

# Charting a course on tax reform

## How the focus on pass-through entities could shape the debate



*Tax reform continues to be a hot topic in Washington. While many expect tax reform to be a multi-year effort with many twists and turns, the journey will be smoother for businesses that engage in the debate from the outset. This article, the second in a series from the Ernst & Young Center for Tax Policy, Ernst & Young LLP, examines how the tax classification of business entities may factor into the broader reform discussion.*

The tax reform debate has focused recently on examining the tax rules related to business structures, with a particular emphasis on pass-through entities. Members of the Obama Administration have expressed interest in this area, with Treasury Secretary Timothy Geithner saying at a Senate Finance Committee hearing early this year that Congress should “revisit” rules that permit businesses to choose their organizational structures. More recently, Senate Finance Committee Chairman Max Baucus (D-MT) suggested larger pass-throughs could be taxed as corporations as part of a broader corporate tax reform effort.

In the US, pass-through entities account for some 90% of businesses, employ more than 50% of the private sector workforce and report more than a third of all business receipts. Moreover, individual owners of pass-throughs pay 44% of all business taxes on their allocable income.<sup>1</sup> Because so many US businesses are currently organized as pass-throughs, the debate over how they are taxed is drawing significant interest among both policymakers and the business community. In fact, policymakers have cited the large number of pass-through entities as one reason tax reform should be expanded beyond corporate taxation to include the individual tax system as well. Extending the tax reform debate to encompass these businesses, as well as other elements of the individual income tax, however, makes the task considerably more complicated and politically charged.

<sup>1</sup>Ernst & Young LLP’s Robert Carroll, speaking on his own behalf before the House Ways and Means Committee, 3 March 2011, p. 1, [www.waysandmeans.house.gov/UploadedFiles/Carroll.pdf](http://www.waysandmeans.house.gov/UploadedFiles/Carroll.pdf).

In fact, the focus on pass-through businesses in connection with tax reform has already raised the stakes of the debate and sparked a strong reaction from the business community. In a recent letter to leaders of the Senate Finance and House Ways and Means Committees, a number of trade groups representing closely held businesses – including the US Chamber of Commerce, National Federation of Independent Business and the S Corporation Association – cautioned against pursuing tax reform that would “benefit C corporations at the expense of flow-through businesses.”<sup>2</sup> In addition, House Republicans have resisted the idea of taxing large pass-throughs as corporations.

Whatever the final outcome, the contours and scope of any potential tax reform are likely to have significant repercussions for these businesses, which play an important role in the US economy.

For purposes of this article, pass-through entities include partnerships, S corporations, limited liability companies (LLCs) and sole proprietorships. At the most basic level, the income or losses of pass-through entities are reported by the owners and are taxed only once, on the owner’s tax return, and at the owner’s tax rate, which may differ from the corporate income tax rate. In contrast, the profits of C corporations are taxed at the corporate level and again at the investor level when dividends are received or capital gains realized. This is often referred to as “double taxation.”

## The role of pass-throughs in the US economy

The number of pass-throughs in the US has grown significantly during the past few decades. In 1980, 83% of businesses chose a pass-through form compared with 95% in 2008.<sup>3</sup> One factor contributing to this shift was the lowering of the individual tax rate relative to the corporate income tax rate in the Tax Reform Act of 1986. Another increase in the use of the pass-through form came when the IRS issued regulations in 1997 allowing many business entities to “check the box” to choose whether they wished to be taxed as a partnership or corporation, which had the effect of encouraging the creation of more pass-through entities.

Pass-throughs can be an attractive option because business owners are not subject to the additional layer of corporate tax that C corporations face. Businesses organized as partnerships have greater flexibility in forming and dissolving than those organized as C corporations and there is less chance of triggering taxable gain in such situations.

