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Passthrough Business, Small Business, and Tax Reform

Good morning Chairman Camp, Ranking Member Levin, and members of the Committee. Thank you for this opportunity to share my views on the important topic of passthrough business taxation.

I. The Importance of Passthrough Business in the American Economy

Over the last three decades, a rapidly increasing number of America's businesses have organized their affairs so that they are entirely free of the corporate income tax. There are three major no-corporate-tax alternatives: S corporations, partnerships, or sole proprietorships. Collectively these three tax classifications are referred to as "passthrough" entities because, unlike C corporations where profits can be bottled up until they are distributed, the profits of these businesses are passed through immediately to owners who must report this income on their individual tax returns.

As shown in Table 1, passthrough businesses accounted for 83 percent of all business returns in 1980. By 2008, that figure had increased to 94 percent. Their share of total receipts, only 13 percent in 1980, grew to 34 percent by 2008. Their share of profits grew from 20 to 47 percent.

Because the corporate tax is being "hollowed" out from below, the corporate tax more than ever is now a tax on big business. This development is the result of two phenomena: the dramatic increase in the size and number of Subchapter S corporations and the surge, mostly in the 1990s, in the number of limited liability corporations (LLCs), which are taxed as partnerships.

Subchapter S Corporations. The dramatic rise in the popularity of Subchapter S status is shown in Figure 1. There were half a million S corporation returns filed in 1980. That number rose to 1.6 million in 1990, 2.9 million in 2000, and 4.0 million in 2008. S corporations grew in size as well as number. As shown in Table 1, profits of Subchapter S corporations in 1980 were just 1 percent all business profits. In 2008 that figure had risen 15 percent.[2]

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[1] The views expressed here are my own and not those of Tax Analysts. Founded in 1970 as a nonprofit organization, Tax Analysts is a leading provider of tax news and analysis for the global community. By working for the transparency of tax rules, fostering increased dialogue between taxing authorities and taxpayers, and providing forums for education and debate, Tax Analysts encourages the creation of tax systems that are fairer, simpler, and more economically efficient.

[2] Subchapter S corporations are essentially taxed liked partnerships. Subchapter S of the Internal Revenue Code was enacted into law in 1958. At the time there was growing concern that big corporations were becoming too dominant in the American economy. The intent of Subchapter S was to strengthen America's small and family-owned businesses.

Table 1. Business Shares by Filing Status, 1980-2008				
	1980	1990	2000	2008
S Corporations				
Returns	4%	8%	11%	13%
Receipts	3%	13%	15%	18%
Net Income	1%	9%	17%	15%
Partnerships				
Returns	11%	8%	8%	10%
Receipts	4%	4%	9%	14%
Net Income	3%	4%	22%	22%
Sole Proprietorships				
Returns	69%	74%	72%	72%
Receipts	6%	6%	4%	4%
Net Income	18%	30%	18%	12%
All Passthrough Businesses (sum of above)				
Returns	83%	89%	91%	94%
Receipts	13%	23%	29%	35%
Net Income	22%	43%	57%	49%
C Corporations				
Returns	17%	11%	9%	6%
Receipts	87%	77%	71%	65%
Net Income	78%	57%	43%	51%

Source: Statistics of Income Division, IRS. For further details see Appendix A of Martin A. Sullivan, *Corporate Tax Reform: Taxing Profits in the 21st Century*, Apress, 2011.

Limited Liability Corporations and Other Partnerships. The size and number of partnerships has also grown rapidly over the last three decades. Table 1 shows that their share of total business profits has risen from 3 percent in 1980 to 22 percent in 2008.[3] At the same time, their share of total returns fell by one percent. This increase is almost entirely due to the sky-rocketing growth of a new form of business organization, the limited liability corporation.

In the early 1980s LLCs barely existed. Now they are available under the laws of all 50 states and the District of Columbia. Figure 2 shows IRS data on business filing tax returns as LLCs as well all other partnerships. The "other partnerships" category includes plain old general partnerships with unlimited liability. And it also includes limited partnerships (different from limited liability partnerships) where some partners have limited liability and some (general partners) have unlimited liability. The first year the IRS collected data on LLCs was in 1993. About 20,000 existed at the

Subchapter S corporations could have the best of both worlds: the legal privileges of a corporation—limited liability, free transferability of shares, unlimited life—without paying any corporate tax. From the perspective of state law, Subchapter S corporations are no different than other corporations. "Subchapter S" is a tax filing status, not a separate type of legal entity. Under the original statute, if a corporation had 15 or fewer shareholders, and those shareholders were individuals and U.S. residents, the profits of the corporation would not be subject to corporate tax. The allowable maximum number of S corporation shareholders was increased to 35 in 1982, to 75 in 1996, and to 100 in 2005. For most S corporations, the number of shareholders limitation is not an issue. In 2008 S corporations with 3 or fewer shareholders accounted for 95 percent of S corporation returns.

