fei financial executives international

COMMITTEE ON PRIVATE COMPANY POLICY

Tax Reform Recommendations
April, 2017

FEI is made up of over 10,000 Chief Financial Officers, Vice Presidents of Finance, Corporate Treasurers, Controllers and other senior financial executives from 74 chapters across the United States. Nearly 60% of our members work for private companies, and the Committee on Private Company Policy (CPC-P) focuses on these members' policy concerns. The following summarizes the CPC-P recommendations with respect to current efforts in Congress to reform the U.S. Tax Code.

Tax Reform

- **Strong Support for Tax Reform and Simplification Among Financial Executives:** Our belief is that Congress should reform and simplify the current income tax regime to enable U.S. companies to grow, create jobs and increase investment. We believe that marginal rates on business income should be lower than the current rates to promote U.S. business' competitive position globally and that taxes on business income should be consistently applied regardless of the form of business. There is strong support among FEI members – both C-corporations and private companies – for comprehensive tax reform. A recent survey of our membership found that 87% of FEI members support tax reform and simplification of the tax code. Sixty-one percent of FEI members believe it is important that Congress level the playing field for corporate tax-payers and pass-through entities to help foster business investment and job creation. Fifty-two percent of our members have indicated that reduced tax rates and simplification will enable them to increase capital investment and grow their payrolls.

- **Private Companies in the U.S. Economy**: Pass-through entities play a critical role in the U.S. economy, serving as a key source of jobs, wages and tax revenue in the United States. Over 90% of U.S. businesses are pass-throughs, providing approximately 57 percent of all private sector jobs in 2014.[1] The latest research available shows that in 2011, pass-through businesses accounted for 64% of total net business income and paid more than $1.6 trillion in wages and salaries.[2] In 2012, pass-through entities contributed nearly $840 billion in business AGI to individual returns.[3]If tax reform is to have a meaningful impact on business investment, productivity growth and job creation, privately held businesses must be included in any tax reform legislation.

- **Unfairness of Current System**: While pass-throughs play a critical role in fueling U.S. economic activity, current tax rates place them at competitive disadvantage that could be deepened if "corporate- C-corporation that earns $1 million would pay nearly $350,000 in taxes at current rates. If that same business were organized as a partnership, it could pay as much as $444,000 in taxes, a difference of 27%. If corporate tax rates were lowered to 28%, that difference would grow to 59%. The House Republican Blueprint proposes a reduction in the corporate tax rate to 20% and establishment of a pass-through income tax rate of 25%. The Trump Administration has proposed taxing all business income, including pass-through income, at 15%. Adoption of a more equitable rate for pass-throughs would not only put pass-through entities on a more level playing field, it would have a significant impact on

[1] Scott Greenberg, "Pass-Through Businesses: Data and Policy", Tax Foundation, January, 2017
[2] Kyle Pomerlau, "An Overview of Pass-Through Business in the United States", Tax Foundation, January 2015
[3] Joseph Rosenberg, "Flow-Through Business Income as a Share of AGI", *Tax Facts*, Urban Institute, September, 29, 2014

economic growth. The Tax Foundation has calculated that creation of a 25% tax rate on pass-through business income would increase U.S. GDP by 1.1%, translating into 257,000 full-time equivalent jobs.

- **Tax Rate Equivalency**: To level the playing field, restore fairness to the tax code, and better position pass-throughs to create jobs and increase investment, any comprehensive tax reform bill should include provisions that permit the bifurcation of business and other income on an individual's tax return, and the application of a business rate equivalent to the highest corporate rate.
    - Congress should create an elective business equivalency rate (BER) on qualified active trade or business income that would ensure that all active business income, whether earned in a pass-through or in a corporation (C-Corp), is taxed at a rate no higher than the maximum corporate rate. BER would be implemented in a two step process:
        1. The pass-through entity would report qualified trade or business income on Schedule K-1;
        2. Taxpayers would report qualified business income on a new schedule similar to Schedule D (for capital gains) that automatically determines tax using the BER.
    - In order to retain equivalency between pass-through and C-Corp rates, qualified business income would not be used when calculating AMT.

