Used and Not Lost: Examining Dynamic Patterns of S-Corporation Loss Use

Lucas Goodman [a] Elena Patel[b] Molly Saunders-Scott [c]

June 6, 2019

Disclaimer: The views expressed in this paper are those of the authors and do not necessarily represent the views of the U.S. Treasury Department or the Congressional Budget Office.

Extended Abstract

Since the Tax Reform Act of 1986, an increasing share of U.S. businesses have organized as pass-through entities rather than subchapter C corporations. Unlike C-corporation income, pass-through business income is generally subject to ordinary income tax rates. As such, owners of pass-through businesses are subject to different pressure points in the tax system than owners of C corporations. Understanding how those differences manifest is of paramount importance in understanding the endogenous relationship between the tax system and organizational form.

[a] Lucas.Goodman@treasury.gov US Department of the Treasury
[b] elena.patel@eccles.utah.edu. David Eccles School of Business, University of Utah, Salt Lake City, UT,
[c] molly.saunders-scott@cbo.gov, Congressional Budget Office

One example of heterogeneity across business form is the tax treatment of negative business income, or losses. In 2017, C corporations earned $447 billion in losses. Those businesses retain losses at the entity level, and, before the 2017 tax act–originally called the Tax Cuts and Jobs Act, losses could be used to offset past and future positive business income.[1] By comparison, S corporations earned $78 billion in losses. However, unlike for C corporations, losses from pass-through businesses can first be used by owners at the individual level to offset contemporaneous income from other sources. Before the 2017 tax act, any remaining unused losses could then be used to offset past and future individual income.[2] To this end, Lim et al. (2018) show that owners of S corporations can offset as much as 68% of losses in the year that they occur, which is in stark contrast to Cooper and Knittel (2006), who show that C corporations generally utilize less than 20% of losses immediately, in the form of a loss carry back, and even after ten years utilize less than 60% of losses earned in a given year.

This striking difference in both loss treatment and loss use reveals an important flexibility for S-corporation owners compared with owners of C corporations. In light of this, it is natural to ask whether and how the tax-treatment of negative business income, or losses, impacts firm behavior. However there is an important practical reason why there is a deep empirical literature examining the response of C corporations to the tax system and relatively little is known about the behavior of owners of S corporations: C corporations are more easily visible in publicly available data sources. By comparison, while there is limited public reporting on S corporations at the entity-level, data on owners of S corporations requires use of individual tax data. In this paper, we use administrative tax data to investigate whether the income that owners of S corporations receive from other sources is sensitive to negative shocks to pass-through income.

[1] The 2017 tax act generally eliminated the ability to carry losses back to offset past positive business income and placed some new limitations on carry forward.

[2] For pass-through losses, the 2017 tax act placed a temporary limit on contemporaneous usage, generally eliminated the ability to carry losses back, and placed some new limitations on carry forwards.

To begin, we document the longitudinal use of business losses at the owner level over a ten-year period. For this analysis, we draw a random sample of owners earning a loss in each of the years 2001–2010 and we follow these owners from 1999–2017. We find that owners of S corporations can use 95% of losses within 5 years. That use-rate is relatively stable across years, even for large losses incurred during the great recession.

Next, we explore the composition of the income that individuals use to offset their S-corporation losses. Overall, we find that 50% of these losses are offset by other pass-through business income and wage income. An additional 17% of losses are offset by capital gains income. However, the overall use pattern masks substantial heterogeneity by size of loss. For the bottom quintile of losses, or losses less than roughly $30,000, 80% are offset by other pass-through income and wage income. For the top quintile of losses, or losses of more than $1.6 million, only 20% are offset by other pass-through income and wage income. Moreover, the largest losses are twice as likely to be offset by capital gains income as the smallest losses.

In light of this empirical evidence, we ask whether we see evidence that owners of S corporations strategically realize income from other sources in years with S-corporation losses. We also examine whether individual earnings portfolios continue to look different in the years that follow a loss realization. To investigate that question empirically, we implement a matching analysis, pairing owners of S corporations with non-owners based on a host of observable characteristics in years before a loss and undertake an event study analysis of income earned from all sources in the years surrounding a loss year.

Our evidence adds to an important and growing literature examining the behavior of pass-through business owners. Those owners have become an increasingly important source of revenue, so understanding the complex ways in which they respond to the tax system is key. Moreover, the flexible and near-immediate use of losses from S corporations provides suggestive evidence of a benefit relative to the C-corporation form that may drive organizational form choice within the US tax system.

References

Cooper, Michael and Matthew Knittel, "Partial loss refundability: How are corporate tax losses used?," *National Tax Journal*, 2006, pp. 651–663.

Lim, Katherine, Elena Patel, and Molly Saunders-Scott, "Examining S-Corporation Losses and How They Are Used," *National Tax Journal*, 2018, *71* (4), 661–686.