FILLING THE GAP

PASS-THROUGH BUSINESSES AND TAX REFORM

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Among the many things you learned from the presidential campaign of 2016 – but probably never really wanted to know – was a whole new vocabulary related to ways in which the wealthy legally avoid taxes. Yes, you've suffered through "carried interest," "tax inversion" and "like-kind exchange." And I know it's cruel to introduce yet another term to this witch's brew.

But be patient; this one's worth a few minutes of head-scratching. Once a limited taxing method used almost exclusively for small or closely held businesses, "pass-through" treatment is now so common that one can longer consider a business tax reform that is limited only to corporations. And tax reform proposals that seek to match corporate rate cuts by providing special reduced individual tax rates for owners of pass-through businesses threaten to open up a major new vehicle for tax avoidance.

FIRST, THE FACTS

Most businesses in the United States do not pay corporate income tax. Instead, they report their earnings to their owners, who include their shares of the profits on their individual tax returns. We refer to these as pass-through businesses because, while many of them benefit from the legal advantages of corporations (notably, limited liability), they do not themselves pay tax, instead passing through their taxable profits to their owners.

PASS-THROUGH MATH

INCOME AND TAXES PAID	PASS-THROUGH	C CORPORATION WITH DIVIDENDS	C CORPORATION WITH RETAINED EARNINGS
Income	$1,000	$1,000	$1,000
Corporate Taxes	0	$350	$350
Dividends	0	$650	0
Individual Taxes	$396	$154.70	0
Total Taxes	$396	$504.70	$350

SOURCE: The author

Both partnerships and businesses owned by individuals (sole proprietorships) typically pay tax under this pass-through method. Pass-through treatment is also allowed for so-called S corporations, which are organized under Subchapter S of the Internal Revenue Code. In contrast, other corporations (C corporations) pay a separate corporate income tax, and then their owners pay individual income taxes on any dividends they receive.

The table above illustrates the differences in tax treatment, comparing the taxes paid by owners of the pass-through businesses with the taxes on regular C corporations that do or do not choose to pay out their profits as dividends. Assume that all three companies earn $1,000 of profits, that their owners are all in the top individual income tax rate bracket (39.6 percent for ordinary income, 23.8 percent for dividends) and that the C corporations pay the maximum federal corporate rate of 35 percent. All can deduct wages and other compensation paid to employees.

For pass-through businesses, the only tax paid is the individual income tax, which is imposed on all their income. At a top 39.6 percent rate, they pay $396 in income taxes.

By contrast, C corporations pay a 35 percent tax on their profits and then their owners pay another $154.70 (at a 23.8 percent rate) when the corporations distribute the after-tax profit of $650. The total tax burden on the owners of a C corporation that distributes its profits is $504.70. If a C corporation chooses to retain its earnings, it pays only the $350 in corporate tax and its owners pay nothing additional.

Pass-through entities plainly enjoy a tax advantage over C corporations that pay dividends. Closely held businesses, however, may pay less tax as C corporations than as pass-through enterprises if their owners do not need cash distributions from the business to meet personal needs. Owners of these companies can thus defer the second level of tax, although they will still bear some tax later when they distribute the profits – or cash them out as capital gains by selling the business.

Historically, the special benefit for a business that organized itself as a C corporation was limited liability. Investors in C corporations could not be held personally liable for debts accrued by the company. Under today's laws, however, any privately owned company can organize itself as a pass-through business while retaining the protection of limited liability for its investors.

C-corporation status is still required, however, for most businesses that choose to issue

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shares that are publicly traded on organized exchanges. For the most part, therefore, the largest businesses with the biggest capital requirements, including most multinationals, continue to file corporate income tax returns and pay corporate income tax – provided they report taxable profits.

WHY YOU SHOULD CARE

Pass-through entities represented 85 percent of business returns in 1984 and fully 95 percent in 2012, as larger businesses joined the crowd long dominated by small ones. It follows that pass-throughs' shares of business income increased disproportionately from 27 percent of all net business income to almost 60 percent.