[3] Unlike Subchapter S corporations, owners of partnerships may include corporations. In 2007 the Treasury Department reported that about 36 percent of total partnership income goes to corporate partners with an unknown split between C and S corporations (Treasury Department, "Approaches to Improve the Competitiveness of the U.S. Business Tax Systems for the 21st Century," Dec. 2007). In its 2010 study, the President's Economic Recovery Advisory Board, advised by the Treasury Department, reported that between 15 and 20 percent of partnership income was taxed at the corporation level. President's Economic Recovery Advisory Board, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," Aug. 2010.

time compared to 1.45 million other partnerships. Subsequently, while other partnerships slowly declined, LLCs rapidly grew in numbers – 720,000 in 2000 to 1.9 million in 2008.

Sole proprietorships. When it comes to sheer numbers, you can't beat sole proprietorships. There were 22.6 million in 2008. Approximately one out of every six individual tax returns filed includes sole proprietorship income. Figure 3 shows that instead of becoming obsolescent, the number of sole proprietorships has grown steadily in every year from 1980 to 2007. The growth from 9 to 23 million sole proprietorships has occurred despite the simultaneous increase in the use of Subchapter S corporations with only one owner. In 2008 there were 2.4 million Subchapter S corporations with a single shareholder.

Unlike Subchapter S corporations and partnerships which on average have grown in size, the size of the average sole proprietorship (adjusted for inflation) has been cut in half between 1980 and 2008. That is probably due to an increase in self-employed consultants, an increase in the number of workers formally classified formed as "independent contractors," and an increase in access to high-speed internet, which allows almost anybody to become an entrepreneur overnight.

Decline of the Corporate Tax. While the passthrough sector has grown, both the absolute number of taxable corporations and their share of total business income have shrunk. In 1994, there were 2.3 million Subchapter C corporations subject to the corporate tax. By 2008, the number had declined to 1.8 million. Because most smaller businesses are switching from Subchapter C to passthrough status large corporations account for an increasing share of corporate tax revenue. In 1994, the top

Figure 1. Growth in S Corporations, 1980-2008
(in millions)

