Testimony before the

Committee on Ways and Means

Subcommittee on Select Revenue Measures

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Chairman Tiberi, Ranking Member Neal, and distinguished members on the Committee, thank you for the opportunity to testify today regarding the taxation of flow-through businesses[2] and tax reform.

Flow-through businesses play an important role in the U.S. economy. The vast majority of businesses in the United States have chosen to organize as flow-through businesses. Today, flow-through businesses comprise more than 90 percent of all business entities, employ more than 50 percent of the work force and report more than one-third of all business receipts. Forty percent of business net income is reported by individual owners of flow-through businesses. These taxpayers pay 43 percent of business taxes when filing their individual tax returns.

With the increasing prominence of flow-through businesses, it is important to carefully consider how the flow-through form fits into the U.S. tax system and how any particular tax reform might affect flow-through businesses. President Obama recently called for tax reform that emphasizes the need to eliminate "special interest loopholes and to lower the corporate tax rate to restore competitiveness and encourage job creation."[3] While there is substantial evidence that the U.S. statutory corporate income tax rate is out-of-step internationally, elimination of business tax expenditures to finance a lower corporate rate can raise substantial issues for flow-through businesses. Flow-through businesses could potentially lose the benefit of widely used business tax provisions without the benefit of the lower corporate tax rate.

The Internal Revenue Code (the "Code") provides businesses with considerable flexibility in how they organize and structure their business operations. Depending on their ownership and capital needs, businesses can choose between several different organizational forms. The flow-through form helps mitigate the economically harmful effects of the double tax on corporate profits, in which the higher cost of capital from double-taxation discourages investment and thus economic growth and job creation. Moreover, double taxation of the return to saving and investment

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[2] "Flow-through" businesses refer to pass-through entities (S corporations, partnerships, and limited liability companies) and sole proprietorships whose income and expense is reported by the owners along with income received from other sources.
[3] President Obama's State of the Union address, January 25, 2011.

embodied in the income tax system leads to a bias in firms' financing decisions between the use of debt and equity and distorts the allocation of capital within the economy. As tax reform progresses, it is important to understand and consider all of these issues with an eye towards bringing about the tax reform that is most conducive to increased growth and job creation.

I have had the opportunity to consider the impact of taxation on flow-through businesses from a number of perspectives, inside and outside of government, in the context of broad reform of the Code and more particularly reform of the business tax system. More recently I have been analyzing the flow-through sector in the course of prepare a report on behalf of the S Corporation Association. Today I will share my perspectives and provide some preliminary results from the study on the flow-through sector we are preparing for release in the near future.

Current tax treatment of flow-through businesses and the double tax on corporate profits

Flow-through businesses – S corporations, partnerships, limited liability companies, and sole proprietorships – are subject to a single level of tax on the income earned. The income and expenses of flow-through businesses are reported by an entity's owners – hence the name "flow-through" or "pass-through" entities." An individual owner's flow-through income is combined with income they may receive from other sources and subject to individual income taxes. Losses, rather than accumulating within the business entity level, are also passed through to the owner where, subject to various limitations, they may, subject to various limitations, be used to offset income from other sources. Thus, it is the tax rates faced by individual owners of flow-through businesses that affect decision-making and the economic health of these businesses.

In contrast, the income of C corporations is subject to two levels of tax, first when income is earned at the corporate level, and again when the income is paid out to shareholders in the form of dividends or retained and later realized by shareholders as capital gains. These two levels of tax are often referred to as the double tax on corporate profits.

The differential taxation of business income earned by C corporations and flow-through businesses is an important consideration in a firm's choice of organizational form. The double tax is also economically important and can distort a number of business decisions.[4] One important such distortion arises because the double-tax mainly affects business income generated by activities financed through equity capital within the C corporation form. Interest expenses are generally deductible by businesses, leading to a tax bias in favor of financing with debt rather than equity. The double tax thus raises the cost of equity financed investment by C corporations relative to debt financed investment and provides an incentive for leverage and borrowing rather than for equity-financed investment. Accordingly, the double tax contributes to the tax bias for higher leverage. Greater leverage can make corporations more susceptible to financial distress during times of economic weakness.