This rapid growth reflects changes in tax law that made it more advantageous for businesses to organize in the pass-through form. For one thing, it has become easier to establish both S corporations and limited liability partnerships. The 1986 Tax Reform Act increased the number of shareholders allowed in an S corporation from 35 to 100. Meanwhile, changes in state laws in the 1980s facilitated the growth of limited liability partnerships. And the growth of pass-through businesses was greatly enhanced by "check the box" rules issued by the Treasury Department in 1997, which simplified the process of opting out of the corporate tax.

Reductions in individual income tax rates that exceeded reductions in corporate tax rates also encouraged closely held businesses to switch to pass-through status. Before the 1981 tax cuts, the top corporate rate was 46 percent, compared with a top individual rate of 70 percent. After passage of the 1986 Tax Reform Act, the top individual rate fell to 28 percent, compared with a top corporate rate of 34 percent. In response to this rate change and the expansion of the number of shareholders allowed in an S corporation, S corporations' receipts more than tripled from 1984 to 1988 to $1.2 trillion while their profits increased from $7 billion to $44 billion.

Since 1988, the top individual rate (39.6 percent) has risen slightly above the top corporate rate (35 percent). But pass-through status remains advantageous for any company distributing at least a small share of its profits.

To be sure, most pass-through businesses are still modest in size, and the bulk of reported income from the largest businesses still comes from C corporations. But there are a large and apparently growing number of pass-through businesses that hardly qualify as small. In 2012, S corporations with gross receipts of $50 million or more accounted for 29 percent of total pass-through profits, while partnerships with total assets of $100 million or more accounted for fully half of partnership profits.

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Note, too, that many relatively small enterprises that pay tax as pass-through firms are not necessarily independent businesses. Many franchisees are affiliated with larger corporate enterprises. And many assets previously owned by corporations, such as commercial buildings, have been spun off to pass-through entities that lease them back to the same corporations. The logic is plain enough: lease-back arrangements remove the related profit from the tax base of corporations that can't opt for pass-through status.

The switch to pass-though status has affected not only the collective tax liability of business, but also the distribution of after-tax income, since the bulk of business income goes to the very affluent. The Urban-Brookings Tax Policy Center estimates that in 2016 households in the top 1 percent will receive 54 percent of reported business income, compared with 17 percent of income from all sources.

THE TANGLED WEBS WE WEAVE AND REWEAVE

Tax reform, you must know by now, is the gift that keeps on giving, occupying an army of experts employed in working around old reforms and smothering proposed ones while still in gestation. The gold standard for past tax reform efforts was the Tax Reform Act of 1986, a product of a rara avis: bipartisanship. As noted above, the 1986 reform sharply reduced the top rates on the individual and corporate income tax, making up the revenue loss by reducing or eliminating tax preferences that narrowed the tax base.

Broad-based tax reform modeled on the 1986 law would be harder to enact today for many reasons, including the reality that Republicans and Democrats now mostly talk to each other via cable news. But partisanship isn't the only reason reform is hard. A major obstacle on the individual income tax side is that the most costly tax preferences are popular and widely used – which was why they were left largely intact in 1986. These include preferences you can drive a 16-wheeler through, including the exemption of employer contributions to health insurance plans from taxable compensation, and deductions for mortgage interest, state and local nonbusiness taxes and charitable contributions.

With most base-broadening off the table (and with Democrats drawing the line at lowering the top individual rate), the one tax that still gets reformers on both sides of the aisle excited is the corporate income tax. The U.S. corporate income tax has become increasingly out of step with its counterparts, as other countries have reduced their top rates below the U.S. rate and moved toward systems that exempt foreign-source income of their resident multinationals. Leaders in both political parties have advocated lowering the top corporate tax rate and paying for that reduction wholly or in part by scaling back business tax preferences.

But don't get your hopes up just yet. The rising importance of pass-through businesses throws a monkey wrench into this approach. The largest business preferences, such as accelerated depreciation of equipment, benefit both C corporations and pass-through businesses. A revenue-neutral proposal that closed business preferences to pay for lower corporate tax rates would necessarily raise taxes on pass-through businesses that are taxed under the individual instead of the corporate rate schedules. But the politics of that trade-off are simply awful.