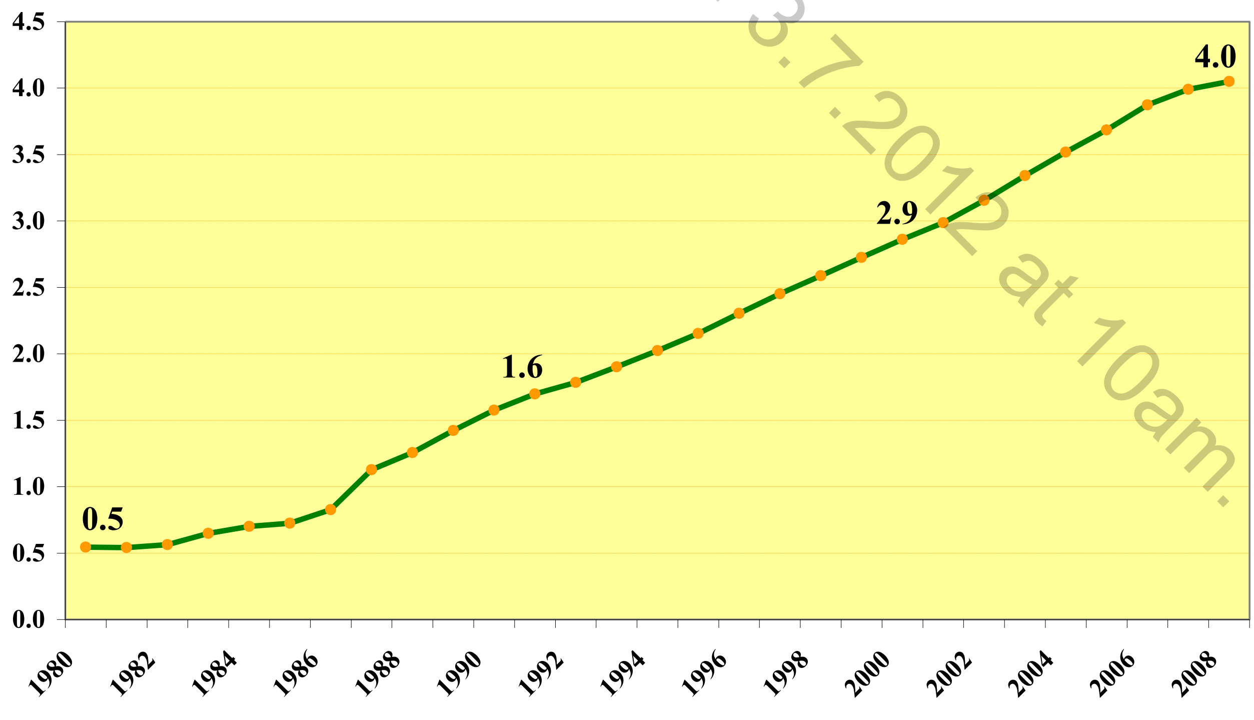


Figure 2. The Rapid Rise of LLCs, 1993-2008
(in millions)

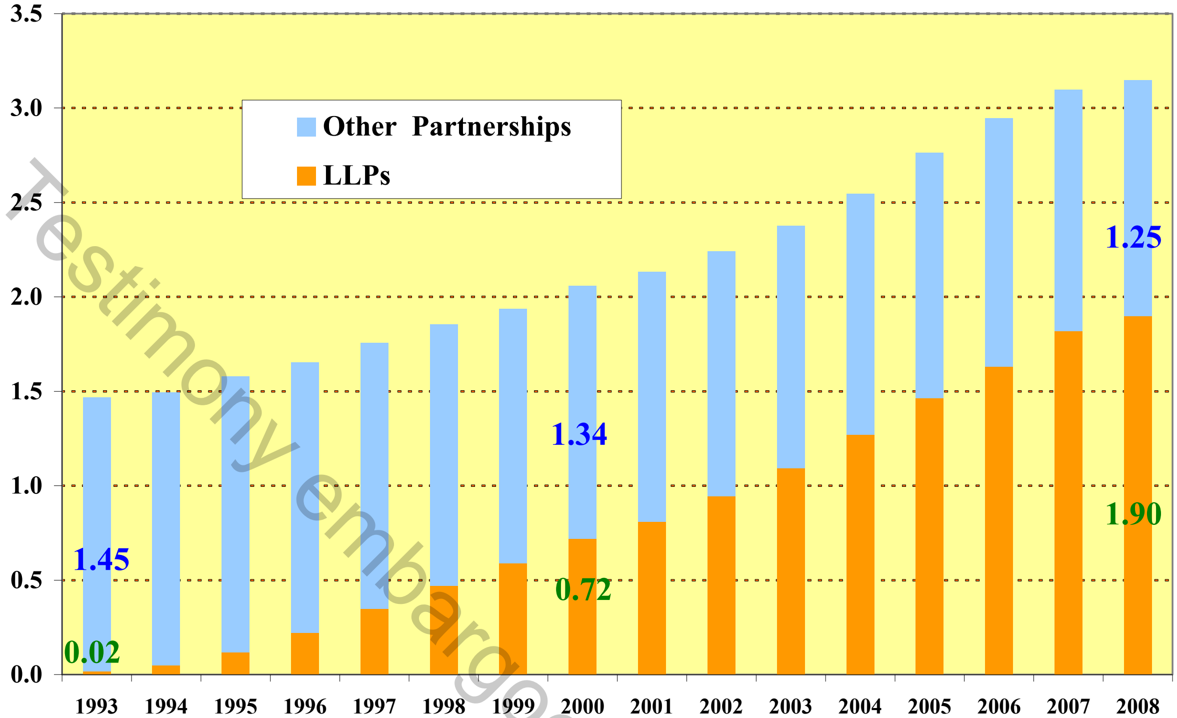
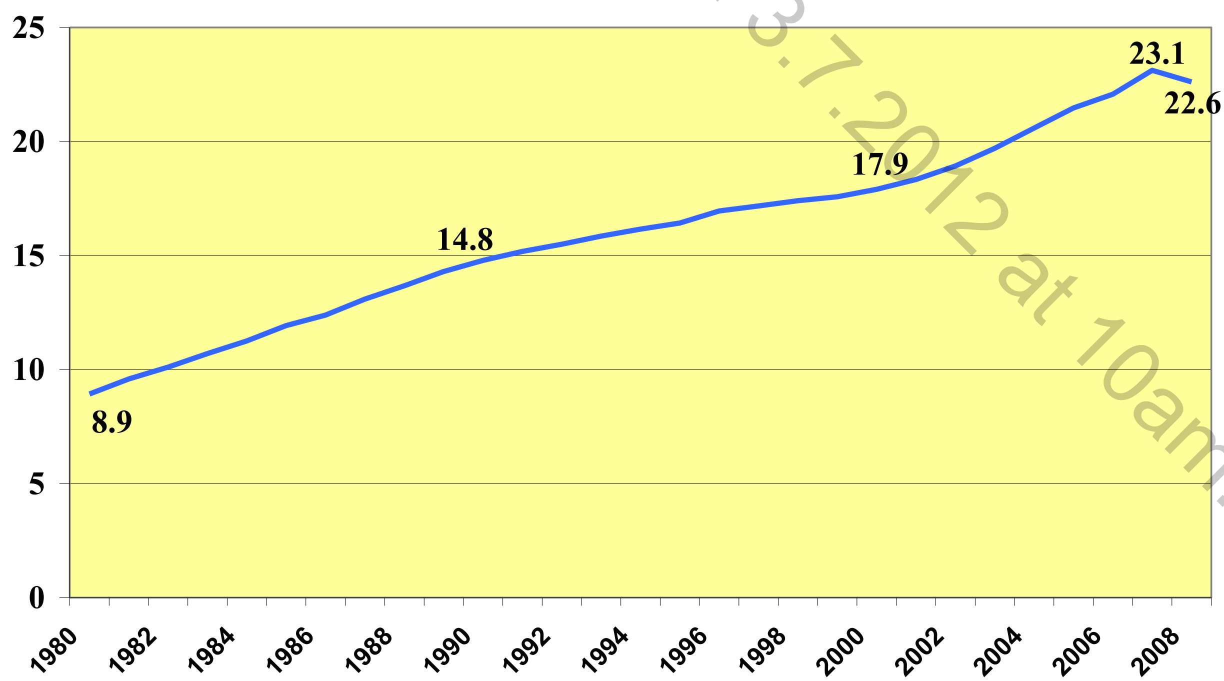


