TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on June 5, 2008

Prepared by the Staff
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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing for June 5, 2008, on selected federal tax issues relating to small business and choice of entity. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides data on the number and size of business entities in the United States, as well as a description of present law, issues, and analysis relating to choice of business entity, conversions of entity form, and payroll taxes.

[1] This document may be cited as follows: Joint Committee on Taxation, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity* (JCX-48-08), June 4, 2008. This document can be found on the internet at www.jct.gov.

I. SUMMARY

The Internal Revenue Code sets out different tax regimes for several different forms of business organizations. In very general terms, it is not possible to relate the differences in tax consequences to any substantive non-tax attributes of these different legal forms of doing business, except that businesses that wish to access the public capital markets generally must be taxed as regular (so-called "C")[2] corporations. Indeed, the Code affords business enterprises and their owners the effective flexibility to elect one tax regime of another without varying any of the meaningful non-tax substantive relationships among the enterprise and its owners.

C corporations, the original taxpayers of our current tax system,[3] were for many years the principal business entity form that could offer limited liability to investors. C corporations are subject to entity level tax in addition to any tax on distributions to shareholders. Partnerships offered the tax advantage of only one level of tax, at the investor level, but for many years Federal taxation as a partnership required at least some exposure to business liability, through a general partner.[4] Congress created S corporations in order to permit a limited liability business form that also provided a single level of tax at the investor level.[5] Most recently, State laws have evolved to permit a new business form, the limited liability corporation ("LLC"), which offers limited liability to investors but which, under relatively recent Treasury regulations, is permitted to be taxed only at the investor level, as a partnership.[6] The old State laws that used to permit only general and limited partners, and that precluded limited partners from active participation in business, now often coexist with LLC and other laws that permit active participation while still offering limited liability.

All forms of entities may be used by business enterprises of any size, from very small to very large, whether measured by assets or revenues. S corporation rules restrict the number and

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[2] The term "C" corporation refers to subchapter C of the Internal Revenue Code, which contains the rules that govern the tax consequences of corporate form, including the tax treatment of contributions, distributions, and mergers and acquisitions. Corporations that pay entity level corporate level tax under section 11 of the Code are subject to these rules.

[3] See Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, Seventh Edition (2006) par. 1.01.

[4] Prior Treas. Reg. sec. 1.301.7701-2 (1960) (withdrawn and replaced in 1997 by the so-called "check the box" regulations, which permit taxpayers to elect classification as a partnership or a corporation).

[5] See Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, Seventh Edition (2006) par. 6.01; S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958), reprinted at 1958-3 CB 922 1137. Many of the rules of subchapter C also apply to "S" corporations, but S corporations must satisfy additional special requirements, must make an election under subchapter S to be eligible for single-level tax treatment, and must follow certain additional rules generally intended to prevent entity-level taxation.

[6] The first LLC statute was enacted in Wyoming in 1977. All States (and the District of Columbia) now have an LLC statute, though the tax treatment of LLCs for State tax purposes may differ.

type of shareholders, but an S corporation may have thousands of employees and unlimited equity valuation. An S corporation may also be a previously publicly traded C corporation that has been taken "private."[7] In general, however, only C corporations are permitted to access the public stock markets.[8]

A recent pamphlet by the Staff of the Joint Committee on Taxation introduced a new paradigm for classifying provisions of the Code as tax expenditures.[9] This revised paradigm divides tax provisions into two categories: tax expenditures that can be identified by reference to the general rules of the existing Code (not, as is the current practice, by reference to a hypothetical "normal" tax), which are labeled "Tax Subsidies," and a new category that is termed "Tax-Induced Structural Distortions." This second category includes a number of important provisions or structural elements of the Code that cannot easily be described as exceptions to an identifiable general rule and that materially affect economic decisions in a manner that imposes substantial efficiency costs.

