IV. Tax Reform: Treatment of Businesses Who File as Individuals (Pass-Throughs) under Corporate Tax Reform

BACKGROUND

Most small businesses are sole proprietorships, subchapter "S" corporations, limited liability companies or partnerships. For the overwhelming majority of small businesses, individual marginal tax rates are much more important than corporate marginal tax rates. According to the **2014 National Small Business Association (NSBA)** tax survey, 83% of these businesses pay taxes on their business at the personal income level; they are "pass-through" entities that are subject to individual tax rates, not the corporate tax rates.

PROBLEM

There are risks to pass-through entities under corporate tax reform. They include:

- **Pass-throughs can't pay at a higher rate than large corporations:** It would be unfair to reduce corporate tax rates without also reducing the individual tax rates that apply to small firms. If the business tax base is broadened and corporate tax rates substantially lowered while individual tax rates are reduced only slightly or not at all, the result will be a large tax increase on small businesses that are pass-throughs.
    - **If pass-throughs are taxed at a higher rate than large corporations, it will have a negative impact on job creation.** Pass-throughs will lack the incentive to expand and grow their business, thus hurting job creation in the country. According to U.S. Small Business Office of Advocacy, the vast majority of new job creation nationally is done by small businesses, whether its existing operations or new ventures. Since the start of the recovery, small businesses have generated 4.2 million or 63% of the net 6.7 million private sector jobs.

- **Corporate tax rate reduction may be funded by provisions that benefit pass-throughs without those businesses receiving a compensating tax cut.** If provisions, such as "accelerated" capital cost recovery allowances and Last In First Out inventory accounting are repealed then corporate tax reform could end up substantially increasing the tax burden on pass-throughs while increasing the cost of capital to small firms.

SOLUTION

Reform of the tax code is necessary, not just for corporate entities. Tax reform must be all-inclusive and must be carried out in such a way that it does not hurt small businesses. It can't take away flexibility or increase the effective tax rate by eliminating most of the deductions and credits used by small business while not reducing the tax rates sufficiently enough to make up for the loss of the deductions or credits.

SMC supports keeping the tax rate for pass-through entities equal to or below the corporate tax rate. There must be parity for small businesses. Tax reform should do as much to help a small family business create jobs and compete as it does for a large company.

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Please consider SMC Business Councils as a resource when you need facts, figures, information, and testimony from small employers. Visit www.smc.org to view SMC Business Councils 2014 Federal Position Papers.