Figure 3. Sole Proprietorships, 1980-2008
(in millions)



1,500 corporations paid 70 percent of corporate tax revenue. In 2008 it only took the top 600 corporations to account for 70 percent of corporate revenue.

International comparisons. As noted by the Treasury Department in 2007, non-corporate businesses play an unusually important role in the U.S. economy. Survey data collected by the OECD shows that among 15 OECD countries for which data are available, the United States (at 82 percent) had the second highest percentage of unincorporated businesses in 2004, 13 percentage points above the OECD average. More important for their influence on general economic activity is the size of U.S. non-corporate businesses; they are more heavily represented among large businesses than in other countries reporting to the OECD. For businesses reporting profits of at least $1 million, the United States (at 66 percent) had the highest share of unincorporated business among reporting OECD countries.[4]

II. Potential Pitfalls of Corporate Tax Reform for Passthrough Businesses

A quarter century ago, the United States had one of the lowest corporate tax rates in the world, but it has not reduced its corporate tax rate since 1986. On April 1 of this year, when Japan will reduces its corporate rate, all of our major competitors will have reduced their corporate tax rate, leaving the United States—with a combined federal-state tax rate of 39.2 percent—with the highest statutory corporate tax rate in the world.

In general, economists agree that significant rate reduction will increase investment in the United States, reduce the use of costly tax planning and convoluted tax shelters, reduce the incentive to shift profits to foreign tax havens, and reduce the incentive to increase debt. But while it is easy for tax economists to agree about the desirability of a lower corporate rate, the hard part is paying for it. Under current budget constraints tax reform almost certainly will needs to be at least revenue-neutral. The additional revenue from increased long-run economic activity that would follow a corporate tax cut will not be nearly enough to offset the revenue loss. Rate reduction for Subchapter C corporations must be paid for with offsetting tax increases.

There is a wide range of possible revenue sources to pay for a corporate rate cut. A commonly suggested approach is eliminating some, or even all, business tax expenditures. According to Treasury Department estimates, eliminating *all* domestic-only tax expenditures would allow a revenue-neutral rate reduction to 28 percent. Eliminating all business tax expenditures—including the research credit—would be extremely difficult. Moreover, if this approach is adopted, it would adversely impact passthrough businesses that would only lose deductions and credits and not get any benefit from the lower corporate rate.

