Examining S-Corporation Losses: How are they used and what changed under TCJA?

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Tax Treatment of Losses

If treatment were symmetric

- Losses would result in immediate tax refund

Actual treatment (pre-2017 tax act)

- Loss does not result in immediate refund
- For any portion of business loss treated as a net operating loss (NOL)
  - Immediately carry back to offset prior payments
  - Carry forward to reduce future tax liability

Tax Treatment of Losses

C Corporations, pre-2017 tax act

- Negative taxable income → NOL
- Immediately carry back up to 2 years
  - ~15% of losses carried back (Cooper and Knittel (2006))
- Carry forward up to 20 years
  - Reduces real value of losses (Cooper and Knittel (2010))
- Asymmetric treatment affects investment
  - Auerbach and Poterba (1987), Altshuler and Auerbach (1990), and others

Tax Treatment of Losses

S Corporations, pre-2017 tax act

- Business losses allocated to shareholders
  - Losses can first be used to offset income from other sources
  - Losses not offset by other current-year income treated as NOLs, use to offset past or future income
  - Losses can be used by owner even if business shuts down
- More flexibility
  - Important for young businesses? cyclical industries?
  - How large is the benefit?

Changes to the Tax Treatment of Losses in the 2017 tax act

Changes to Treatment of NOLs

- Carrybacks eliminated
- No expiration of carryforwards
- Deduction for NOLs limited to 80 percent of taxable income

Additional Change for Pass Throughs

- Ability to use losses to offset current-year non-business income limited ($250K/$500K)

Goals

We provide descriptive information based on the losses of S corporations including

- Trends in losses over time
- Comparison to C corporations
- Characteristics of S corporations with losses

Trace losses to individual returns to begin to examine how losses are used at the individual level

- Compare to hypothetical scenario where losses could only be used at the entity level

Data Sources

Entity-Level Descriptive Statistics

- Ten-Year SOI Corporate Sample: 2005 – 2014
- Representative of population of corporations

S Corporation Use of Losses at Individual Owner Level

- 2005 SOI S corporation sample matched to administrative data on individual owners
  - Match based on IRS Form K-1
  - Examine IRS Form 1040 over time

S Corporation Use of Losses at Entity Level

- Start with 2005 SOI Sample limited to S corporations
- Match to administrative data for Form 1120-S to follow these firms over time

Where are S-Corp Losses?

Entity source: Ordinary Business Income (loss)