The double tax also increases the cost of investment in the corporate sector relative to the rest of the economy. This tax bias against investment in the corporate sector leads to a misallocation

[4] For a discussion of these issues see Robert Carroll, "The Economic Effects of the Lower Tax Rate on Dividends," Tax Foundation Special Report No. 181, June 2010.

of capital within the economy whereby too little capital is allocated to the corporate sector because of the double tax. This in turn reduces the productive capacity of the capital stock and dampens economic growth. As noted before, the diversity of organizational forms can be seen as a useful choice for businesses to make in organizing themselves, but the impact of differential treatment should be recognized. Finally, the double tax raises the overall cost of capital in the economy, which reduces capital formation and, ultimately, living standards.

Overall, the flow-through form provides an important benefit to the economy by reducing the economically harmful effects of the double tax.

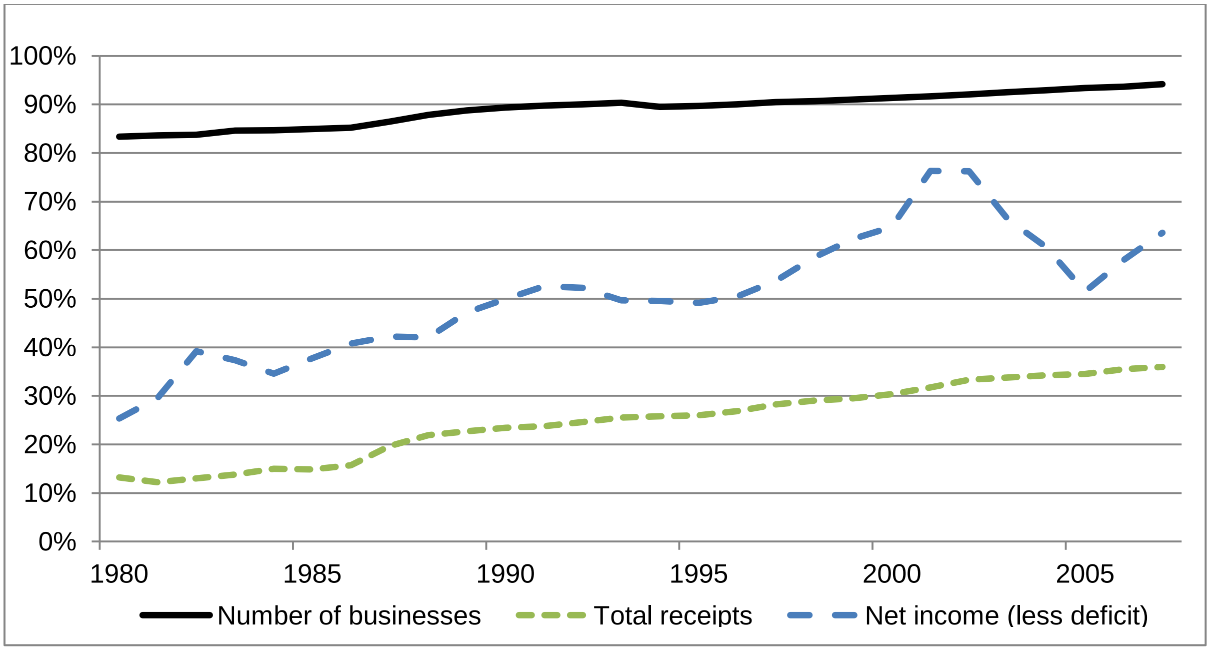
The growth and economic footprint of the flow-through sector

