AGC Tax Reform Update

Associated General Contractors of America

June 7th, 2018

S CORP

DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES

Tax Reform & Pass-Through Businesses

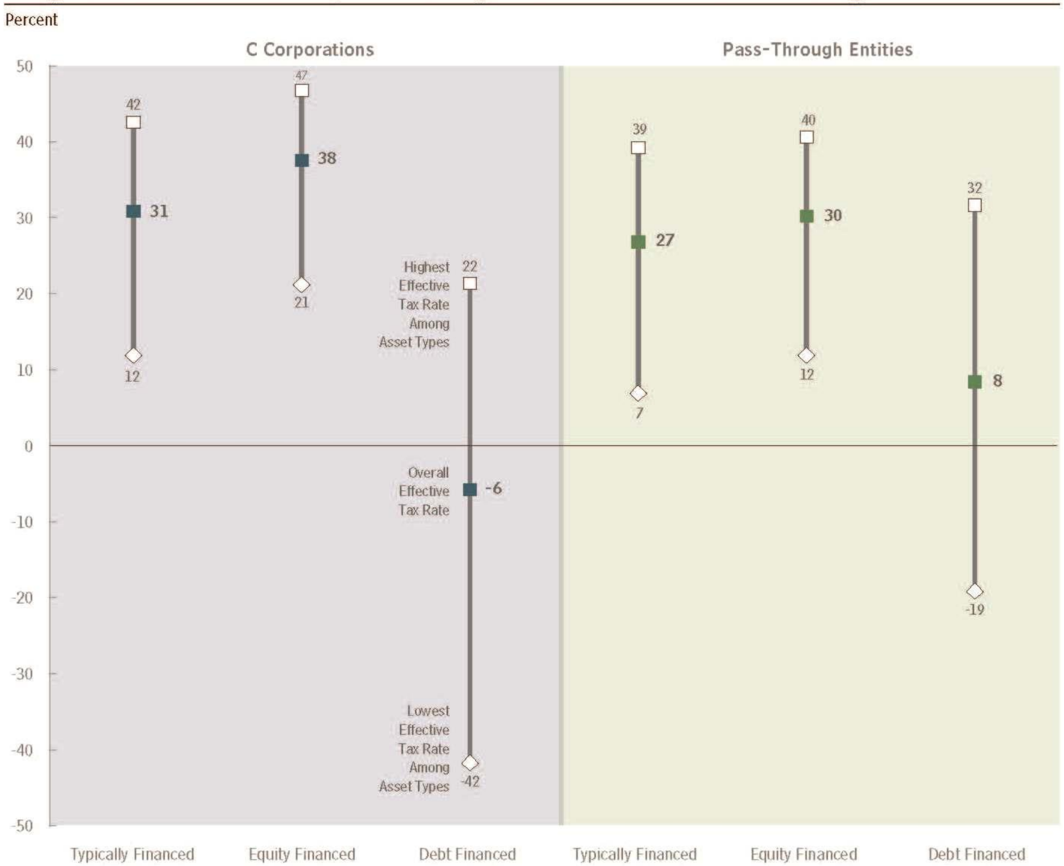
The New Tax Reform Law

- Headline: Congress just passed biggest Tax Code rewrite in 30 years!
- Effort was driven by a desire to make the US a more attractive place to do business
- Successful tax reform would:
  - Reduce the cost of investing here in the US
  - Level the tax burden on investments and industries
  - Level the tax burden on debt and equity
  - Simplify!
- An illustration of the challenge