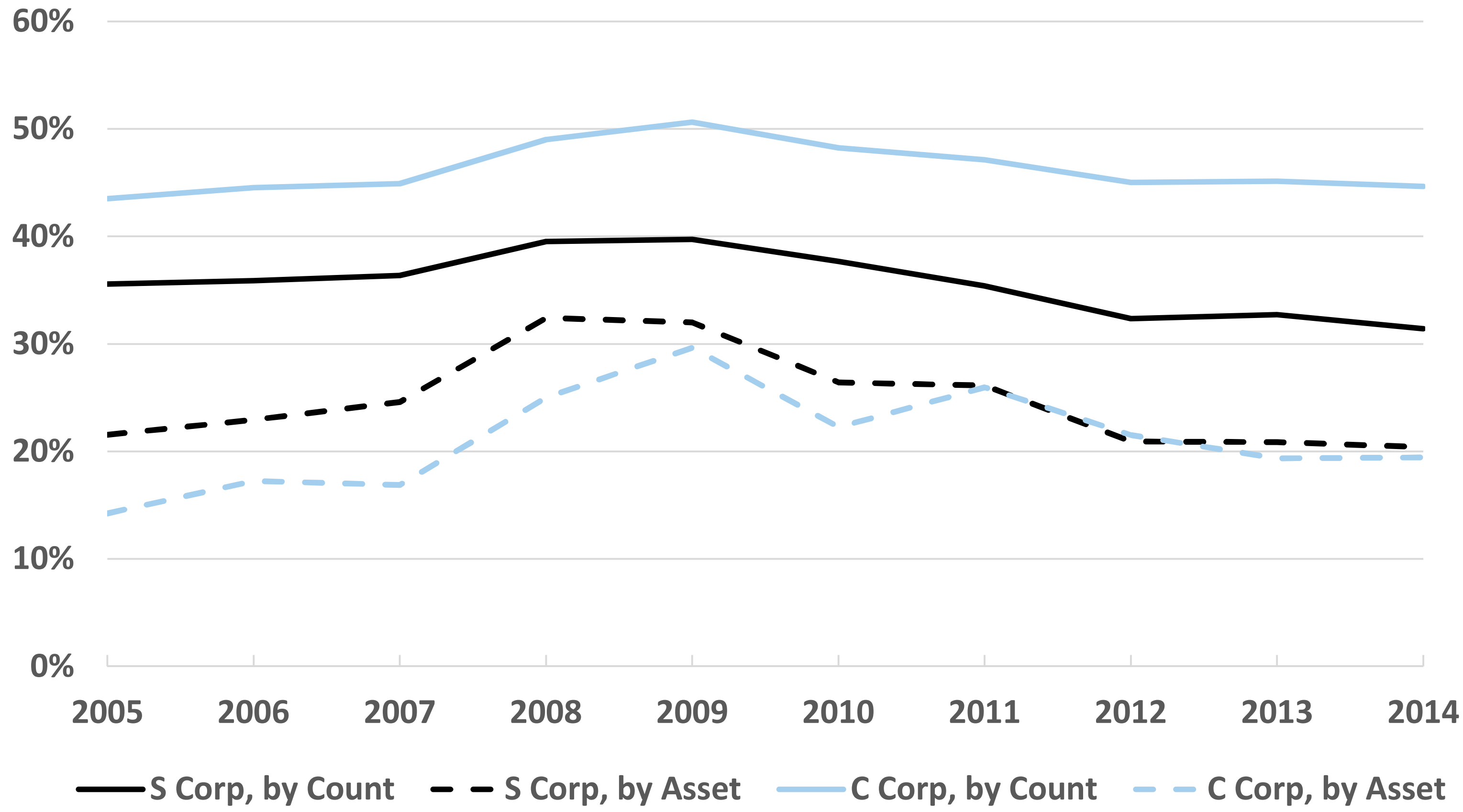
- 1120-S Line 21
- For comparisons with C corporations we combine Line 21 with Schedule K to mimic loss calculation for C corporations
  - Schedule K includes interest income/expenses, royalties income, dividend income, etc.

Shareholder level:

- Owner share of loss reported on Schedule K-1
- Owner share transferred to 1040 Schedule E
- Ability to use loss at individual level might be limited by basis limitations, at-risk limitations, and passive activity limitations