Flow though businesses have grown rapidly over the past several decades. Two changes contributed to this growth.[5] First, the individual tax rate was lowered relative to the corporate tax rate under the Tax Reform Act of 1986. The change in the relationship of the individual and corporate tax rates had the effect of making the flow-through form more attractive for many businesses. Second, actions by the Internal Revenue Service ("IRS") made limited liability companies (LLCs) offer flow-through treatment along with limited liability for their owners a more attractive organizational form in the late 1980s and 1990s than had previously been the case.[6] First, the IRS determined in 1988 that firms organized as LLCs would be taxed as flow-through businesses.[7] Next, the IRS simplified the classification of businesses as LLCs beginning in 1997 by allowing them to simply "check the box" on Form 1065-B to make an election to be treated as a corporation or partnership (or sole proprietorship) for tax purposes.[8]

The economic footprint of flow-through businesses has grown steadily by several different measures. The percentage of businesses choosing the flow-through form rose from 83 percent in 1980 to 94 percent in 2007.[9] The share of net income and total receipts generated by flow-through businesses has nearly tripled since the early 1980s with the flow-through share of net income growing from 25 percent in 1980 to 64 percent by 2007 and total receipts rising from 13 percent in 1980 to 36 percent by 2007 (see Chart 1).

[5] Limited partnerships, which offer limited liability to the limited partners, along with flow-through treatment, were available.
[6] S corporations, limited partnerships and limited liability companies (LLCs) all offer limited liability for their owners.
[7] In 1988 the IRS issued a revenue ruling indicating that it would treat LLCs established under Wyoming state law as partnerships for tax purposes. Other states subsequently enacted similar LLCs statutes.
[8] In 1995, there were 118,559 LLCs in the United States. By 2008 the number had grown to 1,898,178. Internal Revenue Service, *Partnership Returns, 2008*, Statistics of Income Bulletin, Fall 2010.
[9] Internal Revenue Service, Statistics of Income, computations from various historical data.

Chart 1. Flow-through shares of all business returns, receipts, and net income, 1980-2007

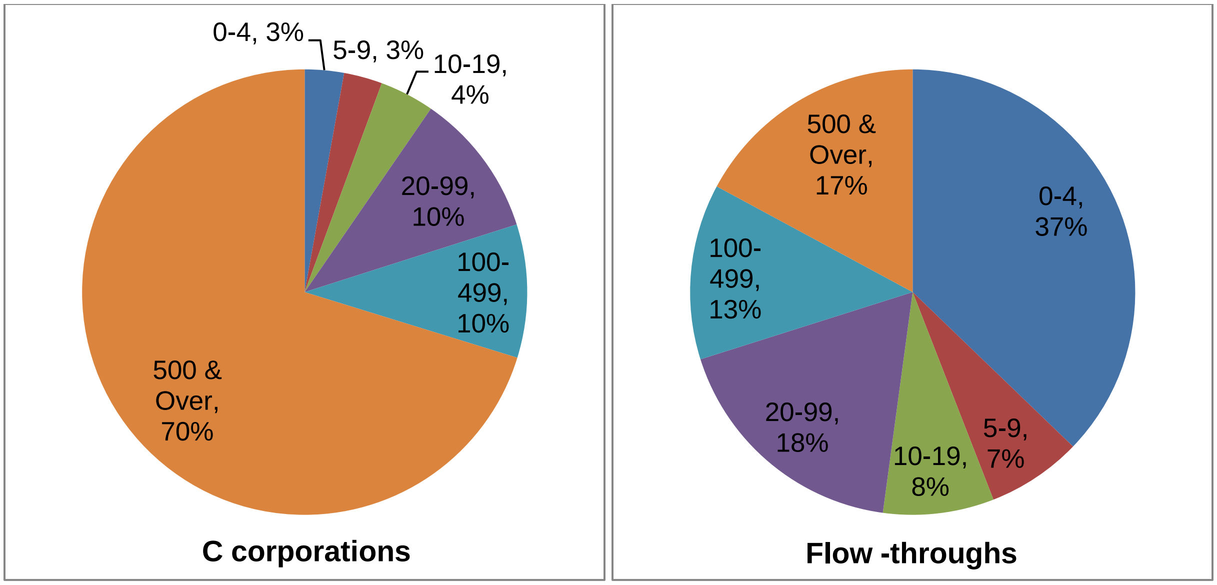


Note: These data include some flow-through entities, primarily partnerships, which are owned by C corporations. Data focusing on individual owners of flow-through businesses are presented below in Chart 4.
Source: Internal Revenue Service, Statistics of Income, Integrated Business Data.

