Parity for Main Street Employers

Can Main Street Businesses Just Convert? No!

Nor Should They. Here's why.

If "corporate-only" advocates have their way and the corporate tax rate is reduced, should pass-through businesses just switch to C status to access the lower rates? Would that shift improve the tax code and how we treat closely-held businesses? The answer to both questions is an emphatic no. Here are the main points:

- It's the opposite of tax reform. Taken as a whole, the corporate-only approach is effectively "anti-tax reform" in that it will return us to the pre-1986 era, when corporate tax rates were significantly lower than the top individual rate and tax shelters and gaming dominated taxpayer behavior.
- It's a tax hike either way. Pass through businesses that retain their status would pay a top rate of 45 percent. Those that switch to C status would pay the lower corporate tax, but also be subject to a second layer of tax on their dividends, so their total combined tax would be 48 percent. It's a tax hike either way, even with the lower corporate rate.
- The double tax applies to the sale of closely-held C corporations too. When a pass-through owner sells their business, they pay the capital gains rate on any gain. The same treatment applies to shareholders of publicly traded corporations -- they pay a single tax at the capital gains rate. But gains from the sale of a closely-held C corporation are taxed twice, first at the corporate rate and again at the capital gains rate. Even with the lower corporate tax rate, that combination still means a total effective tax of over 40 percent.

Let's take these points one at a time:

1. Corporate-Only is Anti-Tax Reform

   - Under today's rules, shareholders of an S corporation that makes $100 dollars would pay $45 to the federal government, regardless of whether the business distributes any earnings. (This amount is the total of the 39.6 percent federal tax, plus the new 3.8 percent investment tax, plus the reinstatement of the Pease limitation on deductions.)
   - A C Corp, on the other hand, would pay $35 only, but then face a choice -- either retain the income at the firm and avoid the second layer of tax or pay out a dividend and pay another $24 in taxes (the 20 percent dividend tax plus the 3.8 percent investment tax), for a total tax hit of $50.

   You'll notice that the C Corp has a very strong incentive to keep its post-tax income within the firm and not pay that second layer of tax. Tax Attorney Tom Nichols hit this point in his testimony before Ways and Means last year:

   > *When I first started practicing law in 1979, the top individual income tax rate was 70 percent, whereas the top income tax rate for corporations taxed at the entity level ("C corporations") was only 46 percent. This rate differential obviously*

> *provided a tremendous incentive for successful business owners to have as much of their income as possible taxed, at least initially, at the C corporation tax rates, rather than at the individual tax rates, which were more than 50 percent higher.*
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> *This tax dynamic set up a cat and mouse game between Congress, the Department of the Treasury and the Internal Revenue Service (the "Service") on the one hand and taxpayers and their advisors on the other, whereby C corporation shareholders sought to pull money out of their corporations in transactions that would subject them to the more favorable capital gains rates that were prevalent during this period or to accumulate wealth inside the corporations. Congress reacted by enacting numerous provisions that were intended to force C corporation shareholders to pay the full double tax, efforts that were only partially successful.*

Efforts to lower the corporate rate while raising rates on pass-through businesses and investors would increase the incentive to shelter income and should be deemed "anti-tax reform". They will return us to the world Tom describes above, effectively reversing the broad changes made by Congress in 1986 and creating a tremendous incentive for taxpayers to organize their income to take advantage of the lower corporate rates and then shelter that same income from the higher rates.

2. Either Way, It's a Tax Hike

Advocates for "they can just convert" need to check their math, because the only thing they are offering successful pass through businesses is a tax hike, whether they convert to C status or not.

Consider the scenario embraced by the Administration, where the top marginal rate for all pass through businesses is 45 percent while the corporate top rate drops to 28 percent, even as the tax on shareholders rises to 28 percent.

- Under this approach, the combined tax on C Corps would be 48 percent! Talk about an incentive to move operations and headquarters overseas.
- For those C Corps who stay here, they face an increased incentive to hoard earnings within the company. A C Corp that retains earnings would pay just 28 percent. One that distributes them would pay 48 percent. The economic distortion caused by this rate imbalance is going to be large and harmful.
- Meanwhile, successful pass through businesses face a tax hike either way. Those that remain a pass through face a top tax rate of 45 percent plus the higher rate on capital gains when they sell the business (see below), while those that convert could access the lower corporate rate, but only if they stop paying dividends and never sell the business. Again, the economic harm from these perverse incentives will be significant

The winners from this approach would be C corps that don't pay dividends, have large numbers of tax exempt shareholders, and/or are publicly traded and have liquid markets for their stock. The losers will be pass through businesses, closely held C Corps, and those C Corps, public or private, that have to pay dividends.

3. Double Tax Applies to Business Sales

The "they can just convert" argument also ignores the penalty closely-held C Corps face when they are sold. The 1986 Tax Reform Act applied the double layer of tax onto sales of closely-held C corporations, which means a C corporation sold this year is subject to a combined federal tax rate of over 50 percent versus just 24 percent for the sale of an S corporation. Under the Obama approach of lower corporate rates but higher capital gains rates, the combined tax would be 48 percent.

This double tax makes switching to C Corp status a non-starter for entrepreneurs who might sell their business someday. Many business sales are tied to the retirement of the owner, where the proceeds are used to fund their retirement, so rates that high are a threat to their retirement security.

It's different for publicly held C corporations. Individual stockholders can sell at any time, often at higher multiples, and business to business acquisitions can be done with stock, often on a tax-free basis, once again giving public C corporations a tax advantage over private ones.

So arguing that pass through businesses can just "convert" simply is not credible. Some businesses might be in a position to switch to C status, but there are higher taxes waiting on the other side. Given that pass through businesses employ more than half the private sector workforce, how does any of this make sense? More broadly, how does forcing more companies into the inefficient and investment-stifling double tax model make America's companies more competitive, or America a more attractive place to invest? Sounds like a plan to do the exact opposite.