By far the two most important tax expenditures for passthrough businesses are accelerated depreciation (including section 179 expensing) and the section 199 deduction for domestic manufacturing. According to the latest tax expenditure budget from the Joint Committee on Taxation, $8.3 billion out of total of $23.7 billion (35%) of the projected average annual benefit of accelerated depreciation goes to passthrough business. With respect to the deduction for domestic

[4] See, U.S. Treasury Department, Treasury Department, "Treasury Conference on Business Taxation and Global Competitiveness: Background Paper," July 26, 2007; Peter R. Merrill, “The Corporate Tax Conundrum,” *Tax Notes*, October 8, 2007; and Organization for Economic Co-operation and Development, "Survey on the Taxation of Small and Medium-Sized Enterprises: Draft Report on Responses to the Questionnaire," revised 25 July 2007, Table 1.

manufacturing, $4.6 billion out of total of $14.4 billion (32%) of the projected average annual benefit goes to passthrough business.[5] Manufacturers are the major beneficiaries of these provisions, so eliminating these tax benefits would be particularly harmful to manufacturers organized as passthrough businesses.

According to background documents provided by this committee, Chairman Camp's draft proposal for international tax reform is intended to be revenue-neutral.[6] Given our enormous budget deficits, and the generosity of current U.S. international tax rules, that is a reasonable approach. However, as tax reform progresses, there will be tremendous pressure from multinational businesses for international reform to include an overall tax cut on foreign-source income. Just as a corporate rate cut provides no benefit to passthrough businesses, tax cuts on foreign profits provide little or no benefit to most passthrough business. And, to the extent foreign tax benefits reduce revenue, there will be increased pressure to raise taxes on passthrough benefits.

It is important to keep in mind that a tax hike is more painful for a small business than a large business -- especially since the financial crisis. Cash flow is important to all businesses. But it is usually much more critical to a small business -- which may not even be able to obtain a bank loan -- than it is to a large business --which can borrow directly in bond and commercial paper markets at low interest rates.

There is also another reason for lawmakers not to take their cue only from large publicly traded corporations when assessing the effect of some tax changes. With respect to accelerated depreciation (and certain other tax benefits that arise from timing differences), the tax benefit does not translate into a lower *reported* effective tax rate and higher profits *reported* to shareholders. CFOs can obsess about their reported effective tax rate, and CEOs can pay an inordinate amount of attention to reported profits. Because less accelerated depreciation does not affect those measures, publicly traded corporations and other businesses using GAAP accounting may be far less resistant to such a change than a small business using cash accounting.

III. Large Passthrough Businesses

In the past, when there were not so many self-employed consultants, and not so many people working as independent contractors, before the loosening of Subchapter S requirements, before the invention of LLCs, it was not so terrible to use the data on passthrough businesses as a measure of all small businesses. But today's passthrough entities are an extremely heterogeneous lot. As technology, work relationships, and business organization have evolved dramatically, we can no longer think of that mass of income tax filings as providing us with a picture of small business.

Many large businesses are Subchapter S corporations and limited liability companies. As shown in Table 2, there were 14,000 S corporations with more than $50 million in receipts in 2008. They accounted for 29 percent of all S corporation profit. Their average level of profit was $6.4 million.

[5] Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015," January 17, 2012.

[6] "Summary of Ways and Means Discussion Draft: Participation Exemption (Territorial) System" October 26, 2010. The document states: "The discussion draft is intended to be revenue neutral in and of itself when considered as part of comprehensive tax reform legislation. The Committee does not believe that domestic base broadening should be used to finance international tax relief, and vice versa."

Other IRS data (not shown in the table) indicate that more than 8 percent of Subchapter S corporation profits were earned by businesses with over $250 million in assets.

Table 2. Subchapter S Corporations with $50 Million or More in Receipts, 2008				
	Number	**Total Profit (billions)**	**Avg. Profit (millions)**	**% of Total (all size) S Corp. Profit**
All Industries	**14,192**	$ 90.7	**$ 6.4**	**29%**
Agriculture, Forestry	147	$ 0.7	$ 4.7	25%
Mining	122	$ 3.9	$ 31.9	28%
Utilities	25	$ 0.4	$ 14.3	58%
Construction	2,201	$ 13.1	$ 6.0	36%
Manufacturing	2,363	$ 20.0	$ 8.5	47%
Wholesale, Retail Trade	7,031	$ 24.0	$ 3.4	44%
Transportation, Warehousing	405	$ 1.7	$ 4.1	23%
Information	148	$ 2.3	$ 15.6	44%
Finance and Insurance	153	$ 7.1	$ 46.4	23%
Real Estate, Rental, Leasing	81	$ 0.3	$ 4.2	3%
Professional, Technical Services	515	$ 6.5	$ 12.6	13%
Holding Companies	95	$ 4.6	$ 48.9	72%
Administrative, Support Services	450	$ 3.2	$ 7.1	26%
Educational Services	32	$ 0.5	$ 16.0	19%
Health Care, Social Assistance	192	$ 0.8	$ 4.2	3%
Arts, Entertainment, Recreation	76	$ 0.8	$ 10.5	22%
Accommodation, Food Services	115	$ 0.5	$ 4.2	13%
Other Services	39	$ 0.3	$ 8.5	5%