The flow-through sector comprises a large fraction of business activity not only based on number of firms, and income/receipts, but also based on the number of workers it employs. In 2008, the flow-through sector employed 54.3 percent of the private sector work force, with C corporations employing the remaining 45.7 percent.[10] As shown in Chart 2, and as one might expect, private sector employment within the flow-through sector is highly concentrated among small firms. About 37 percent of workers within the flow-through sector were with firms with four or fewer employees. About 52 percent of workers in the flow-through sector held jobs in firms with fewer than 20 employees. In contrast, among C corporations 70 percent of workers held jobs in firms with more than 500 employees and 90 percent of workers held jobs in firms with more than 20 employees.

[10] This calculation excludes the non-profit and government sectors. U.S. Bureau of the Census, Center for Economic Studies, 2008.

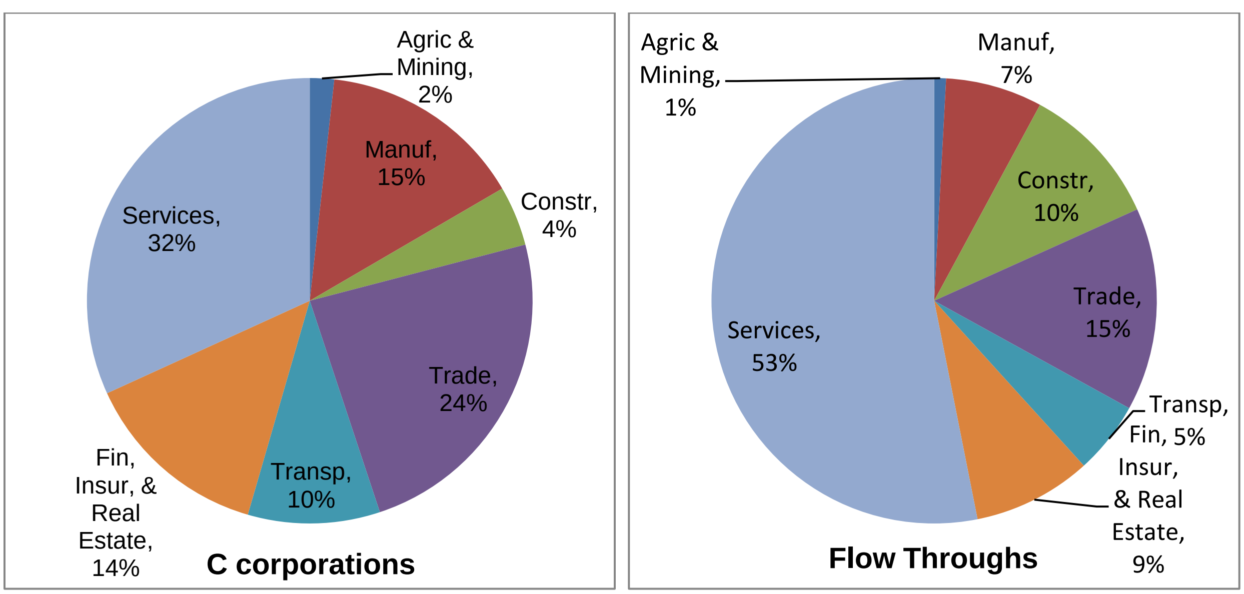
Chart 2. Employment by size of firm, C corporation and flow-through sectors, 2008



Source: U.S. Bureau of the Census, Center for Economic Studies.

There are also considerable differences in the employment within various industies for these two sectors, with significantly greater respresentation of flow-through employment in the services and construction industries (see Chart 3). In contrast, C corporation employment is more dominant in the manufacturing, wholesale and retail trade, and transportation industies. This likely reflects the scale of enterprises in these industries, with construction and services firms tending on average to be smaller than in those other industries.