Tax Reform & Pass-Through Businesses

Business Tax Reform – The Basic Challenge

Range of Effective Tax Rates by Form of Organization and Source of Financing

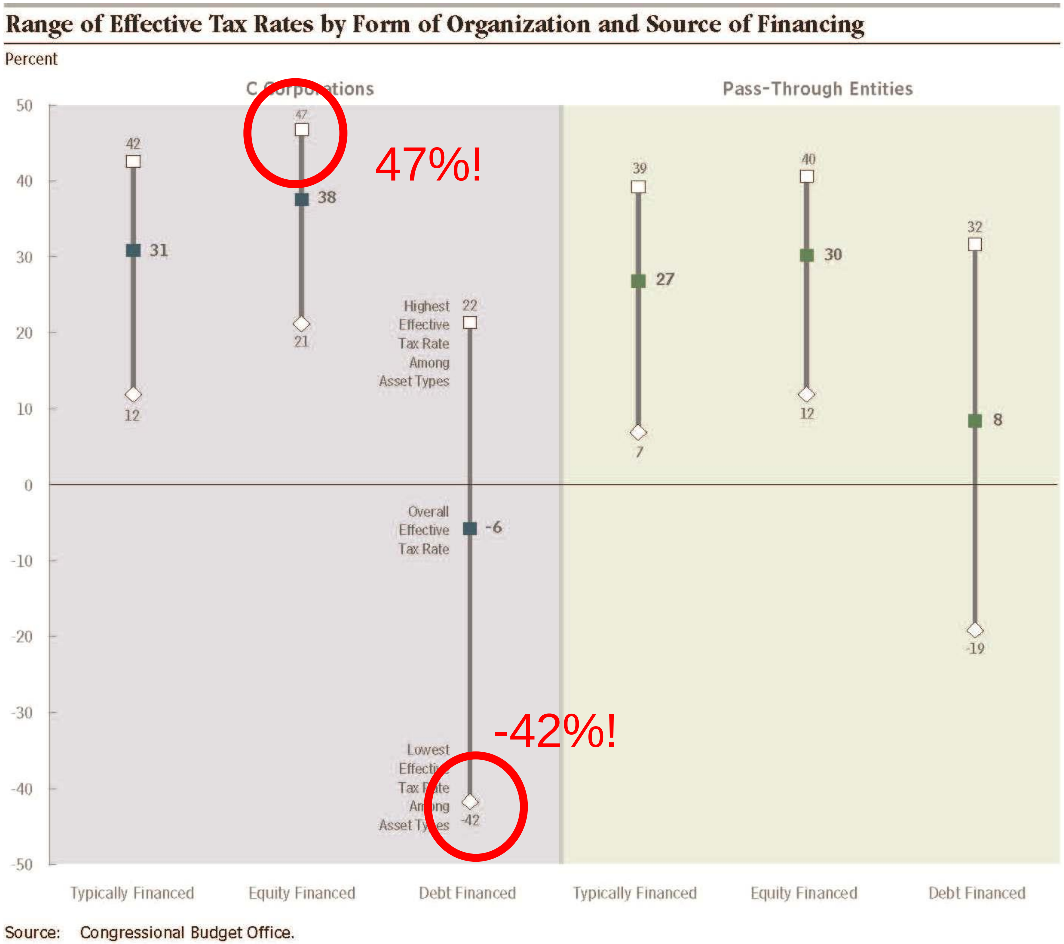


Source: Congressional Budget Office.

These long lines are the problem…

Tax Reform & Pass-Through Businesses

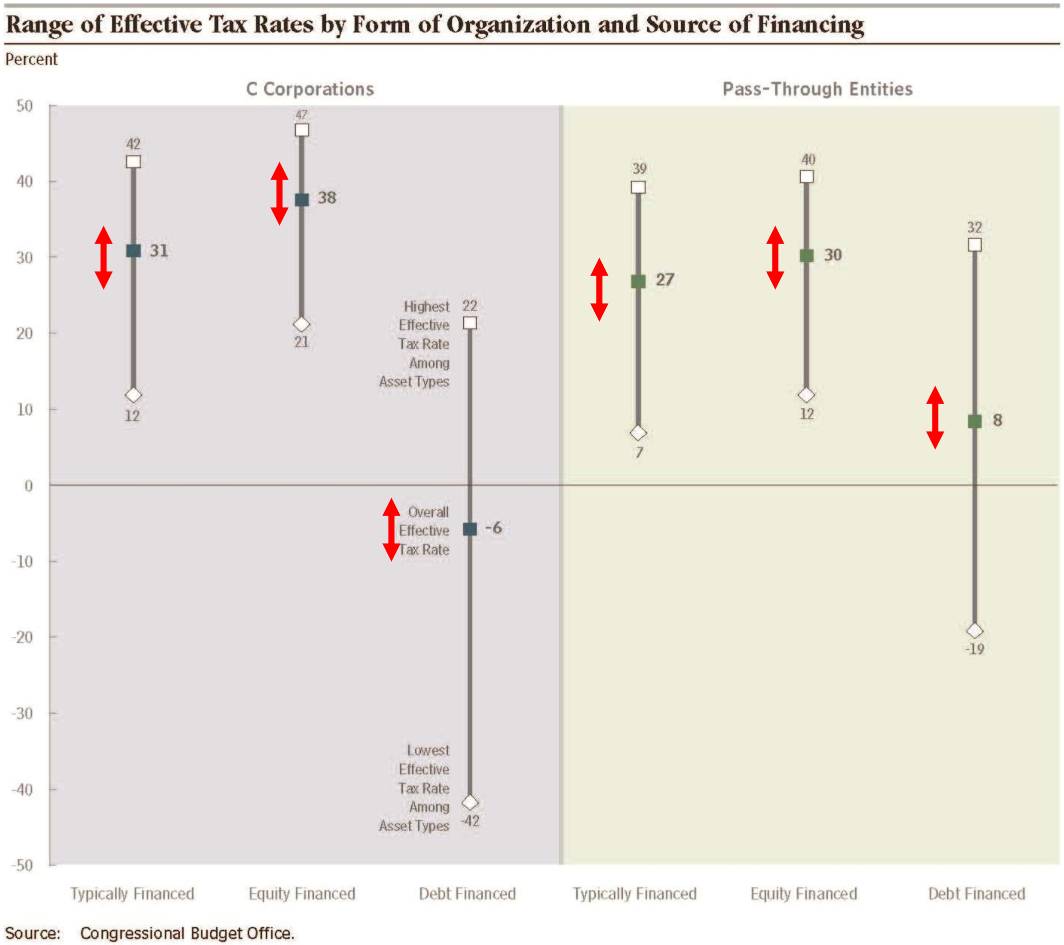
Business Tax Reform – The Basic Challenge