Table 3 looks at large partnerships. It presents 2008 data on the 18,000 returns of those partnerships that had assets of $100 million or more. Even though these partnerships were only 0.6 percent of the 3.1 million total partnerships, they accounted for 64 percent of the profits of all partnerships. For this group, the average number of partners was 300 and the average profit was $16.2 million.[7]

To summarize, because of tremendous growth in the use of LLCs and Subchapter S corporations, it is a serious mistake to conflate the terms “passthrough” and “small business.”

As the determined effort continues for revenue to pay for lower corporate tax rates, there is growing interest in taxing large passthrough businesses as corporations. If base-broadening is the means of paying for lower rates, it is only logical to include, as an option, subjecting large passthrough businesses to the same tax as their Subchapter C competitors.

Ideally, all businesses should be subject to only one layer of tax. But *as long as there is a corporation tax*, the most economically efficient way to collect it is over a broad base and over the broadest number of businesses with as low a rate as possible. Taxing large passthrough businesses removes their unfair competitive advantage over taxable corporations, and the revenue raised can

[7] Between 15 and 20 percent of partnership profits is subject to corporate tax. See footnote 3.

reduce the corporate rate. Just like other base-broadening measures under consideration as part of tax reform, this proposal will help promote economic growth.[8]

Table 3. Partnerships with $100 Million or More in Assets, 2008					
	Number	**Avg. # of Partners**	**Total Profit (billions)**	**Avg. Profit (millions)**	**% of Total (all size) Partner-ship Profit**
All Types	**18,180**	**300**	**$ 294.3**	**$ 16.2**	**64%**
By Legal Form:					
LLC	6,899	82	$ 27.9	$ 4.0	51%
Other	11,281	434	$ 266.4	$ 23.6	66%
By Broad Industry Class:					
Finance	9,884	222	$ 146.8	$ 14.9	67%
Real Estate	4,403	116	$ 1.2	$ 0.3	29%
Other	3,893	708	$ 146.2	$ 37.6	62%

IV. About Individual Tax Rates and Small Business

Without congressional action, individual income tax rates will rise at the beginning of 2013. Although there is general consensus that the so-called Bush tax cuts should be extended for low- and middle-income taxpayers, there is disagreement about whether the two top rates should be allowed to continue at their 33 and 35 percent levels or revert to their pre-2001 levels of 36 and 39.6 percent. Proponents of the lower-rate option argue that raising the top two rates would impede job creation by passthrough businesses.

Although only a small fraction (about 3 percent) of passthrough businesses would be affected by this individual income tax rate hike, the portion of passthrough business profits affected would be much larger. There are many issues with interpreting data on passthrough businesses, and there is no one correct way to present them. However, a new technical paper from the Treasury Department has greatly increased our understanding of passthrough businesses and the tax situation of their owners.[9] Based on data disclosed in this study, we can estimate that 44 percent of income generated by small business owners would be affected by a change in the top two rates.[10] If we look at the income generated by all -- not just small -- business owners, 61 percent of that income would be affected by the rate change.

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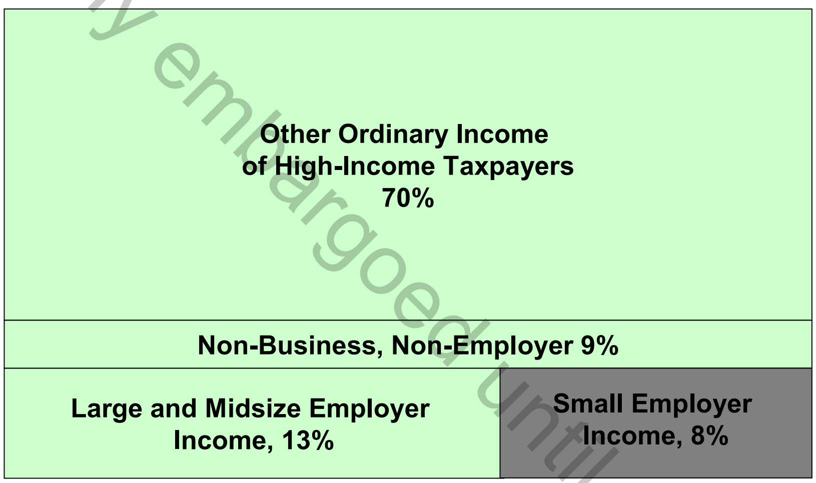
[8] Martin A. Sullivan, "Why Not Tax Large Passthroughs as Corporations?" *Tax Notes*, June 6, 2011.

