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Tax Reform Proposal Not Favorable To S Corporations

Law360, New York (March 18, 2014, 9:50 PM ET) -- On Feb. 26, 2014, House Ways and Means Chairman Dave Camp, R-Mich., released a 979-page "Tax Reform Act of 2014" discussion draft (Camp proposal). The Camp proposal contains sweeping, sometimes surprising, and controversial changes to both individual and business taxation.

In general, the Camp proposal makes substantial cuts to individual and corporate income tax rates while also eliminating or limiting many individual and business deductions and/or credits. Because of the elimination or limitation of many popular tax deductions, such as the limitation on home mortgage interest and the elimination of the deduction for state and local taxes, the Camp proposal is likely to generate significant debate.

This article will briefly summarize select business and individual tax reform proposals contained in the Camp proposal, but will specifically exclude proposed tax reforms in the international tax, exempt organization, financial institution and retirement plan areas. The last comprehensive change to the tax code was made by the Tax Reform Act of 1986.

Individual Tax Proposals

Tax Rates

The linchpin of the Camp proposal is the reduction of both individual and corporate tax rates. Although Camp has stated that there are only two tax brackets for individuals under his proposal, plus an additional 10 percent "surtax," the 10 percent surtax will likely be viewed by most people as a third tax bracket. The tax rate changes, as well as most of the other changes contained in the Camp proposal, would become effective Jan. 1, 2015.

A 10 percent tax bracket would apply on adjusted gross income (AGI) up to $71,199, and the 25 percent tax bracket would apply to AGI from $71,200 up to $450,000 for married taxpayers filing jointly and up to $400,000 for other taxpayers.

The new 35 percent tax bracket, or 10 percent "surtax" as Camp prefers to refer to it, applies to a different tax base referred to as "modified adjusted gross income" (MAGI), which is broader than AGI. The 35 percent tax rate, which also works in conjunction with the phase-out of the 10 percent tax bracket, applies to married taxpayers having MAGI of more than $450,000 and to other taxpayers having MAGI of more than $400,000.

MAGI contains items that are not otherwise included in AGI for those taxpayers in the 10 percent or 25 percent tax brackets (i.e., includes items that are otherwise nontaxable). MAGI specifically includes all income otherwise taxable at the 10 percent and 25 percent tax rates plus tax-exempt interest, employer-sponsored health insurance payments, self-employed health insurance deductions, pretax contributions to defined contribution retirement plans, medical savings account deductions, income excluded as foreign earned income, income excluded as apportioned to U.S. territories, and excluded Social Security or Railroad Tier One benefits.

The inclusion in MAGI of tax-exempt interest and state and local municipal bond interest, as well as the inclusion of pretax contributions under Section 401(k) plans, is highly controversial.

Qualified domestic manufacturing income, which is similar to qualified production activity income under current Section 199, is excluded in computing MAGI. Consequently, qualifying manufacturing income of individuals, including individuals who are partners in pass-through entities such as S corporations or limited liability companies, would be taxed at the same 25 percent rate as corporations.

The 10 percent rate is phased out for taxpayers having MAGI over $300,000 for married taxpayers filing jointly and over $250,000 for all other taxpayers, so that taxpayers who have MAGI greater than $450,000 (for married taxpayers filing jointly) or greater than $400,000 (for all other taxpayers) will be subject to a tax of 25 percent on their AGI up to those threshold amounts, and then subject to a 35 percent tax rate on MAGI in excess of such amounts.

When compared to the current maximum marginal rate of 39.5 percent, the maximum marginal individual tax rate of 35 percent, which applies to a broader base of income than the current 39.5 percent, combined with the effect of the elimination of the deductions and credits discussed below, will result in many taxpayers paying higher effective tax rates under the Camp proposal than they do under current tax law.

Capital Gains and Dividends

Under current law, capital gains and dividends are subject to a maximum marginal tax rate of 20 percent. Under the Camp proposal, 40 percent of capital gains and dividends generally will be excluded from a taxpayer's income, with the remaining 60 percent subject to taxation at the ordinary income tax rates of 10 percent, 25 percent and 35 percent.