Chart 3. Employment by industry, C corporation and flow-through sectors, 2008

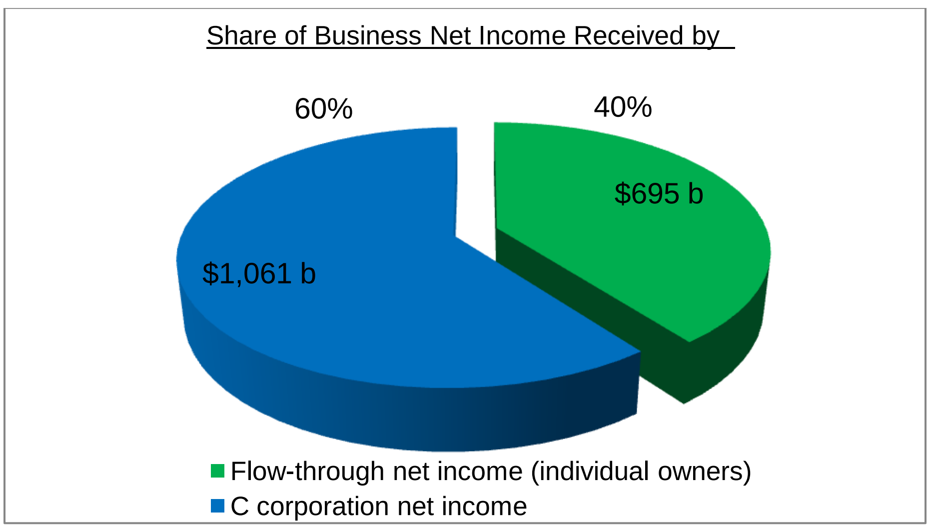


Source: U.S. Bureau of the Census, Center for Economic Studies.

While the foregoing data provides a picture of the growth and economic footprint of flow-through business entities, the owners of some flow-through businesses (primarily some partnerships[11]) are corporations, not individuals. This distinction is important because it is the individual owners of flow-through businesses who are taxed under the individual income tax. About one-half of partnership income flows through to corporate owners. This income is often associated with various types of joint ventures between corporations. The other half of partnership income flows through to individual owners.[12] This distinction explain the difference in the net income of flow-through business entities (64 percent shown in Chart 1) and individual owners (40 percent shown in Chart 4)

In 2007, $695 billion in flow-through income was reported on the roughly 30 million individual tax returns of individual flow-through owners who paid $176 billion in individual income taxes on this income (see Chart 4).[13] In comparison, C corporations reported $1,061 billion in net income and paid $229 billion in corporate income taxes in 2007.[14] That is, 40 percent of business net income and 43 percent of business taxes were paid by individual owners of flow-through businesses in 2007.[15]

Chart 4. Individual owners of flow-through entities receive 40% of business net income



Source: Internal Revenue Service, Statistics of Income, 2007 Corporate Source Book and Individual Tax Returns (publication 1304), 2007.

[11] Sole proprietorships are, by definition, owned by individuals and the ownership of S corporations is generally restricted to individual shareholders.
[12] Tim Wheeler and Nina Shumofsky, *Partnership Returns, 2008,* Statistics of Income Bulletin, Fall 2010.
[13] The $176 billion in individual income taxes paid on the $695 billion in flow-through income reported on individual income tax returns was estimated using the Ernst & Young LLP Individual Tax Micro-simulation Model. Tax was first calculated under current law and then compared to the tax the owners of flow-through entities would pay if they were assumed to have no flow-through income.
[14] Internal Revenue Services, Statistics of Income, 2007 Corporate Source Book, 2010.
[15] This calculation only accounts for the taxes paid on business net income. Taxes on dividends and capital gains are not included.

Moreover, research has found that individual income tax rates affect various economic decisions of flow-through businesses. For example, tax rates have been found to affect the entry and exit from flow-through form as individuals decide whether to open up their own business or work for another firm.[16] Tax rates have also been found to deter these businesses from hiring worker and investing and affect the rate at which flow-through businesses grow.[17] The effect of the individual tax rates on these types of economic decisions is one reason the tax treatment of flow-through businesses have figured prominently in recent discussions of changes to these tax rates.