Another factor contributing to the growth of pass-throughs in the US is their ability to accommodate different business configurations. Pass-throughs can vary greatly in both size and structure. Sole proprietorships are owned and run by one individual. S corporations may have up to 100 shareholders and generally cannot have corporate owners. Partnerships range from very small to very large in size and often accommodate joint ventures between or among corporations. The assets and gross receipts of pass-through businesses can vary significantly (see table below).

### Pass-through statistics, 2006

Type of entity	Gross receipts > \$50 mil		Assets > \$50 mil	
	% of returns	% of positive net income	% of returns	% of positive net income
Partnerships	0.3%	53.1%	0.1%	59.1%
S corporations	0.4%	24.7%	0.2%	20.2%
Sole proprietorships	0.0%	0.4%	N/A	N/A
<b>All entity types</b>	<b>0.1%</b>	<b>34.9%</b>	<b>0.5%</b>	<b>45.3%</b>

Note: 2006 is the latest year complete data was available for all business forms. Amount in “all entity types” row includes only S corporations and partnerships. Percentages do not total because each category of pass-throughs accounts for a different percentage of the total group.

Source: Ernst & Young LLP calculations based upon data from Internal Revenue Service, Statistics of Income Division.

<sup>2</sup> Letter from closely held business organizations to Senate Finance Committee Chairman Max Baucus, 11 May 2011, [www.s-corp.org/wp-content/uploads/2011/05/FINAL-Business-Tax-Reform-Letter.5.11.11.pdf](http://www.s-corp.org/wp-content/uploads/2011/05/FINAL-Business-Tax-Reform-Letter.5.11.11.pdf)

<sup>3</sup> Robert Carroll and Gerald Prante, *The flow-through business sector and tax reform: The economic footprint of the flow-through sector and the potential impact of tax reform*, Ernst & Young LLP report prepared on behalf of the S Corporation Association, April 2011.



From 2004 through 2008, individual owners of pass-through businesses reported an average of \$1.2 trillion annually and paid an average of \$232 billion annually in individual income taxes. This works out to 54% of business net income and 44% of business taxes being paid by owners of pass-through businesses during this period.<sup>4</sup>

## International comparisons

Policymakers may examine factors such as the tax classification of businesses and business entities in other countries as they weigh US tax reform options. As popular as the pass-through form is in the US, such entities are not as prevalent in the economies of most other developed countries. According to a 2007 study by the Organisation for Economic Co-operation and Development (OECD), of 15 nations reporting, only Mexico had an unincorporated sector with a larger share of its businesses (88%) than the US (82%).<sup>5</sup>

In other developed countries, businesses pursuing limited liability are guided toward the corporate form; while in the US, entities can achieve limited liability through a variety of organizational forms. In fact, 7 of 17 countries responding to an OECD questionnaire reported having no business form that provided limited liability without a requirement to pay the corporate income tax.<sup>6</sup>

Most other developed nations have provided some relief from the double tax on corporate profits by integrating their individual and corporate income taxes in some manner. In the US many companies have, in effect, achieved a similar result by organizing as pass-through businesses.<sup>7</sup>

## Reform options

In the current deficit environment, the revenue impact of tax changes is a critical consideration. Policymakers and legislators are discussing reducing the corporate income tax rate and how to pay for that reduction. Discussions have focused on financing a lower corporate tax rate by broadening the business tax base.<sup>8</sup>

Various tax reform proposals would reduce or eliminate business tax expenditures to offset the cost of a corporate tax rate cut. Examples of major business tax expenditures that could be affected include accelerated depreciation and the research credit. Business tax expenditures are used by C corporations and pass-through entities.