The opportunity for taxpayers to elect to conduct a business through either a taxable entity (e.g., a corporation) or a nontaxable entity (e.g., a partnership) is a Tax Induced Structural Distortion under the proposed definition. As a general matter, operation of a business through an entity may enhance efficiency by providing owners with flexibility to combine and transfer assets and to allocate tax attributes to different investors. On the other hand, the availability of multiple entity types with different tax treatments may induce taxpayers to alter their behavior, at the possible cost of other economic business considerations, to obtain the maximum tax benefits or avoid adverse consequences of one or another form.

Some such behavior can affect the capitalization of the business. For example, on purely taxable income grounds, a profitable C corporation and its shareholders would generally prefer debt capitalization to equity.[10] Taxpayer behavior also may result in combining particular assets or enterprises that might not otherwise be combined in the same way or for the same time period,

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[7] See, e.g., Tribune Company Form 10-Q, First quarter 2008 p.7, n.3, available on the internet at http://www.sec.gov/Archives/edgar/data/726513/000072651308000018/firstquarter10q2008.htm

[8] There are some exceptions for certain activities that can be conducted as publicly traded partnerships and not taxed as C corporations. Certain special entities, such as regulated investment companies and real estate investment trusts, can be publicly traded and be taxed at only one level; however, such entities must distribute 90 percent of their income (other than certain capital gains, which are taxed at corporate rates and are also subject to an excise tax unless treated as distributed.) Also, such entities are generally required to invest in certain passive income assets and are not permitted to engage in active business.

[9] See, Joint Committee on Taxation, *A Reconsideration of Tax Expenditure Analysis*, JCX 37-08 (May 12, 2008) pp. 9-12, 41.

[10] However, a C corporation with earnings but little currently taxable income may prefer equity capitalization that can offer corporate investors a dividends-received deduction.

to maximize tax-free transferability under rules relating to different entities.[11] There may also be incentives to create complex structures of related brother-sister entities, or tiers of entities, to obtain benefits or avoid adverse effects of each of the forms. In addition, investor treatment can vary depending on the choice of entity. In most situations a tax-exempt investor, including any pension plan permitted to invest, would experience unrelated business income tax on its share of partnership, LLC, or S corporation business income. This is because business income is not generally considered exempt from tax even in the hands of a tax-exempt entity, unless it is received indirectly, in the form of dividends from a C corporation that has already potentially borne entity level tax. A notable exception to this general rule of business income taxation is the present law permitted investment of an ESOP in an S corporation without any unrelated business income tax on the income attributed to the ESOP.[12]

Choice of entity also can affect the taxpayer's flexibility to designate income as subject (or not subject) to payroll taxes. The evolution of present law with respect to limited liability companies, and the failure of the Code to clarify the payroll tax consequences for different contractual relationships made possible by these new forms, have created areas of significant uncertainty and potential planning opportunities with respect to payroll taxes. The situation is exacerbated by the fact that S corporations are subject to a different regime for determining labor income subject to payroll taxes than are partnerships, creating another potential planning option.[13]

As tax rates change, one or another entity form may become more attractive, leading to fluctuating expressions of tax remorse. Under present law, from the point of view of tax rates alone, the C corporation form is unattractive due to the potential for taxation at both the entity and the individual level and the general equivalence of the top individual and corporate tax rates; on the other hand, businesses that wish to access public capital markets generally (but not universally) are required to subject themselves to tax as a C corporation. However, if as a result of change in law the combination of C corporation rates and individual dividend rates were to become less than the ordinary business income rate applied to income earned outside a C corporation, then a C corporation could become a preferable form. This situation may exist

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[11] A discussion of the differing corporate and partnership rules that permit tax-free transfers of assets is beyond the scope of this pamphlet.

[12] See, e.g. Tribune Company Form 10-Q, First quarter 2008 p.7, n.3, available on the internet at http://www.sec.gov/Archives/edgar/data/726513/000072651308000018/firstquarter10q2008.htm.

Certain special entities, such as regulated investment companies and real estate investment trusts, can permit income of the entity to be non-taxed to the extent of tax-exempt organization ownership. However, such entities are generally required to invest in certain passive income assets and are not permitted to engage in active business.