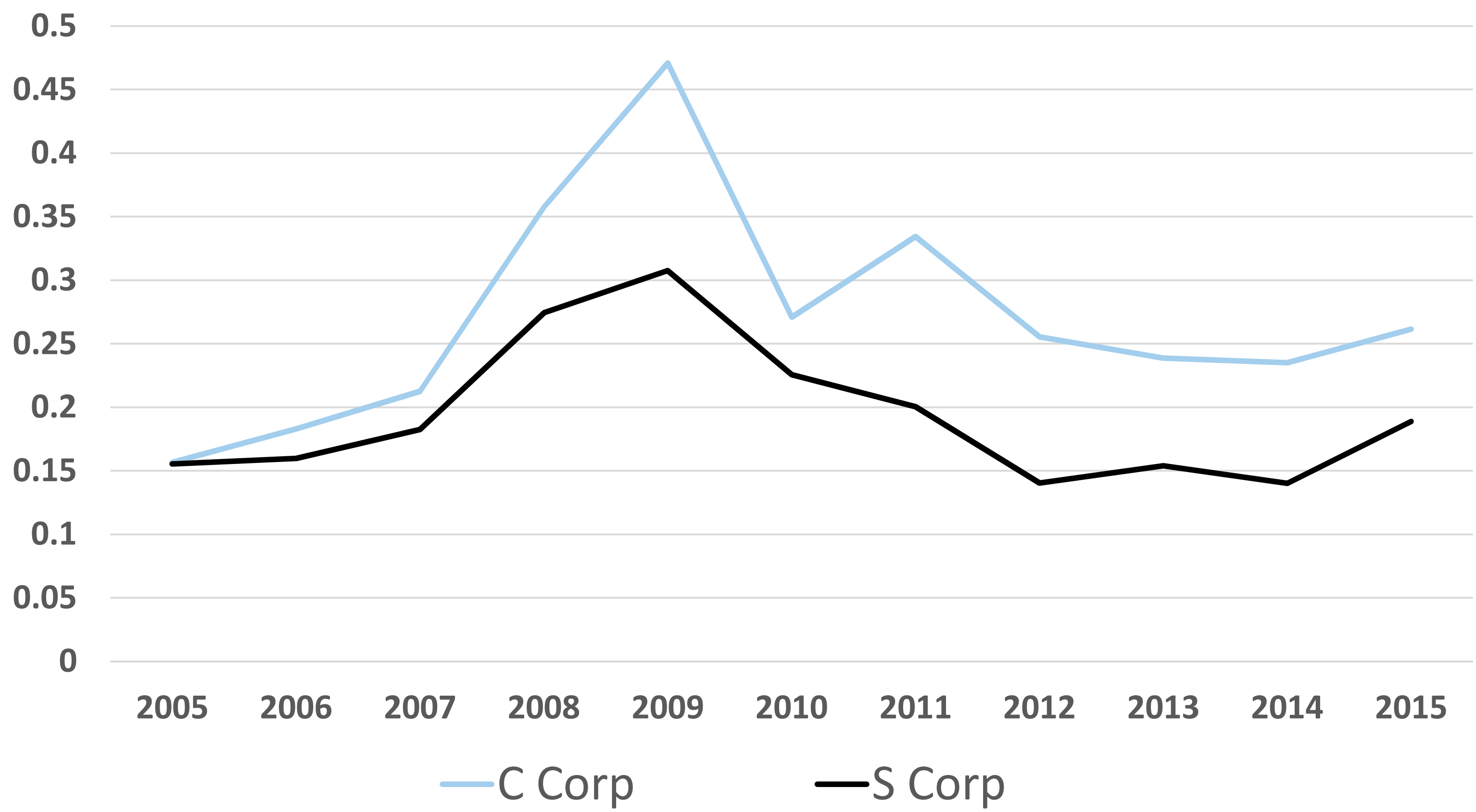
Evolution of Losses

S Corps vs C Corps, Share of businesses in loss

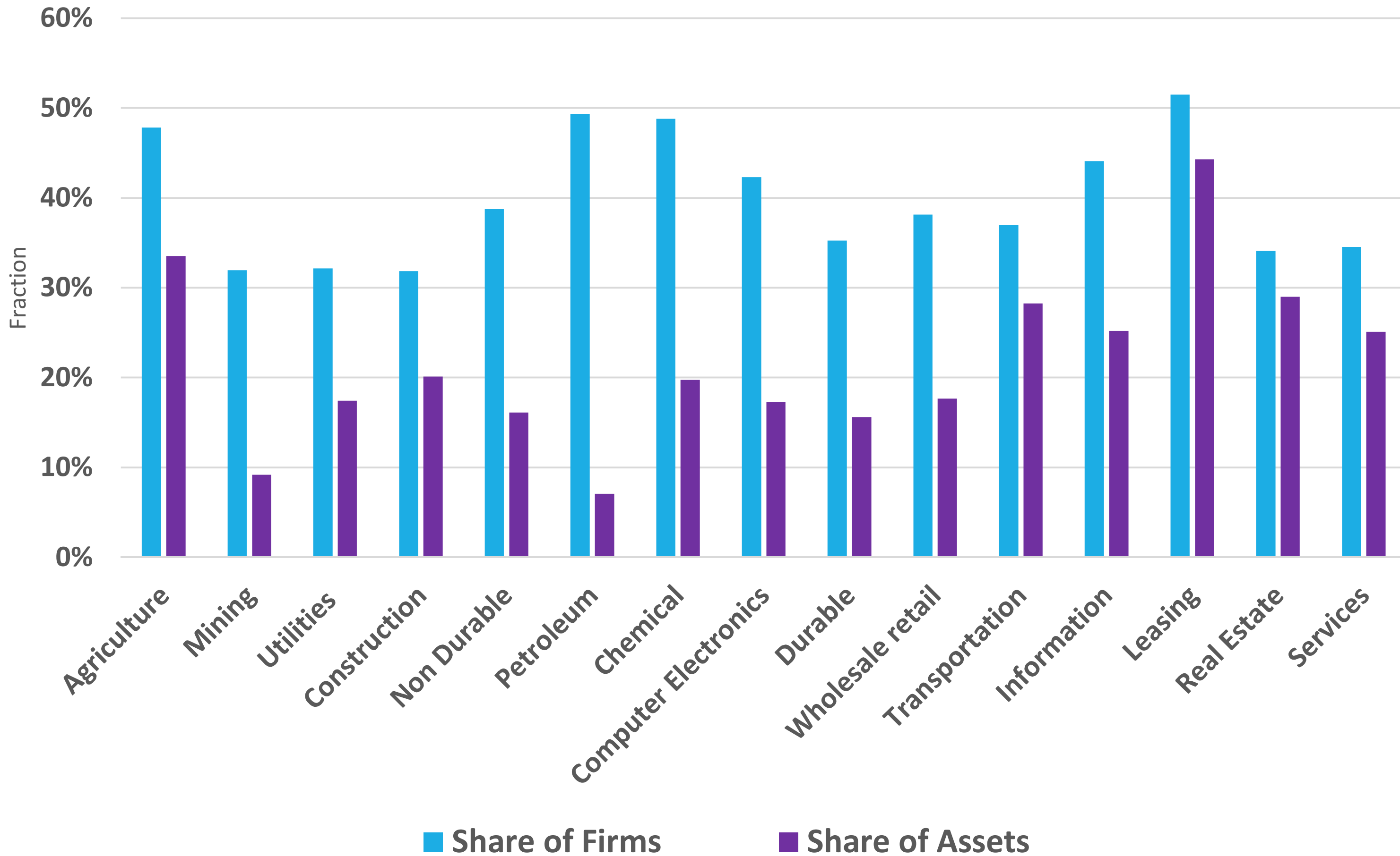


Evolution of Loss-to-Income Ratio

S vs C Corp

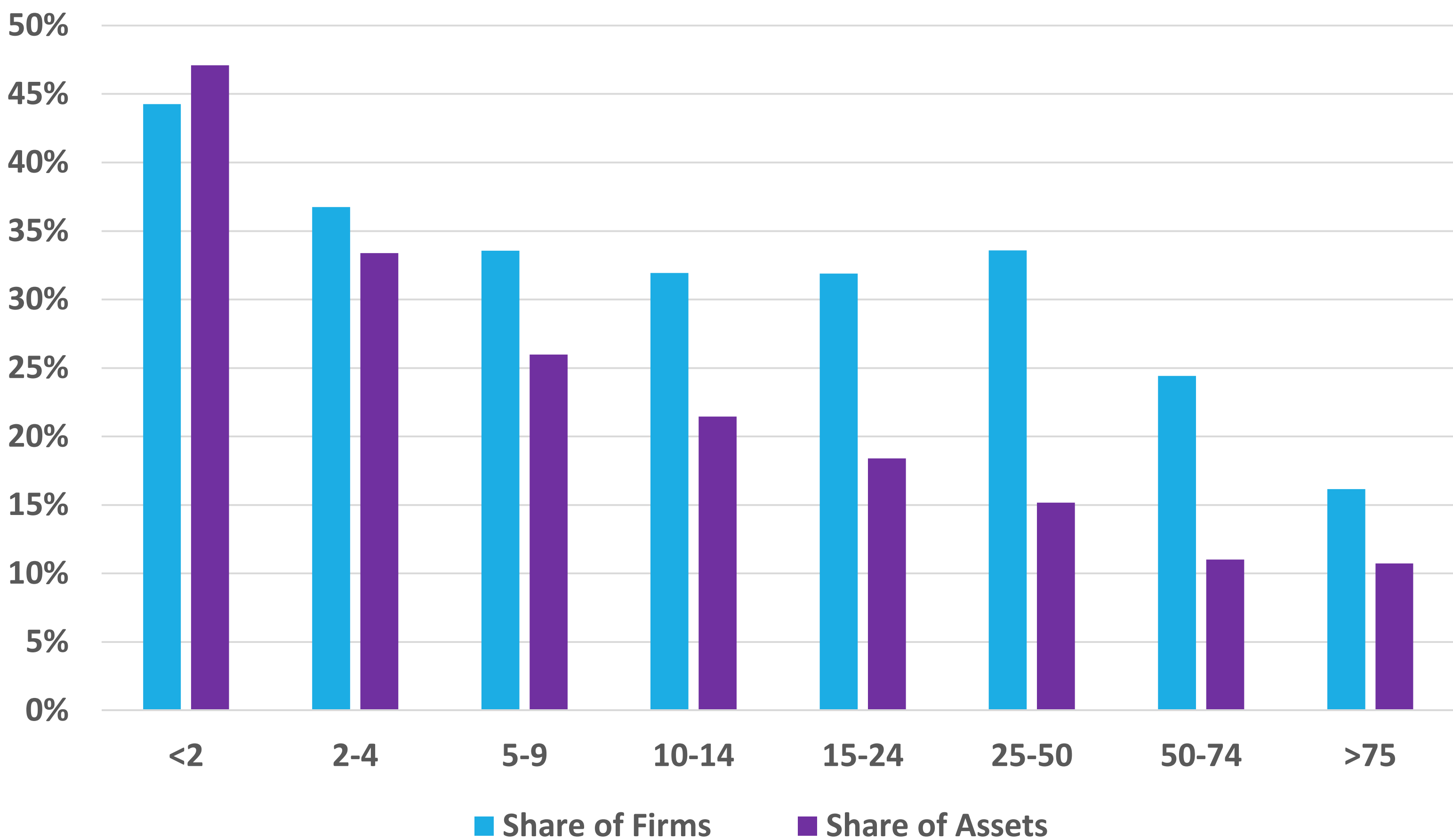


2005 Losses
S Corps, by Industry



2005 Losses

S Corps, by Age



Owners' Offset of 2005 Losses Using 2005 Income, Weighted

	Millions $		Cumulative Offset	
	Losses	**Losses Offset**	**K1 Losses**	**Sch E Losses**
Total K1 Losses 2005	-54,600			
Total on Schedule E	-46,100			
Net Against Partnership/S Corp Income	-34,000	12,100	22%	26%
Net Against all Schedule E Income	-30,900	3,100	28%	33%
Net Against Other Income	-8,600	22,300	69%	81%