They are all over the place! One asset faces an effective tax rate of positive 47%, while another is negative 42%!

Tax Reform & Pass-Through Businesses

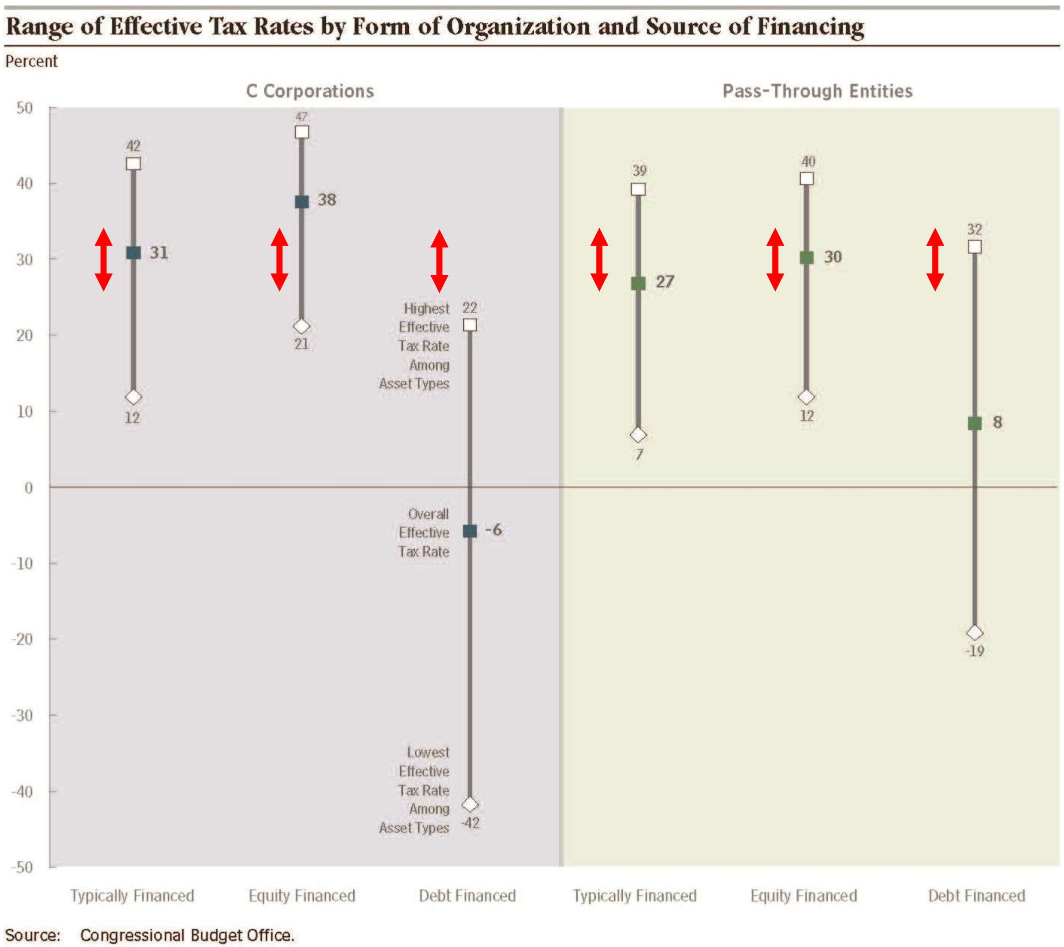
Business Tax Reform – The Basic Challenge



Done correctly, tax reform would shorten the lines…

Tax Reform & Pass-Through Businesses

Business Tax Reform – The Basic Challenge



…and level out tax burdens so that all investments face a similar level of tax.