Elimination or Limitation of Deductions and Credits

The Camp proposal eliminates or limits a plethora of deductions and credits currently available to individual taxpayers. On the positive side, the standard deduction under the Camp proposal would rise from $6,100 to $11,000 for individuals and from $12,200 to $22,000 for married taxpayers filing jointly. However, the basic standard deduction is phased out for taxpayers with MAGI over $513,600 (for married taxpayers filing jointly) and over $356,800 (for all other taxpayers). Additionally, under the Camp proposal, deductions for personal exemptions are eliminated altogether.

Some of the more popular deductions and credits that will be affected by the Camp proposal include:

1. Reduction of the $1 million loan cap on the deduction of mortgage interest for all mortgages entered into after Dec. 31, 2014, phased in over a four-year period so that the mortgage interest deduction would be limited to loans of no more than $500,000 beginning in 2018. Additionally, the deduction for interest associated with home equity indebtedness would be eliminated. The elimination and limitation

of these deductions are likely to draw great ire from residential home builders.

2. Under the Camp Proposal, the charitable deduction is available for individuals only to the extent total contributions exceed 2 percent of the individual's contribution base. However, the Camp proposal reduces the current 50 percent and 30 percent limitations applicable to individuals under present law to 40 percent and 25 percent, respectively, and eliminates the lower percentage limits for contributions to certain private foundations.

3. The elimination of the deduction for state and local income taxes and property taxes.

4. The elimination of the deduction for personal casualty losses.

5. The elimination of the deduction for tax preparation expenses.

6. The elimination of the itemized deduction for medical expenses.

7. The elimination of the deduction for alimony payments by the payor (and corresponding inclusion in gross income by the recipient of the alimony payments).

8. The elimination of the deduction for moving expenses.

9. The elimination of the deduction, and exclusion from income, for contributions to medical savings accounts.

10. The elimination of the deduction for interest on student loans.

11. The elimination of the exclusion of income from U.S. Savings Bonds used to pay higher education tuition and fees.

12. The elimination of the exclusion of income from discharge of student loan indebtedness.

13. The elimination of the deduction for unreimbursed employee expenses.

14. The elimination of the exclusion for employer-provided education assistance, which presently is limited to $5,250 per year and applies to both graduate and undergraduate courses.

15. The elimination of the dependent care credit.

16. The elimination of the adoption credit.

17. The elimination of the nonbusiness energy property credit.

18. The elimination of the residential energy efficiency credit.

19. The elimination of the alternative fuels vehicle credit.

20. The elimination of the health insurance credit.

21. The elimination of the first-time home buyer credit.

Changes to Contribution Limit on Pretax Contributions to Section 401(k) Plans

Although the Camp proposal makes a number of changes in the retirement plan area (which is beyond the scope of this article), one of the more significant changes made in this area is the reduction by one-half of the existing limits on employee pretax contributions to Section 401(k) plans, with the remaining one-half eligible to be contributed on an after-tax basis to a Roth account.

In 2014, the limit on elective deferrals is $17,500, with an additional $5,500 available to employees age 50 and older as a “catch-up” contribution for a total of $23,000. Under the Camp proposal, any contributions in excess of one-half of the existing limits ($8,750 and $11,500, respectively) would be to a Roth account and would not be deductible pretax.

The combination of including pretax contributions to 401(k) plans in MAGI subject to the 35 percent tax bracket and reducing the contribution limits available to employees on a pretax basis to Section 401(k) plans would seem to have a very negative impact on the ability of individuals to save for retirement, and is likely to be hotly debated.

Alternative Minimum Tax

One of the changes made by the Camp proposal that surely will receive almost uniform support is the repeal of the complicated alternative minimum tax imposed on individuals.

Corporate Tax, Pass-Through Entity and Other Business Tax Reforms

Corporate Tax Rates

The Camp proposal eliminates the current tax brackets ranging from 15 percent to 35 percent for C corporations in favor of a single 25 percent rate. Additionally, the special provision applicable to personal service corporations that currently requires such corporations to be taxed at a flat rate equal to the maximum corporate rate of 35 percent would be repealed. The 35 percent top corporate tax rate would be reduced over a period of five years from 35 percent to 25 percent.