Pass-through businesses are mostly domestic companies, many of which are owned by very successful, influential people and employ mostly domestic workers. C corporations, by contrast, are increasingly global enterprises with sales, employment and shareholders throughout the world and tenuous connections to the United States. In 1953, a GM executive (Engine-Charlie Wilson) who was nominated for secretary of defense could assert that he faced no conflict of interest because "what's good for GM is good for the country." It would be hard for a leader of a multinational corporation to make the same claim with a straight face today.

Remember, too, that most small businesses are currently taxed as pass-through businesses. What sane politician would want to

advocate raising taxes on Mom and Pop at the deli in order to give multinationals a break?

Lowering the corporate rate without reducing the individual rate would cause added problems. If the gap between the corporate and individual rate becomes large enough, owners of closely held pass-through businesses could turn their firms into C corporations that retained most of their income. This would enable high-income business owners to defer paying the top individual rate.

Why not lower the individual rate, too, so that pass-through businesses do not end up paying higher taxes and the gap between individual and corporate rates does not widen? There is a simple reason: the math does not work. Most income taxed under the individual income tax consists of wages and salaries, not business profits. Reducing the individual income tax rate enough to compensate business owners would result in a massive revenue loss unless popular individual tax preferences were eliminated, too. And we've already discussed that non-starter.

TANGLED WEBS, PART II

OK, tax reformers, you're not dead yet. If individual rates need to be lowered to prevent tax reform from raising taxes on pass-through businesses, but it is too expensive to cut individual rates for everyone, why not create a separate rate for business income declared by households?

This approach seems to be gaining some traction. Candidate Trump's tax plan, which may or may not be President Trump's plan, illustrates some of the thorny issues in business tax reform. It would reduce the top rate on both corporate income and business income of individuals to 15 percent, while cutting the top individual income tax rate on earnings only to 33 percent. The House GOP tax plan, which presumably still reflects the preferences of the House leadership, would also reduce the top individual rate to 33 percent on earnings, but set a maximum rate of 25 percent on profits of pass-through entities.

As with all other attempts to apply different tax treatment to activities that can appear similar, this approach, alas, would open huge opportunities for gaming the taxman. For one thing, much of the income of owners of pass-through firms is, in fact, compensation for their labor services rather than a return on business equity. How, then, is the IRS supposed to distinguish the component of pass-through income that represents reasonable compensation for work effort?

Note, too, that dual rate schedules would be a huge incentive for people to alter their employment relationships. A key researcher in an economic consulting firm could, for example, resign as an employee and then sell her services to the firm as a consultant. This would reduce her income tax rate under the Trump proposal from 33 percent to 15 percent.

What sane politician would want to advocate

Actually, drawing lines between wages and business profits is already difficult under current law. Earnings of employees are currently subject to a 15.3 percent payroll tax under the Federal Insurance Contributions Act, which is divided equally between employers and employees. The self-employed pay the same 15.3 percent tax rate. But they can deduct 7.65 percent of their gross earnings from their tax base to achieve parity with the FICA tax rate, which applies to earnings net of the 7.65 percent employer contribution.

The incentive here to shift income from labor compensation to profit is even stronger than it first appears. The 12.6 percentage points of the payroll tax that are dedicated to Social Security pensions are capped at $118,500 for tax year 2016, but the 2.9 percent portion that funds Medicare applies to all earnings. As a result, the highest earners face a 2.9 percent additional marginal tax rate on all their wages that does not apply to an additional dollar of business income.

A nice chunk of the federal tax code must thus be dedicated to differentiating business income from labor compensation. Suffice it to say that interpreting the code (and subsequent case law) keeps the accountants, lawyers and auditors very, very busy. Indeed, in some situations, individuals supplying personal services through S corporations have successfully avoided substantial amounts of payroll tax by understating what most people would think was compensation. This has been called the John Edwards/Newt Gingrich loophole, after the two former legislators who stretched the definition of business income to the limit.

Opening a gap between the top tax rates applied to business income and salaries would substantially exacerbate the existing problem because payroll taxes apply to earnings but exclude some business income.