Tax Reform & Pass-Through Businesses

The New Tax Reform Law

- How did the new tax law do?
- For C corporations, the bill offers
  1. A sharply lower top rate of 21%
  2. More balanced treatment of equity and debt
  3. Territorial tax treatment on international income
  4. Simplification through the elimination of numerous deductions and credits, including the elimination of the Corporate AMT
- The net result is a lower overall effective tax rate, a more balanced treatment of debt & equity, and a more competitive (and fair) treatment of international income

Tax Reform & Pass-Through Businesses

The New Tax Reform Law

- For pass-through-businesses, the law is a little more complicated:
  1. Top rates on pass-throughs range from 29.6% to the mid-40s;
  2. Pass-throughs don't get the new territorial tax treatment
  3. The Individual AMT, Estate Tax, and Net Investment Income Tax remain in place
  4. Its temporary -- the pass through deduction sunsets beginning 2026
- So lower rates for many pass-through businesses, but accompanied by more complexity and uncertainty
- The temporary nature of the new deduction creates a multi-fold dilemma for pass-throughs
  - Business planning is more complicated starting now
  - We face a new fiscal cliff starting 2026

Tax Reform & Pass-Through Businesses

New Pass-Through Deduction

- The new law combines a 37% top individual rate with a new, 20% business deduction, resulting in a 29.6% top rate for *some* pass through businesses
- There are significant limitations
- For S-Corp owners a "reasonable comp" standard applies – the deduction does not apply to what would otherwise be wages
- For owners above an income threshold, additional limitations apply:
  - "Specified Service Businesses" are excluded, as are businesses where their "principal asset" is the "reputation or skill of a single employee"; and
  - The deduction is subject to a wage test and an alternative capital test
- How does it all work?

Tax Reform & Pass-Through Businesses

Deduction Example #1

- Owner A is above the income threshold and owns 33% of a manufacturing S Corporation
  - S Corp has $3000 in net income, $900 in total W-2 wages and $10,000 of qualified capital
- Owner A's share of pass-through income is $1000, so his preliminary deduction is $200 (20% x $1000)
  - That's weighed against 50% of his share of W-2 wages: $300 * 0.5 = $150; or
  - 25% of W-2 wages plus 2.5% of qualified capital: $300*0.25 + $3333*.025 = $158
- Both limits are lower than the preliminary deduction, so Owner A may claim a pass-through business deduction equal to the higher limit -- $158.
- Instead of a 29.6% rate, Owner A is subject to a 31.2% rate

Tax Reform & Pass-Through Businesses

Deduction Example #2

- Owner B has income below the threshold and owns 100% of an S Corp accounting firm
  - The business has $1000 of income, no employee W-2 wages and no capital
- Owner B is below the income threshold, so the “specified services business” limitation, the employee W-2 test, or the qualified capital test do not apply
- The only limitation that applies is the “reasonable compensation” rule:
  - To determine his deduction, Owner B must first ensure that he is paying himself “reasonable” wages
  - Any income beyond this amount would be considered business profits and would be eligible for the 20% deduction

Tax Reform & Pass-Through Businesses

Base Broadening Provisions

- In addition to the lower tax rates, the new law includes extensive base broadening, much of it affecting both C corporations and S corporations:
  - Interest Expense Deduction Limitation
  - 199 Deduction Repeal
- Several provisions apply to pass-through businesses only:
  - Loss of State & Local income tax deductions
  - Pass-Through Loss Limitation
- *All* the base broadening will hurt S corporations more, since their marginal rate is so much higher than the C corporation rate:
  - The loss of a $1 deduction will cost C corporations just 21 cents, whereas it will cost an S corporation 29.6 to 40 cents or more