Although there will be more discussion below of the changes made by the Camp proposal to the taxation of pass-through entities such as S corporations and limited liability companies, it should be noted that the great majority of America’s small businesses are conducted through pass-through entities such as S corporations, partnerships, LLCs or through sole proprietorships.

While reduction of tax rates for C corporations in order to make them more competitive internationally has been heralded by Camp (and many others), C corporations are generally limited to large publicly held corporations, including multinational corporations. Consequently, under the Camp proposal, while these large publicly-held and multinational corporations will enjoy a flat tax rate of 25 percent, the majority of America’s small businesses, which conduct their businesses through S corporations, partnerships, LLCs and sole proprietorships, will be subject to the three bracket system to which individuals are subject, and as such, will be subject to a top marginal tax rate of 35 percent.

Combined with the elimination of many business deductions and credits by the Camp proposal, which will be discussed below, this could have a crippling effect on America’s small businesses and have a substantial adverse effect on the economy. In this regard, the Camp proposal’s focus on making large publicly traded corporations and other multinational corporations more competitive internationally because they are currently subject to a 35 percent maximum marginal tax rate seems misplaced because the effective tax rate paid by many of these large corporations under the current system is many times far less than 35 percent.

Giving this break to large publicly held corporations and multinational corporations, while still retaining a 35 percent maximum marginal tax rate for pass-through entities and sole proprietorships, which constitute the majority of America's small businesses (and employ the majority of America's workers), seems not only unwise from an economic standpoint but patently inequitable.

Elimination or Minimizing of Business Tax Deductions and Credits

Some of the more popular deductions and credits available to businesses that will be affected by the Camp proposal include the following:

1. A taxpayer may currently claim a deduction under Section 199 for certain qualified production activities performed in whole or in significant part in the United States, subject to certain limitations. The Camp proposal repeals Section 199 for tax years beginning after Dec. 31, 2016, and reduces the applicable percentage for 2015 and 2016. However, as discussed above, for individuals who are partners and shareholders of pass-through entities, a new exclusion similar to Section 199 is provided for the purpose of determining individual taxable income.

2. The Camp proposal repeals the ability of businesses to currently expense research and experimental expenditures, including software development costs under Section 174, and requires such expenditures to be capitalized and amortized ratably over a five-year period.

3. On the other hand, the Camp proposal modifies and makes permanent the research credit available under Section 41 for tax years beginning after 2013, and for amounts paid or incurred after 2013.

4. Another limitation on deductions not likely to be well received contained in the Camp proposal is the provision that only allows 50 percent of certain advertising expenses to be currently deductible, while the remaining 50 percent of such expenses would be amortized ratably over a 10-year period.

5. Another major change in the Camp proposal is the repeal of the Modified Accelerated Cost Recovery System and replacing it with a slower depreciation system for property placed in service after 2015. Additionally, the Camp proposal would repeal the special depreciation rules, such as bonus depreciation and the special allowance for qualified disaster assistance property.

The Camp proposal does allow taxpayers to elect to take an additional depreciation deduction to take the effect of inflation into account on depreciable personal property. Overall, the new depreciation system under the Camp proposal would slow down the recovery of costs for companies that invest in equipment and make other capital expenditures. This change would therefore have an adverse effect on businesses that are capital intensive.

6. The Camp proposal also repeals the last-in first-out inventory method of accounting, which is popular with a number of industries (such as car dealerships). Under the Camp proposal, any taxpayer required to change from LIFO to another inventory accounting method will be required to take any net positive Section 481(a) adjustments into account over four tax years, beginning with the taxpayer's first tax year beginning after Dec. 31, 2018.

7. Under current law, intangible assets may be amortized over a period of 15 years. Under the Camp proposal, the amortization period is extended from 15 years to 20 years for property acquired after Dec. 31, 2014.

Like-Kind Exchange Rules

In a very controversial move, the Camp proposal repeals the like-kind exchange rules for transfers occurring after Dec. 31, 2014. Under current law Section 1031, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a “like kind” that is held for productive use in a trade or business or for investment.

The underlying reasoning for not recognizing gain in the case of a like-kind exchange is that the taxpayer has not cashed out of his investment but has merely continued his investment in like-kind property, and as such, it is not appropriate to impose tax at such time.