Both the Trump and House GOP plans take a whack at this problem, but neither approach looks especially promising. The Trump plan provides little safeguard against abuse. It would require distributions from large pass-through businesses paying the 15 percent rate to bear a second level of tax, at the 20 percent dividend tax rate he proposes. This would make the combined tax rate on income of these businesses 32 percent (15 percent plus 20 percent of the 85 percent of income that can be distributed after paying the business tax rate.)

The Trump proposal does not, however, define a "large" business, leaving open the possibility that many medium-sized businesses might qualify as "small" for the purpose of avoiding the second level of tax. And Trump has proposed no rules to prevent employees from redefining themselves as independent contractors.

The House GOP plan would seek to prevent such tax avoidance by requiring pass-through businesses to pay "reasonable compensation" for tax purposes, so that the preferential rate would not apply to labor compensation of self-employed persons and active partners or S corporation shareholders. But it does not define reasonable compensation. This would presumably be spelled out in the actual legislation, the wording of which would no doubt be free of influence by K Street lobbyists.

raising taxes on Mom and Pop at the deli in order to give multinationals a break?

Even in the best of circumstances, then, the IRS would confront the same enforcement problem it currently faces in trying to determine compensation of S corporation shareholders for the purpose of calculating payroll tax liability – but with higher stakes because the tax savings per dollar of misclassified income would be 7.65 cents instead of 2.9 cents.

An alternative approach that could be easier to enforce would be to define how much of business profits is a return to capital and measure compensation as what's left. This could be done, but would hardly be simple. The return to capital could be imputed by multiplying the tax basis of the firm's capital assets by an assumed "normal" rate of return. These imputed capital returns would receive

the benefit of the reduced tax rate. Any additional returns would be deemed labor compensation or excess profits and subject to taxation at full ordinary income tax rates.

This approach – defining profits as the return to invested capital – would permit pass-through businesses to gain some benefit from a preferred rate on business income without providing a rate cut to employees who redefine themselves as independent contractors. It would not, however, benefit those pass-through businesses, especially small businesses, that are allowed under current law to expense their investments and therefore report no tax basis (and, thus, no return on invested capital). And it would not place pass-through businesses on an equal footing with C corporations, which would receive a rate cut on both the portion of their profits that represent a normal return to investment and the portion of their profits that represent "super-normal" returns.

IN FOR A PENNY...

This tortuous discussion has illustrated how difficult it would be to design a business-only tax reform, now that the group includes large numbers of both of pass-through businesses whose owners pay individual income tax rates on their business profits and C corporations that pay a separate corporate-level tax on their profits before paying taxable distributions to shareholders. Taxing highly substitutable forms of income at different rates always results in tax avoidance problems and causes economic distortions as taxpayers shift activities toward more lightly taxed forms. Rules to protect the tax base against these forms of gaming would be complex and imperfect.

If we're going to get serious about reform, then, everything points to the need for more far-reaching reforms. And I mean far-reaching. For example, a former Treasury official, Michael Graetz, would substitute a value-added tax for the income tax for most taxpayers, while retaining a corporate income tax at much lower rates and an individual income tax on high-income taxpayers to maintain progressivity.

Alan Viard of the American Enterprise Institute and I would go a different direction. We have developed a plan to replace a large portion from the corporate tax with a tax at ordinary income rates on accrued (not just realized) income of shareholders in publicly traded corporations. The economists Rosanne Altshuler and Harry Grubert have proposed a similar plan, but they would tax capital gains upon realization, with an added charge to offset the advantages of deferral, instead of annually as accrued.

Thinking somewhat smaller, Graetz and Alvin Warren have proposed eliminating the double taxation of corporate dividends, an approach that is also being considered by Senate Finance Chairman Orrin Hatch, the Utah Republican. The economist Alan Auerbach has proposed replacing the corporate income tax with a destination-based cash flow tax that would apply to all businesses. A variant of the Auerbach approach, albeit with major differences, has been adopted in a recent proposal by the House Republican Caucus.

While these approaches differ greatly, they all acknowledge the need to rethink the taxation of business income from the ground up. While incremental reforms are usually the better policy approach, the U.S. system for taxing business income has entered a zone of baroque complexity that defies efforts to sync it with both the way businesses are organized in the United States and the growing integration of the global economy. One way or another, something big has to give if we are to tap business income as an equitable and efficient source of taxes.