How does the flow-through sector in the United States compare to other countries?

The flow-through sector in the United States differs markedly from many other developed nations. In the United States, non-publicly traded businesses can organize themselves in ways that allow them to receive limited liability protection and avoid the double tax on corporate profits. This provides highly flexible ownership structures and legal forms that help meet the specific organizational and capital requirements of businesses. Of 17 countries responding to a question from the OECD, 7 reported having no form of business organization that provides limited liability without an obligation for the corporate income tax. The business forms available in other countries appear to push businesses towards the corporate form in pursuit of limited liability, whereas in the United States, such limited liability is attainable through various organizational forms outside of the corporate sector.

This has resulted in a non-corporate sector in the United States that is larger than in most other developed nations. Of the countries responding to a 2007 OECD survey, as shown in Chart 5, only in Mexico was the unincorporated sector larger share of the total number of businesses (88 percent) than in the United States (82 percent).[18] Another difference between the United States and other nations was that businesses with taxable profits greater than $1 million have greater representation in the flow-through sector in the United States than in the other countries responding to the OECD survey.[19] From an economic policy perspective, this self-help integration is beneficial in that it helps reduce the harmful effects of the double tax.

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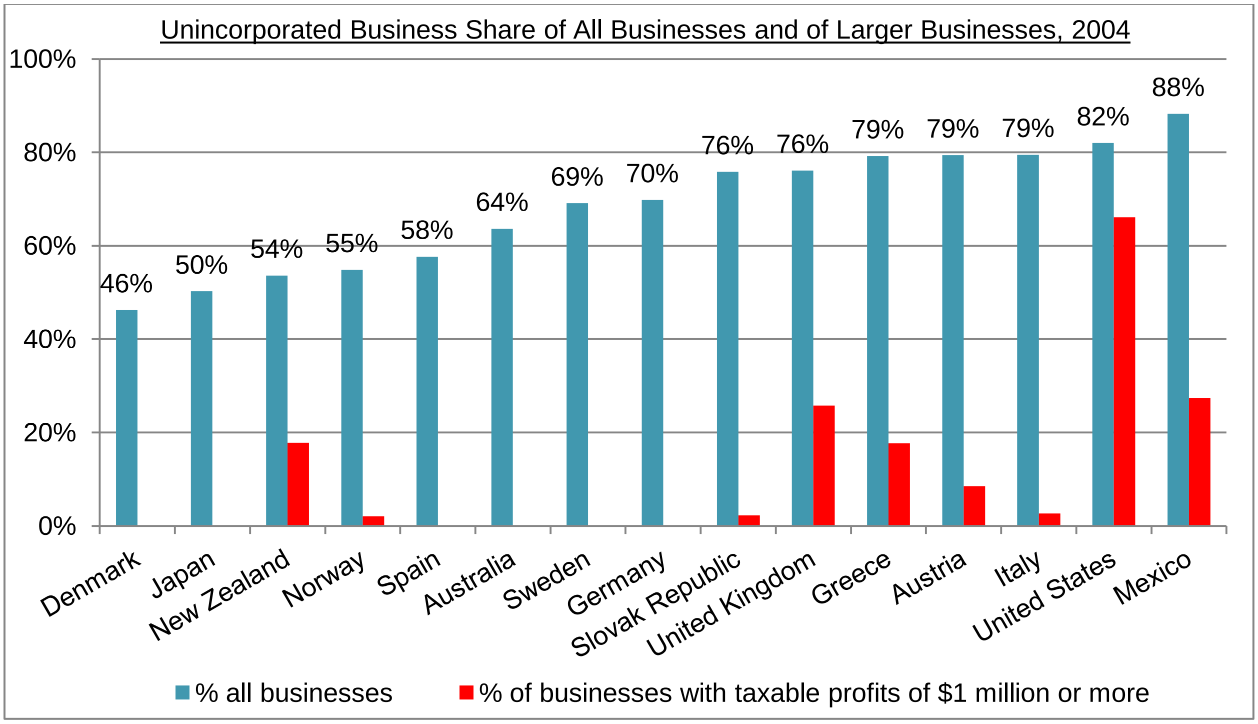
[16] Donald Bruce and Tami Gurley-Calvez, “Federal Tax Policy and Small Business,” In Overcoming Barriers to Entrepreneurship, Rowan and Littlefield Publishers, forthcoming; William M. Gentry and R. Glenn Hubbard, “‘Success Taxes, Entrepreneurial Entry, and Innovation,” Working Paper No. 10551, National Bureau of Economic Research, June 2004.