[9] Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce, and Richard Prisinzano, "Methodology to Identify Small Businesses and Their Owners," Office of Tax Analysis, Technical Paper 4, Aug. 2011. For more discussion of this data, see Martin. A. Sullivan, "Should We Raise Taxes on Wealthy Employers?" *Tax Notes*, Sept. 12, 2011 and "The Myth of Mom and Pop Business," *Tax Notes*, Sept. 12, 2011.

[10] The Treasury study defines small passthroughs as those with less than $10 million of gross receipts. The tax return data Treasury uses does not include the number of employees at passthroughs. According to Census Bureau data for 2007, employers with between $7.5 million and $10 million of gross receipts had an average of 52 employees. This seems reasonable. (See Table 3, Receipt Size of Employer Firms, 2007, http://www.census.gov/econ/smallbus.html.)

Does it follow that because rate increases would affect a significant portion of passthrough business income that the Bush tax cuts should be extended to all upper income taxpayers? I would strongly argue that it does not. Let me begin by calling your attention to Figure 4. It shows that of all the high-bracket income subject to regular tax rates (that is, excluding capital gains and qualified dividends) about 30 percent is related to passthroughs. Only about 21 percent of ordinary high-bracket income is from passthrough employers. And only about 8 percent of ordinary high-bracket income is generated by *small* business employers. The bottom line is that most income affected by the rate change has nothing to do with small business employment. If the goal is to promote employment at small businesses, providing tax relief to *all* income in high brackets is an extremely inefficient way of achieving that objective.

Figure 4. Composition of Income Affected by High-Bracket Rate Changes



Because (as discussed below), there are alternative methods of providing tax relief to small business employers, there is no reason for the debate on extension of the Bush tax cuts for high-income households to pivot on its impact on small business employment. The merits of extending high-end rate cuts should be judged with relation to larger issues, such as: the need for deficit reduction, their impact on fairness, and their impact on the *overall* economy.

The best way to provide tax relief for small business is not through broad-brush policies like changes in high-end rates, but through tax relief targeted toward small business. Along those lines, House Majority Leader Eric Cantor is proposing a deduction equal to 20 percent of passthrough income for businesses with less than 500 employees.[11] Although this proposal is a far more cost-effective method of providing assistance to small business than a rate cut, it suffers from two major problems.

[11] Eric Cantor, "Memorandum to House Republicans—First Quarter Legislative Agenda," Feb. 1, 2012.

First, it would require complex anti-abuse rules to prevent high-bracket taxpayers from shifting non-business income into these new tax-advantaged vehicles. Without those rules, passthrough businesses would become tax shelters for the wealthy. Second, the proposal is not well targeted for encouraging job creation. For example, a small law firm with $10 million of profit and only 10 employees would get half the tax benefit received by a small service firm with $5 million in profit and 100 employees. Moreover, the new deduction would provide no marginal incentive to increase employment. If either of the firms in this example hired more employees, it would not receive any additional tax benefit.[12]

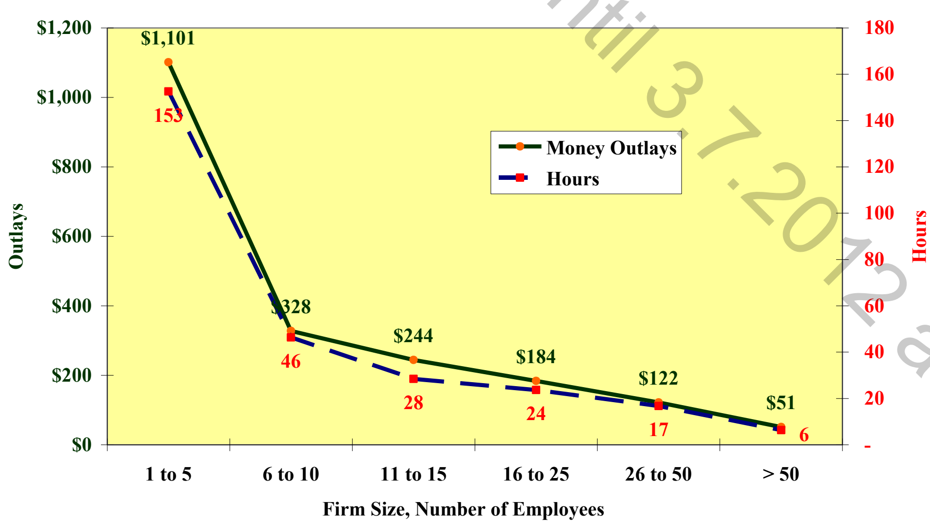
If we wish to use the tax code to promote small business job creation, the best approach would be to provide permanent deductions or credits equal to a percentage of each employee's payroll with a limit on the number of employees that can qualify. This would provide a simple and easy-to-understand incentive to increase and retain employees. Under this proposal, adding jobs would reduce taxes. Businesses with few employees and large profits would not receive large windfalls.