A like-kind exchange merely defers recognition of gain because the taxpayer’s basis in the newly acquired property in a like-kind exchange generally is equal to the taxpayer’s adjusted basis in the exchanged property. The repeal of Section 1031 is one of the more surprising provisions contained in the Camp proposal, and the author believes it would have a substantial adverse effect on a broad range of taxpayers, including C corporations, pass-through entities and individuals.

Use of Cash Method of Accounting

Under current law, S corporations, partnerships (without C corporation partners), and qualified personal service corporations are allowed to use the cash method of accounting as opposed to the more complicated accrual method of accounting. Under the Camp proposal, although businesses with average annual gross receipts of $10 million or less could continue to use the cash method of accounting, businesses, including pass-through entities, with more than $10 million of gross receipts would be required to use the accrual method of accounting.

The author believes that this provision also would have a substantial adverse effect on pass-through entities such as partnerships and S corporations which, as discussed above, constitute the majority of the businesses operated in the United States.

Expensing of Some Assets for Small Businesses

On a positive note, the Camp proposal would make permanent Section 179 expensing for the cost of investments in property, equipment and computer software, rather than depreciating such costs over the recovery period of such property. The Camp proposal uses the 2008-2009 levels so that taxpayers could expense up to $250,000 of investments in new equipment and property per year, with the deduction phased out for investments in excess of $800,000.

Repeal of Corporate Alternative Minimum Tax

As with the individual alternative minimum tax, the Camp proposal repeals the corporate alternative minimum tax.

Tax Reform to Pass-Through Entities

With respect to the taxation of pass-through entities, most practitioners and taxpayers will be happy to find that the unified pass-through regime proposed in the discussion draft last year is not adopted in the final Camp proposal, but that the Camp proposal retains Subchapters S and K, subject to certain changes.

Tax Reform Provisions Affecting Partnerships

Although Camp's original discussion on tax reform, issued last year, did not address so-called "carried interest," the new Camp proposal does include a provision to treat as ordinary income a portion of the earnings stemming from an applicable partnership interest held in connection with the performance of services.

The provision applies to service providers of a partnership that are engaged in a trade or business of (1) raising or returning capital; (2) identifying, investing in, or disposing of other trades or businesses; and (3) developing such trades or businesses. Significantly, specifically excluded from the carried interest rules are partnerships engaged in a real property trade or business. Other changes to the taxation of partnerships include the following:

1. The rules related to guaranteed payments are repealed.

2. The Camp proposal requires mandatory adjustments of a partnership's basis in partnership property upon a transfer of a partner's interest or when the partnership distributes property to a partner.

3. Any distribution of inventory is treated as a sale or exchange (without the requirement of the inventory being "substantially appreciated"), and unrealized receivables includes any property other than inventory (to the extent of the amount that would be treated as ordinary income if the property were sold for its fair market value).

4. The seven-year time period on so-called "anti-mixing bowl" transactions relating to a partner who contributes property with precontribution built-in gain or loss to a partnership is eliminated so that such partner must recognize gain or loss when the partnership distributes the property, or the partner receives other property in exchange for the contributed property, regardless of when that event occurs.

5. On a positive note, the technical termination rule providing that a partnership terminates if more than 50 percent of the interests of the partnership are sold or exchanged is repealed.

6. The 1982 Tax Equity and Fiscal Responsibility Act Audit Rules would be repealed and replaced by a streamlined method that would audit large partnerships much like C corporations are currently audited.

7. Finally, in somewhat of a surprising move, the Camp proposal severely cuts back on the ability of publicly traded partnerships (also referred to as master limited partnerships) to be taxed as partnerships (rather than as C corporations). In general, the rule allowing publicly traded partnerships to be taxed as partnerships rather than as C corporations is now restricted to mining and natural resource partnerships. All other publicly traded partnerships will generally be taxed as C corporations.

S Corporation Tax Reforms

Although there are several positive changes made to the S corporation provisions (which will be discussed below), the Camp proposal includes a shocking change that imposes the self-employment tax (SECA) on S corporation shareholders who materially participate in their businesses within the meaning of Section 469.