Tax Reform & Pass-Through Businesses

Effect on Pass-Through Rates

- The combination of a limited deduction, the loss of the state and local income tax deduction, and retention of the 3.8% NIIT results in a remarkable variety of top rates applying to S corps

S Corporation Effective Marginal Rates				
Specified Service Business		**No Income Tax State**	**Average-Income Tax State**	**High Income Tax State**
	Active Shareholder	37.0%	39.0%	41.0%
	Inactive Shareholder	40.8%	42.8%	44.8%
Non-Specified Service Business				
	Active Shareholder	29.6%	31.6%	33.6%
	Inactive Shareholder	33.4%	35.4%	37.4%

- These rates are then applied to a broader base of business income, so for some S corporations, the net effect could be a tax hike rather than a tax cut

Tax Reform & Pass-Through Businesses

Tax Reform Overview – Pass Throughs

- It could have been worse!!!
- During consideration, S-Corp worked with its allies like the APA and key Hill offices to win improvements to the original tax reform bills
- Senators Johnson (R-WI), Daines (R-MT) and Inhofe (R-OK) in particular led the way in getting key changes made, including:
  - An increased pass-through deduction
  - A lower individual top rate
  - Preserved IC-DISC benefits
  - Expanding the deduction to include trusts and estates
- These changes should enable many S corporations to remain as S corporations in the future

Tax Reform & Pass-Through Businesses

S-Corp Member Survey

- S-Corp and several other groups surveyed their members on the new law, getting more than 200 responses
- The key theme was "uncertainty"
- The Tax Cuts and Jobs Act was designed to spur economic growth, yet:
  - Half the respondents are unsure if their taxes go up or down under the new law; and
  - One-third responded they don't know if they will even get the new pass-through deduction
- These results point to the importance of:
  1. Treasury issuing timely and pro-growth rules to help implement the new law
  2. Congress making the provisions permanent!
- To make these improvements, we need to first reassert the value proposition of pass-through taxation and the need for parity

Tax Reform & Pass-Through Businesses

<u>Tax Reform & Parity</u>

- Message: Parity through permanence and effective implementation
- The pass-through sector continues to press for tax parity for all business types
- True reform would establish the same top tax rate for all businesses while eliminating multiple layers of tax
- Key steps towards parity are to make permanent the pass-through provisions while implementing rules that are pro-growth and pro-Main Street

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Tax Reform & Pass-Through Businesses

Tax Reform & Permanence

- Tax reform shifted balance between pass-throughs & corporations
  - We need to dispel the myth that pass-throughs are "tax advantaged"
- The temporary pass-through provisions result in a tax hike and an effective rate eight points higher then C-corps starting 2026

Table 4
Modeled Tax Policy Parameters

	Baseline	Law as written	Provisions permanent
Corporate tax rate, τ_c	38.0%	27.0%	26.0%
Corporate R&E Credit rate	5.0%	6.1%	5.0%
Pass-through tax rate, τ_p	35.2%	35.5%	31.1%

Tax Reform & Pass-Through Businesses

Tax Reform & Permanence

- This 2026 tax hike reduces the economic benefits of the tax overhaul

Table 1
Summary of the Major Macroeconomic Results for Featured Parameters
(percent change)

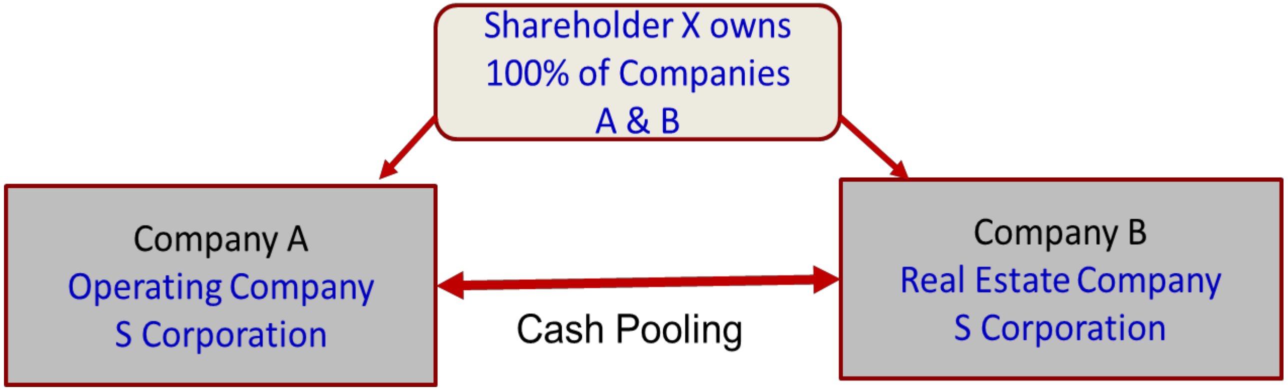
	Law as written	Provisions permanent
Long Run Results		
Corporate productivity	2.5%	4.7%
Pass-through productivity	-0.8%	3.1%
GDP per capita	0.9%	3.1%