[13] In some situations, it also appears that loss entities and C corporations subject to the lower graduated rates have an incentive not to designate as labor income (subject to payroll tax) the value of services of certain owner-service providers. See report of preliminary research by Bull and Burnham, at 119 Tax Notes 657 (May 19, 2008).

today for some small C corporations whose income does not exceed the lower graduated C corporation tax rates, and may exist in the future if C corporation rates are reduced significantly while the current 15 percent rate tax rate on dividends paid to individuals (which is scheduled to expire after 2010) is extended.

The question may arise whether simplification and efficiency might be improved by limiting the variety of tax consequences that attend different entity forms, especially in light of the lack of substantive non-tax differences in the use of the different forms. One possibility might be to require C corporation treatment for publicly traded entities,[14] while unifying the treatment of pass-through entity forms, perhaps under a partnership model. Any such proposal would have to address issues that would arise on conversion from C to pass-through status. Some of those issues are similar to the issues that arise under present law on conversion from one form to another.

Largely as a result of changes in the tax law that were made in 1986 to conform the corporate level taxation of dispositions by continuing businesses and the taxation of dispositions by business that are sold,[15] the Code imposes tax on corporate level asset appreciation if a corporation converts to partnership form. Some C corporations may have, or be able to obtain, a capital structure that would permit conversion from C corporation to S corporation status without current tax on asset appreciation, thus obtaining a single level of tax on future earnings. If a C corporation converts to S status, present law retains a C corporation tax on "built-in" gain from certain sales of assets that were appreciated as of the conversion date. Some business owners today express frustration in the structural tax obstacles to converting their businesses from a corporate form they may not have chosen were the businesses formed today, due to the current rate structure and the tax on certain transfers of assets.

Whether or not a simplified regime were adopted for income tax purposes, it might be possible to adopt more clear and consistent rules for payroll taxes. At the very least, the rules relating to partnerships and LLCs might be clarified and conformed. In addition, S corporation rules also might be modified to provide consistency with the other pass-through forms.

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[14] Proposals to "integrate" the tax system so as to impose only one level of tax, even on C corporation earnings, must confront both administrative and revenue considerations. Issues of how to treat tax exempt and foreign investors may be particularly troublesome. A discussion of “corporate integration” proposals is beyond the scope of this pamphlet. In addition to the taxation of tax exempt and foreign investors, another primary issue is the extent to which tax incentives such as deductions and credits at the entity level should be passed through to investors. A brief discussion of corporate integration can be found in Joint Committee on Taxation, *Present Law and Background Related to Selected Business Tax Issues*, JCX-41-06 (September 19, 2006) at pp. 26-31.

[15] See. H.R. Rep. 99-426, 99th Cong., 1st Sess. (Dec. 7, 1985) at pp 281-282; H.R. Rep. 99-841, 99th Cong. 2d. Sess., Vol. II (Sept. 18, 1986) at pp. II-198 to II-207.