The Camp proposal generally subjects 70 percent of the combined compensation and the distributive share of an S corporation's (or partnership's) combined and distributive share of the entity's income as net earnings from self-employment subject to FICA or SECA, as applicable.

Under present law, S corporations are required to pay "reasonable compensation" to their shareholder-employees, which is subject to FICA, but neither the income that passes through to the shareholders or dividend distributions made by an S corporation to its shareholders is subject to FICA or SECA (or the new 3.8 percent tax imposed on net investment income provided that the S corporation shareholder materially participates in the trade or business conducted by the S corporation).

Consequently, under current law, the profits of an S corporation that are distributed to its shareholders as dividends are not subject to FICA or SECA taxes provided that the S corporation is paying reasonable compensation to its shareholder-employees for the services they are actually rendering to the S corporation.

While there certainly is a reasonable argument that different rules in the self-employment tax area should not apply to limited partners versus LLC members versus S corporation shareholders (despite the fact that there any many other provisions of the code that benefit partnerships and LLCs that don't benefit S corporations and thus are not applied uniformly among pass-through entities as a whole), the imposition of the self-employment tax on 70 percent of the total amount of compensation and distributive share of an entity's income is completely arbitrary and not at all consistent with the purpose of FICA and SECA, which is to impose a tax on income derived from personal services actually rendered by an individual.

Well-developed law as to what constitutes "reasonable compensation" has provided the IRS with a successful tool for attacking abusive situations and recharacterizing S corporation distributions as wages subject to FICA in appropriate circumstances. Consequently, if any rule is to be applied uniformly to all pass-through entities, it should be the rule currently in effect for S corporations providing that only reasonable compensation paid for services rendered by the owners for services they actually render to the entity should be subject to SECA or FICA.

The author believes that Camp's proposal would have a crippling effect on many small businesses that utilize pass-through entities (which overwhelmingly outnumber C corporations), and gives no credit whatsoever to the large capital investments many of these pass-through entities, such as those in the manufacturing sector, have made in their businesses.

Camp's proposal on this issue is completely arbitrary and totally inequitable to pass-through entities, especially S corporations, which have been formed with increasing frequency by taxpayers to conduct their businesses in reliance upon the rules currently in effect regarding application of SECA and FICA to S corporations and their shareholders.

The Camp proposal does, however, make the following favorable changes to the S corporation provisions:

1. The Camp proposal reduces the 10-year recognition period for the imposition of built-in gain tax

imposed under Section 1374 to five years, effective for tax years beginning after 2013.

2. The Camp proposal also makes permanent a provision that limits basis adjustments to a shareholder's basis in the S corporation for contributions of appreciated property by the S corporation to the basis of the property contributed to the charity. This provision generally operates to allow S corporation shareholders to take a charitable deduction for the fair market value of the property contributed to the charity.

3. Additionally, the Camp proposal permits nonresident alien individuals to be potential current beneficiaries of an electing small business trust.

4. The Camp proposal also increases the excess passive investment income threshold under Section 1375 from 25 percent of gross receipts to 60 percent of gross receipts before the tax on excess passive investment income (the so-called "sting tax") is imposed on an S corporation.

5. Additionally, the Camp proposal repeals altogether the provision under Section 1362(d)(3) that causes a corporation's S election to terminate as a result of having excess passive investment income combined with Subchapter C earnings and profits for three consecutive tax years.

6. The Camp proposal also conforms the rules for an electing small business trust to deduct charitable contributions to those applicable to individuals.

7. Finally, the Camp proposal simplifies S corporation elections and qualified Subchapter S subsidiary (QSub) elections so that such elections may be made by the due date of the corporation's return (including extensions), for the year in which the election is desired, as opposed to two months and 15 days following the desired effective date of such election.

Conclusion

While the Camp proposal does contain a number of provisions favorable to taxpayers, and appears to simplify the tax code by eliminating a multitude of individual and business deductions/credits currently available to individuals and businesses, it would appear that the overall impact of the Camp proposal would favor large publicly traded C corporations, but would likely have a very detrimental effect on individuals and pass-through entities, which operate a majority of America's small businesses.

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