- **Compensation of Active Pass-through Entity Owners:** The burden of proof for characterizing the "employment" income of a pass-through entity owners should reside with the pass-through entity. A safe-harbor would be helpful to eliminate the uncertainty from a taxpayer perspective and minimize the review effort by the IRS.

- **Territorial Tax System Access/Deemed Repatriation**: Private companies are significant exporters. 8 of the top 25 US exporters are private companies. [4] Increasingly, large and medium-sized pass-throughs are expanding their businesses by exporting and establishing offshore operations as business requirements and opportunities dictate. Broadly, tax reform legislation should create a territorial system that puts all U.S. businesses on an even footing with their US and foreign competition, removing disincentives for capital mobility and earnings repatriation from overseas, aligning U.S. tax policy with other developed countries, eliminating complexity in organization structure driven by the current foreign tax credit regime, and providing consistent tax treatment for all US businesses.
- only" tax reform is enacted. Since 2013, pass-throughs have been subjected to a higher marginal tax rate on business income than C-corporations. Currently, the top tax rate on individuals is 39.6% while the top corporate tax rate is 35%. The disparity puts privately-held and family-owned businesses which operate as pass-throughs at a huge competitive disadvantage, limiting their ability to create jobs and invest in their businesses. For example, a
    - Current territorial tax proposals are limited to C-Corps. Congress should grant pass-throughs access to any new territorial tax regime.
    - Pass-throughs have very complex international structures because they don't qualify for the Section 902 indirect credits even though they have exposure to Subpart F income. Some have CFCs for offshore deferral, but most use a combination of check the box and hybrid entities to manage tax exposure. A territorial system could reduce the need for this complexity.
    - Under a territorial system, pass-throughs could establish specified accumulated adjustment accounts (AAA) for offshore earnings and the entity could make distributions comprised of proportionate shares of foreign and domestic earnings as reported on Schedule K-1.

[4] Marsha Salisbury, Research Editor, "Mergers and acquisitions reshape top US exporter ranking", The Journal of Commerce, June 9, 2016

    - Transition to a territorial system by providing a toll charge applicable to prior period accumulated untaxed foreign earnings that would be payable over a period of years and differentiates between cash and non-cash assets.
    - Absent consistent treatment of US corporations and pass-through entities, the tax rate paid by pass-through entities on foreign source earnings would be almost 50% higher than C corporations, putting US pass-through entities at a competitive disadvantage with their US corporate and foreign competitors when operating in foreign jurisdictions.

- **S-Corp gains recognition period:** Make permanent the reduced recognition period for built-in gains for S corporations.

<u>Other Tax Issues</u>

- **Estate Tax:** FEI believes that repeal of the estate tax is the best solution to protect all family-owned businesses from the serious transition challenges posed by existing estate taxes.
    - The estate tax is one of the largest drains on resources for privately-held and family-owned businesses in the United States. The death of a shareholder in a closely held business creates a liquidity and tax event for the entity. To preserve the continuity of the business, companies often deploy techniques that pull capital out of the business while the principals are living to prepay the death tax liability. This inhibits companies from hiring workers and expanding their businesses. It adds significant costs for lawyers, accountants, life insurance contracts and management's time, in addition to funding the tax itself. Banks, one of the principal funding sources for private companies, are reluctant to lend companies money for the purpose of satisfying the shareholder's death tax resulting in forced sales or liquidations.
    - It is difficult to know the value of a privately-held business for estate tax purposes, (which is often audited and "negotiated"); this makes planning for the tax amount highly problematic. In many cases, the owners are faced with the difficult decision of selling their business while alive or risking them going out of business after their deaths.
    - Consequently, if repeal is not forthcoming, in order to alleviate these pressures, FEI supports facilitating the election to pay now or defer on a carry-over basis into the next generation.

<u>For Additional Information please contact:</u>

Brian Cove
Managing Director, Technical Activities
Financial Executives International (FEI)
973.765.1092
bcove@financialexecutives.org