[17] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, “Income Taxes and Entrepreneurs’ Use of Labor,” *Journal of Labor Economics,* April 2000, 18(2), pp. 324-351; Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, “Personal Income Taxes and the Growth of Small Firms,” *Tax Policy and the Economy*, NBER, Vol. 15, 2001, pp. 121-147; and Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, “Entrepreneurs, Income Taxes, and Investment,” In *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, Joel Slemrod, ed., Russell Sage Foundation and Harvard University Press, NY, 2002, pp. 427-455.

[18] Although they are flow-through businesses, S corporations were included by the OECD with other corporations because they are incorporated. Thus, the size of the flow-through sector in the United States is understated in Chart 5 below.

[19] Organisation for Economic Co-operation and Development, Center for Tax Policy and Administration, "Survey on the Taxation of Small and Medium-Sized Enterprises: Draft Report on Responses to the Questionnaire," revised 25 July 2007; Table 1.

Chart 5. The United States has among the largest unincorporated business sectors within the OECD



Source: OECD, Center for Tax Policy and Administration, "Survey on the Taxation of Small and Medium-Sized Enterprises: Draft Report on Responses to the Questionnaire," revised September 2007; Tables 1-3.

Tax reform can have significant consequences for flow-through businesses

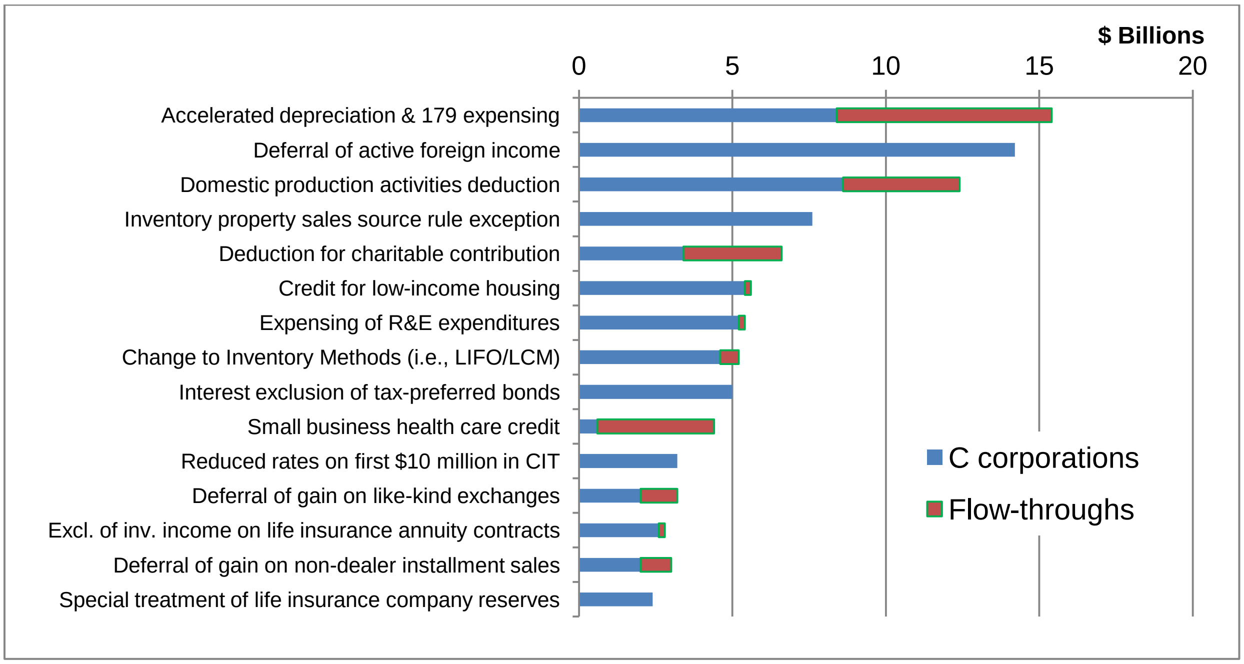
Some have suggested that tax reform focus first on reform of the corporate income tax before focusing on reform of the individual income tax. With the flow-through sector representing more than half of all business activity, as measured by employment, and paying 43 percent of total business taxes, it is difficult to see how significant reform of the corporate income tax system can be achieved without also addressing the taxation of the flow-through sector.