V. Conclusion: How to Really Help Small Business

According to the latest estimates, small businesses spent about 1.75 billion hours and $15.5 billion on income tax compliance.[13] Most of the time burden is for record keeping. And most of the financial burden is in paying for professional help. What about differences in cost by firm size? Estimates shown in the Figure 5 confirm what common sense would have us assume: small businesses face significant fixed compliance costs, and cost per employee decreases with firm size.

The figures demonstrate the need for small business tax simplification. The inordinately large

Figure 5. Business Federal Tax Compliance Burden, Per Employee



Source: DeLuca, Guyton, Lee, O'Hare, and Stimlar (2007), Table 9.

[12] It is also possible that passthrough employers approaching the 500-employee threshold would be discouraged from increasing employment, and that firms above the threshold might actually cut employment to qualify for the new deduction.

[13] Donald DeLuca, John Guton, Wu-Land Lee, John O'Hare, and Scott Stilmar, "Estimates of U.S. Federal Income Tax Compliance Burden for Small Businesses," *IRS Research Bulletin*, 2007.

compliance costs faced by small businesses place a tax penalty on them that is the economic equivalent of a tax surcharge for being small. That distorts the allocation of capital away from small businesses and reduces economic growth.

Of course, everybody wants a simpler tax system. But lawmakers need to understand that tax simplification is especially important to small businesses. In particular, the instability of the code caused by frequent tax changes and expiring tax provisions is a drain on the limited resources of a small business.

Simplification of provisions that particularly affect small businesses should also be a priority. Along these lines, Congress should consider simplifying entity choices. Currently, the small business owner must consider the advantages and disadvantages of choosing among four different forms: sole proprietorship, partnership, Subchapter S, and Subchapter C. Proposals are already on the table that would give businesses the choice of a simple partnership or, if circumstances warrant, a more complicated partnership regime. Graduated corporate rates should be entirely eliminated, or small businesses simply should not be allowed to adopt Subchapter C status.[14]

Another promising approach for small business tax simplification is an expansion and simplification of cash accounting methods used to compute income tax. In a recent paper in *Tax Notes*, David Kautter and Donald Williamson propose that small business recognize income and deductions only when cash is received or expenses are paid.[15] This proposal includes the elimination of calculations for depreciation and cost of goods sold, which the authors believe will not reduce government revenue and will increase compliance among small businesses and entrepreneurs. This is just the most recent in a long line of proposals for simplified accounting for small business.[16]

In-depth examination of tax rules required to achieve small business tax simplification is neither easy nor glamorous. But it is one surefire way to reduce business costs and promote economic growth with minimal damage to the deficit.

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Thank you for this opportunity to comment on this important topic.

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[14] See, George K. Yin and David J. Shakow, "Reforming and Simplifying Income Taxation of Private Business Enterprises," in Joint Committee on Taxation, "Study of the Overall State of the Federal Tax System and Recommendations for Simplification," Vol. III, JCS-3-01, 2001; Jeffrey L. Kwall, "Taxing Private Enterprise in the New Millennium," *Tax Lawyer*, Vol. 51, No. 2, 1997; Martin A. Sullivan, “Business Tax Reform from the Bottom Up, *Tax Notes*, Oct. 17, 2011.

[15] David Kautter and Donald Williamson, “A Simplified Cash Method of Accounting for Small Business,” *Tax Notes*, February 13, 2012.

[16] President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," Nov. 2005;. Treasury Department, "Approaches to Improve the Competitiveness of the U.S. Business Tax Systems for the 21st Century,” Dec. 2007; President's Economic Recovery Advisory Board, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," Aug. 2010; Nina E. Olson, "How Tax Complexity Hinders Small Business: The Impact on Job Creation and Economic Growth,” (testimony of the national taxpayer advocate before the House Committee on Small Business), Apr. 13, 2011.