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Family Businesses Deserve a Tax Break

'S corporations' are major job creators but get a bumrap.

By Brian Reardon
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The U.S. is unique in its prevalence of small and family-owned businesses. S corporations and other pass-throughs employ the majority of workers and are the foundation of thousands of local economies, ensuring that the benefits of economic growth aren't concentrated in a few financial centers.

The tax-reform debate has largely ignored this reality. Instead, it has been mired in claims that family businesses do not pay enough taxes. In reality, the combination of higher marginal rates, the individual alternative minimum tax, and the inability to shift income to lower-taxed countries results in S corporations, not C corporations, paying the highest effective tax rate. There is good reason to support cutting rates for C corporations, but there is an even better argument to apply those rate cuts to pass-through businesses.

What about the tax on dividends and capital gains—the so-called corporate double tax? Only a small percentage of C corporations today pay any dividends, and most of that money goes to shareholders with limited or no tax liability, such as pensions, mutual funds, nonprofits and foreign investors. The Congressional Budget Office estimates that shareholder taxes add just 2 percentage points to the corporate effective tax rate.

Pass-through businesses are more than law firms and hedge funds, too. There are 4.3 million active S corporations, and they are in every industry and every corner of the country. S corporations easily outnumber C corporations in manufacturing, construction, wholesale trade, agriculture, mining, transportation and food services.

Large pass-through businesses are a major source of employment. A 2011 Ernst & Young report estimates that pass-through businesses with at least 100 workers account for nearly 1 in 6 private- sector jobs. The income from these businesses, even when reinvested in the company, helps to push their owners into the top tax brackets.

Cutting the C corporation rate while leaving pass-through rates high would put these employers in a no-win situation: They could remain as they are and pay higher taxes. Or they could convert to C corporation status and pay higher taxes. Unlike most C corporations, these businesses would be subject to the entire double tax.

Either option is unsustainable. A business that operates with effective tax rates in the mid-30s cannot long survive competing against companies paying effective rates in the low 20s or high teens.

The third alternative would be to sell the family business. That might be good for private-equity investors eager to snap them up, but it would be bad for local communities. The choice whether to keep production domestic or move it offshore is more meaningful when the person making the decision lives in the same community as the workers whose jobs are at stake.

The good news for these communities is that the tax reform framework targets family businesses for lower rates similar to the rate cuts for C corporations. For tax reform to help all employers, these lower rates need to stay in the plan.

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