	0		$ 4.25	4.25
State Tax Due	4.25	4.25	4.25	0.00	0.00
Fed Taxable Income	100.00	100.00		95.75	95.75
Federal Tax	37.00	29.60		35.43	28.34
Effective Fed Tax Rate	38.64%	30.91%		37.00%	29.60%
Tax Savings	NA	NA		1.57	1.26

[1] Because there has to be an "entity" to tax at the Federal level, sole proprietorships would not benefit from SB 1170.

Activity by Other States

If Michigan does act on this reform, it would not be alone. Since the tax overhaul was passed, several states have either adopted or are in the process of considering legislation similar to SB 1170:

> Connecticut: Connecticut was to take action. Their Governor proposed the change at the beginning of the year, and the Connecticut legislature adopted the reform last May. The new law includes the same key provisions as SB 1170 – a shift to an entity level tax on Connecticut pass-through businesses, a tax credit for Connecticut pass-through owners to protect them from being double-taxed, and recognition of similar tax credits from other states to business owners residing in Connecticut. A key difference is there is no election in the Connecticut law.
>
> New York: Earlier this year, the New York Department of Taxation released a draft SALT pass-through proposal and requested comments. S-Corp submitted extensive comments along with a number of other interested parties, and we have continued to work with the Department on their proposal. We hope to see the product of their work proposed by the Governor in time for next year's legislative session.
>
> Arkansas: The Arkansas Tax Reform and Relief Task Force included in its most recent report a recommendation that the state adopt a "Connecticut" style pass-through reform. The legislation is being drafted and we hope to see it considered next year.
>
> New Jersey: A bipartisan group of Senators announced this year that they would introduce legislation along the same lines as Connecticut's new law.

While the details differ, the goal of all these efforts is the same -- to increase fundamental fairness between owners of C corporations and owners of pass-through business entities as it relates to their ability to deduct SALT from their federal taxes. S-Corp is working with allies in other states to increase the number of states acting on this reform next year.

Concerns

Several concerns have been raised regarding these efforts. First and foremost is whether the IRS will take action to block the benefits of SB 1170 to Michigan business owners.

The SALT cap is a new concept and it has yet to be fully vetted by the Treasury, IRS and the courts. The IRS recently proposed new rules blocking the charitable contribution "workarounds" under consideration in several states and just this month it added "Guidance on applying the state and local deduction cap under §164(b)(6) to passthrough entities" to its Priority Guidance Plan.

That said, we believe SB 1170 is on solid ground. A recent paper by the AICPA State and Regulatory Affairs committee identified thirteen states and cities that currently impose entity level taxes on S corporations. A plain reading of the Tax Cuts and Jobs Act is that these taxes clearly remain deductible at the entity level. Importantly, several of these jurisdictions, including NYC, DC and Kentucky, offset the entity level tax at the shareholder level, either through an income exclusion or a tax credit equal to the taxes paid by the entity. As with the credit incorporated in SB 1170, these exclusions and credits are there to preserve a single layer of tax is paid on the business income and that shareholders are not taxed twice on the same income.

Furthermore, a recent clarification by the IRS regarding the charitable workaround in IR-2018-178 made clear that the ability to deduct legitimate business expenses is not affected by the receipt of state or local tax credits:

> *Business taxpayers who make business-related payments to charities or government entities* ***for which the taxpayers receive state or local tax credits*** *can generally deduct the payments as business expenses, the Internal Revenue Service said today. (Emphasis added)*

A tax on business income paid by a trade or business is clearly a legitimate business expense under Section 162, while the existence of several states and localities that currently offset these business taxes with credits or income exclusions at the shareholder sets a helpful precedent for the changes included in SB 1170.

The second concern raised has to do with complexity. Is the creation of an annual election to be taxed at the entity level tax simply too complicated?

In this case, the plan's complexity depends on organization and ownership of the business. For a Michigan S corporation with local ownership operating in Michigan only, there's no new complexity. In fact, SB 1170 could be a simplification.

For a pass-through business with multiple layers of ownership and/or owners spread out in multiple states, however, imposing an entity level tax could get very complex indeed. *But it already is.* An entire industry of SALT accountants exists to calculate the state and local tax liabilities of multi-state businesses. Moreover, the more states adopt this reform, the less complexity they will face, as each state will begin to recognize the tax credits and income exclusions of the other states. Finally, complexity is one reason for states to make the entity level tax an election – businesses can simply opt-out if it is not for them.

The bottom line is we think Michigan should move forward on this reform and give family businesses a chance to restore the deductibility of these legitimate business expenses.

Conclusion

There is no good reason for the federal Tax Code to allow one group of businesses – C corporations – to deduct their state and local taxes while blocking other businesses – S corporations and partnerships – from doing the same. These taxes are an obvious cost of doing business and should be treated as such.

Michigan could fix this unfairness and make its tax policies more attractive to family businesses. Shifting the incidence of S corporation taxation from the shareholder to the entity will reduce the effective tax rates paid by Michigan businesses sharply while making the state a more attractive place to do business, all while remaining revenue neutral to Michigan's Treasury.

We strongly encourage you to move forward on this legislation.