- **Priority One: Make the pass-through deduction permanent!**

Tax Reform & Pass-Through Businesses

Tax Reform & Implementation

- Our second focus is for Treasury to get the rules right
- One fix is for Treasury to allow businesses to “group” similar interests to calculate their deduction
- Many businesses are organized like this “Brother- Sister” structure:



Tax Reform & Pass-Through Businesses

Tax Reform & Implementation

- The use of multiple entities combined with the deduction's "guardrails" can result in businesses losing some or all of the pass-through deduction
- Our Main Street Employer coalition letter signed by 40+ associations calls on Treasury to allow grouping under 199A
- S-Corp, the US Chamber, AICPA, and the ABA *all* submitted comments
- **Priority Two: Make certain the rules coming out of Treasury are pro- Main Street, including allowing pass-through businesses to use grouping to calculate their deduction**

Pass-Through Businesses & SALT

<u>Pass-Through Businesses & SALT</u>

- The new law ends deduction for most State and local income taxes on pass-through businesses
- The simple way to think about it is:
  - If the business pays the tax, it remains deductible
  - If tax is paid by the owner, it is not deductible
- Because most state and local taxes paid on S Corporation income are paid at the shareholder level, they would not be deductible under this language
- **This is a big deal!**

Pass-Through Businesses & SALT

Pass-Through Businesses & SALT

- To address this inequity, S-Corp has a two-step plan:
    1. Work with Hill offices to introduce a legislative fix.
    2. Work with States to adjust their rules -- taxes paid at the entity level are deductible, so give businesses the option of paying tax at the entity level
- Connecticut is the first state to pass this reform. The CT plan would:
    1. Impose a tax on pass-through businesses equal to the individual state income tax of 6.99%
    2. Give pass-though owners a refundable tax credit equal to protect them from double taxation
    3. Include rules to recognize tax credits from other states to business owners living in Connecticut

Pass-Through Businesses & SALT

Pass-Through Businesses & SALT

- How does the math work on the CT plan?

	Prior Law	New Law -- No deduction	CT Proposal
Income	$ 100.00	$ 100.00	$ 100.00
State Tax Rate	6.99%	6.99%	6.99%
Entity Tax	$ -	$ -	$ 6.99
Income Attributed to Shareholder	$ 100.00	$ 100.00	$ 93.01
Credit	$ -	$ -	$ 6.50
Shareholder State Tax (6.99%)	$ 6.99	$ 6.99	$ -
Income for Federal Tax	$ 93.01	$ 100.00	$ 93.01
Federal Tax (39.6%)	$ 36.83	$ 37.00	$ 34.41
Effective Federal Marginal Tax Rate	39.6%	39.8%	37.0%

Pass-Through Businesses & SALT

Pass-Through Businesses & SALT

- So Connecticut has embraced our idea of shifting tax incidence to preserve the SALT deduction
- What are the next steps?
  1. Work with tax attorneys to develop model language based on the Connecticut bill that works in other states
  2. Build out teams of businesses in key states to push this issue
  3. Highlight the effort in the press to make this a national issue
- This approach is a win-win for states and their businesses – it makes the state more business friendly without costing it revenue
- **Priority Three: Restore pass-through SALT deduction!**

S-Corps & Tax Reform

Action Items

- Bottom Line: Tax reform is done, but many challenges remain
- S-Corp will be working with the AGC and our other allies on those issues moving forward, including the three at the very top of our list:
    1. Making the pass-through deduction a permanent part of the Tax Code
    2. Making sure the new deduction is real and workable, including allowing grouping
    3. Leveling the playing field for pass-through businesses on SALT deductions
- Next steps:
    1. Work with our Parity for Main Street Employers coalition to educate Congress on the bill's realities and how it effects pass through businesses; and
    2. Meeting with key Administration offices to work through the implementation challenges and how to best treat pass-through businesses
    3. Generate new data and studies, including a new study from EY, on how the tax overhaul affects different forms of business

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