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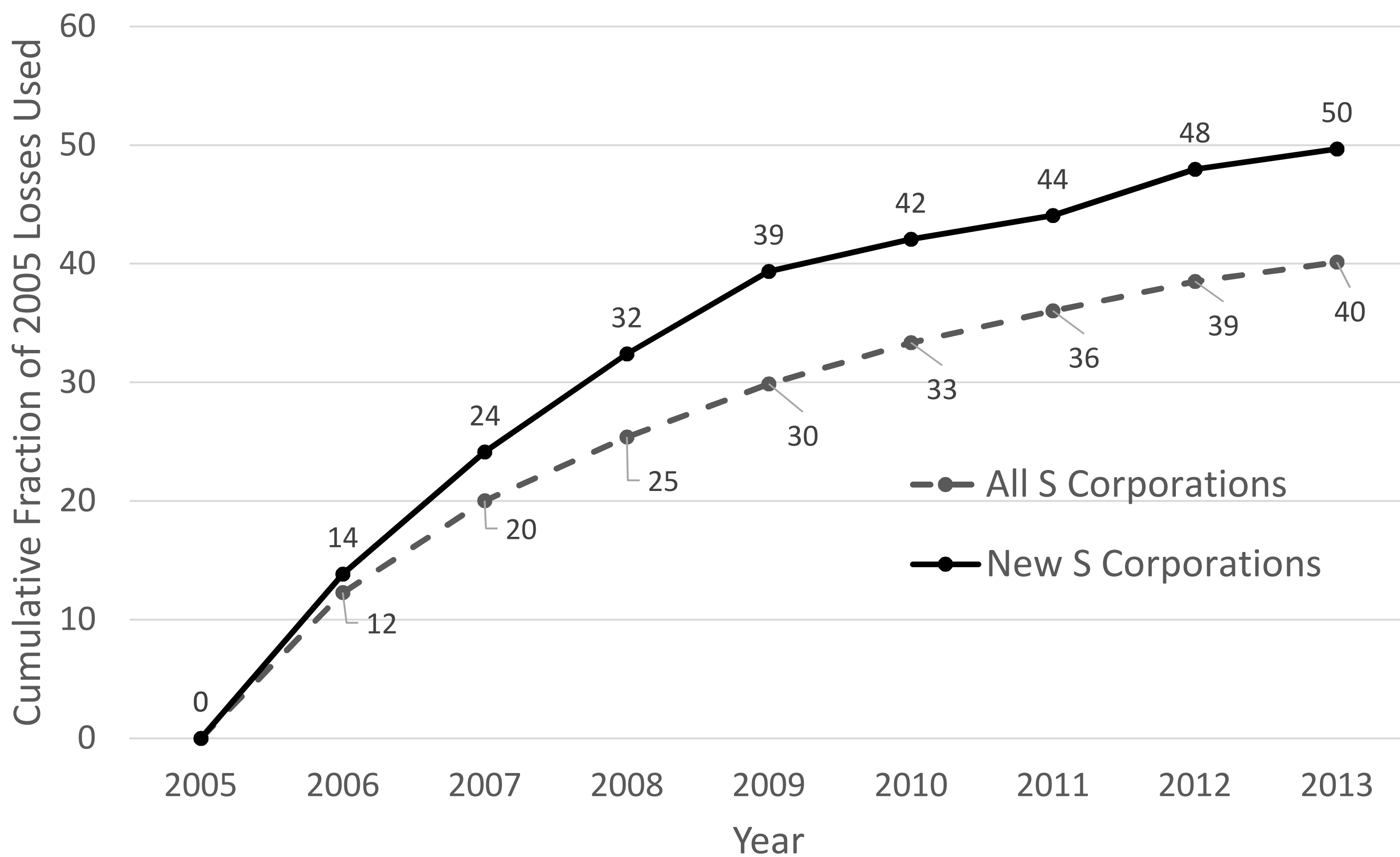
Net Against Other Income (with 250K/500K limit)	-16,000	14,900	55%	65%

Hypothetical Use of 2005 Losses at the Entity Level

2005 SOI S Corporation Sample



Takeaways

S-corporation losses smaller in magnitude and less cyclical than C-corporation losses

- Composition of population is different
- Different exit rates during recession?
- Does pass-through treatment help weather recessions?

Benefit of using losses at the individual level appears to be large

- Share offset in 2005 is much higher than share offset through 2013 at entity level

What’s Next?

- Provide information on owners with S-corporation losses
    - Tax bracket
    - Other types of income
    - Other businesses owned
- Look at owners’ carryback/carryforward of 2005 losses
- Look at how owners use losses at other points in the business cycle
- Quantify benefit of pass-through treatment of losses?
- Partnerships?