One approach to tax reform that has been suggested, for example, is lowering the corporate tax rate and paying for this change by eliminating or limiting business tax expenditures, such as accelerated depreciation and expensing, deferral of foreign source income, the production activities deduction, and other (Chart 6 provides a list of major business tax expenditures). Many of these expenditures are long-standing provisions that are available to and widely used by both C corporations and flow-through businesses. Curtailing business tax expenditures would thus raise the taxes paid by the flow-through businesses, even though these businesses would receive no tax benefit from the lower corporate tax rate.

As shown in Chart 6, flow-through businesses make extensive use of a number of broadly available business tax expenditures such as accelerated depreciation, the deduction for production activities, and the deduction for charitable giving. In total, flow-through businesses used 22 percent of the roughly $100 billion annual average business tax expenditures between

2011 and 2015. Repeal of any of these provisions would entail substantial tax increases for flow-through businesses. On the other hand, a corporate tax reform that lowered the corporate tax rate paid for by eliminating or limiting business tax expenditures only for C corporations would also add substantial complexity to the Code and create additional differences in the tax treatment of C corporations and flow-through businesses. Differences in tax treatment have caused shifting between the C corporation and flow-through business forms in the past,[20] but in this case the shift would be the result of the various tax expenditures being available only to businesses in the flow-through sector.

Chart 6. Largest business tax expenditures in US, Annual 2011-2015 average*



* Includes only permanent, positive tax expenditures. The value of the tax expenditure for tax-exempt bonds includes only the benefit to the corporate investors, not the benefit of lower interest rates to the issuers.
Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014* (JCS-3-10), December 15, 2010, and Ernst & Young LLP calculations.

Conclusion

Recent focus on the need to lower the corporate income tax rate has also drawn attention to how flow-through businesses might be affected by tax reform. Corporate tax reform is an important component of an overall approach to improving the current tax system. As with any such endeavor, however, policy makers should keep in mind the potential for undesirable side effects. Corporate reform that eliminates business tax expenditures would have the unintended impact of raising the cost of capital for businesses organized using the flow through form. Such

[20] See, for example, Robert Carroll and David Joulfaian, “Do Taxes Affect Corporate Financial Decisions? -- The Choice of Organizational Form,” U.S. Treasury Department, Office of Tax Analysis, Working Paper 73, October 1997; and Austan Goolsbee, “Taxes, Organizational Form, and the Deadweight Loss of the Corporate Income Tax,” *Journal of Public Economics*, 69(1), 1998, pp. 143-152.

firms are a large part of the U.S. business sector and important contributors to the economic vitality of the United States.

This sector has grown rapidly over the past several decades to the point where flow-through businesses now employ 54 percent of all private sector workers and pay more than 40 percent of all business taxes. The expansion of the flow-through sector provides the important benefit of reducing the scope of the double tax on corporate profits, as well is providing additional flexibility in the ownership structure of businesses that may provide a better match to their management needs and capital requirements.

The path towards tax reform will need to take into account many features of our tax system and strike a balance between a number of sometimes conflicting and competing objectives. This Committee should be commended for holding this hearing to better understand the role that the flow-through sector plays in the U.S. economy.

Thank you and I would be pleased to address any questions you may have.