While many pass-through entities do not pay corporate income taxes and would not benefit from a lower corporate rate, many do use tax expenditures and would face a greater tax burden if these were curtailed or eliminated. In fact, tax expenditures used by pass-through entities average \$27 billion annually.<sup>9</sup> Pass-throughs account for roughly one-half of total business net income in the US and 23% of business tax expenditures.<sup>10</sup> Eliminating all business tax expenditures would increase the income taxes paid by individual owners of pass-through entities by 8% on average, or \$27 billion annually from 2010 through 2014.<sup>11</sup>

Under a scenario in which tax reform lowers the corporate income tax rate and reduces business tax expenditures, winners could include C corporations, many of which would enjoy a lower tax rate. While it would be technically possible to eliminate or limit business tax expenditures only for C corporations, this would add complexity to the tax code. It would also widen the differences between the tax treatment of C corporations and pass-throughs. Policymakers will undoubtedly weigh the potential revenue effects of reduced tax expenditures against the challenges of cutting tax benefits that have been longstanding fixtures in the tax code.

Sen. Baucus, for example, has said eliminating all business tax expenditures is not an option, and that taxing some larger pass-throughs as corporations is one way to finance a lower corporate tax rate.<sup>12</sup> Criteria to determine an entity's tax status might be a certain threshold of gross receipts or annual revenue, or whether an entity is publicly traded. This type of proposal would be politically contentious and would trigger vigorous debate. Issues would need to be addressed, such as which pass-throughs to tax like corporations and the potential effects on investment and US competitiveness.

Past changes to the tax code have caused businesses to rethink their choice of organizational form. As mentioned above, the Tax Reform Act of 1986's lowering of individual income tax rates relative to corporate rates made pass-through entities a more popular choice than they had been previously. If corporate tax rates were lowered relative to individual rates, it might spur companies to rethink which business model and classification best suits their needs.

Policymakers will also weigh how tax changes might affect business investment and hiring decisions. As a group, pass-throughs employ more than 50% of the private sector workforce. Job creation and economic competitiveness are key prisms through which policymakers are examining tax reform options.

<sup>4</sup> Ibid.

<sup>5</sup> US Department of the Treasury, *Treasury conference on business taxation and global competitiveness background paper*, 23 July 2007, p. 16-17. Although they are pass-through entities, S corporations were grouped by the OECD with other corporations because they are incorporated. Thus, the size of the pass-through sector in the US is understated in this analysis.

<sup>6</sup> Ibid. at 17.

<sup>7</sup> Robert Carroll, *The economic effects of the lower tax rate on dividends*, Tax Foundation Special Report No. 181, 7 June 2010.

<sup>8</sup> For more details on recent tax reform proposals, see Robert Carroll, Tom Neubig and Gerald Prante, *Side-by-side comparison of tax reform proposals reveals patterns in evolving debate*, Ernst & Young LLP Center for Tax Policy, April 2011.

<sup>9</sup> Gerald Prante, Robert Carroll and Tom Neubig, *Lowering business tax rates by repealing tax expenditures: an industry analysis*, Ernst & Young Center for Tax Policy, Ernst & Young LLP, 11 February 2011, p. 2.

<sup>10</sup> Ibid.

<sup>11</sup> Carroll and Prante, *supra* note 3, p. ii.

<sup>12</sup> "Taxing some pass-throughs as corporations may be key for tax reform, Baucus suggests," 5 May 2011, Bureau of National Affairs, *Daily Tax Report*, 87 DTR G-7 (2011).

## Preparing for change

All types of businesses are engaging policymakers on tax reform. As the dialogue intensifies, companies should consider how potential changes to the rules governing pass-throughs could affect their operations. Among the possible outcomes to consider are potential changes to tax classification, the loss of certain tax expenditures, or another layer of taxation if certain pass-throughs are treated as corporations for tax purposes. The analysis should include an examination of the entity's tax classification and how it may relate to future goals, as well as identification of the tax expenditures that benefit the business and the quantification of those benefits.

Businesses can help educate policymakers about these potential trade-offs by explaining the role tax classification plays in their future growth, investment and hiring plans. Those that work to understand the issues and implications now and act early to engage decision-makers will be best able to affect the debate and best prepared for any tax changes that may emerge.



*This is the second in a series of articles on tax reform.*

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