II. DATA ON THE NUMBER AND SIZE OF BUSINESS ENTITIES IN THE UNITED STATES

Trends in use of business entities, 1978-2005

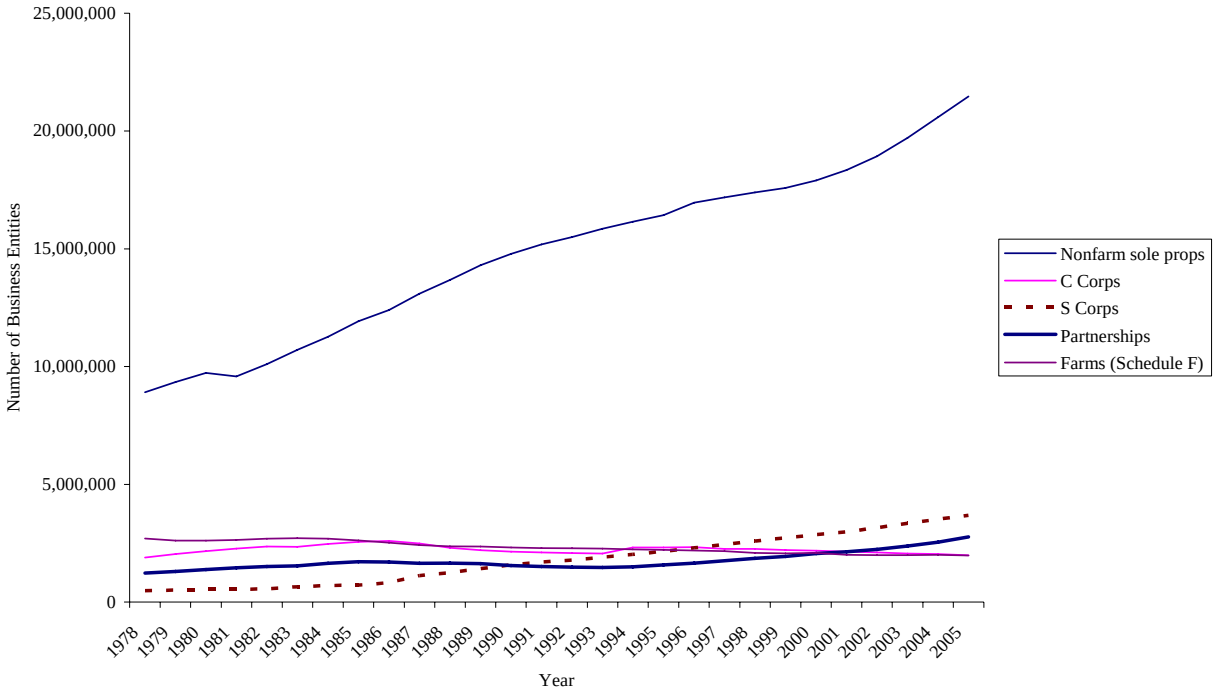
Returns filed by C corporations, S corporations, partnerships, non-farm sole proprietors, and farming enterprises

Figure 1 and Table 1 show data from the Internal Revenue Service's Statistics of Income ("SOI") regarding the number of tax returns filed by different forms of business organizations from 1978 to 2005.[16] In these data, farms are measured solely by reference to those individuals who report income (or loss) on Schedule F of Form 1040. Other individuals engaged in agricultural enterprises may conduct their farm business through a separate legal entity. When this occurs, the data reported below report that entity among the totals of C corporations, S corporations, or partnerships.

Throughout the period 1978 to 2005, nonfarm sole proprietorships made up the vast majority of businesses. The S corporation is the second most numerous business form. In 2005, S corporations constituted 11.6 percent of all business entities. By contrast, two decades ago S corporations accounted for less than six percent of all business entities. The growth in the number of S corporations was most dramatic immediately following 1986, while the number of C corporations declined each year from 1987 through 1993. After an increase in the number of C corporation returns in the mid-1990s, the number of C corporation returns has again declined each year. The number of partnership returns filed reached a peak in 1985 and then generally declined until 1993. Since 1993 partnership returns filed and S corporation returns filed have grown at approximately the same rate. (As described below, limited liability companies generally are taxed, at the election of the owners, either as partnerships or as corporations. In the great majority of case involving U.S. businesses, limited liability companies are taxed as partnerships). The number of farm returns (that is, individuals operating farms as sole proprietorships and reporting their income on Schedule F of Form 1040) generally declined through the 28-year period.

[16] These data are based upon returns filed by individuals and entities. The numbers reported for nonfarm sole proprietorships and for farm returns are based upon the number of taxpayers who file a business return as a sole proprietor (Schedule C to Form 1040) and who file a farm income return (Schedule F to Form 1040). One taxpayer may report more than one business organized as a sole proprietorship; in that circumstance, the data reported here count only one sole proprietorship. On the other hand, the data for C corporations, S corporations, and partnerships count the number of tax returns and information returns filed by C corporations, S corporations, and partnerships. One taxpayer may own more than one corporation. When this occurs, unlike the case in sole proprietorships, the data reported here count each corporation as a separate entity. Thus, the data are not perfectly comparable across entity classification.

Figure 1.–Number of Different Types of Business Returns, 1978-2005



Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

Table 1.–Number of Different Types of Business Returns Relative to All Business Returns, 1978-2005

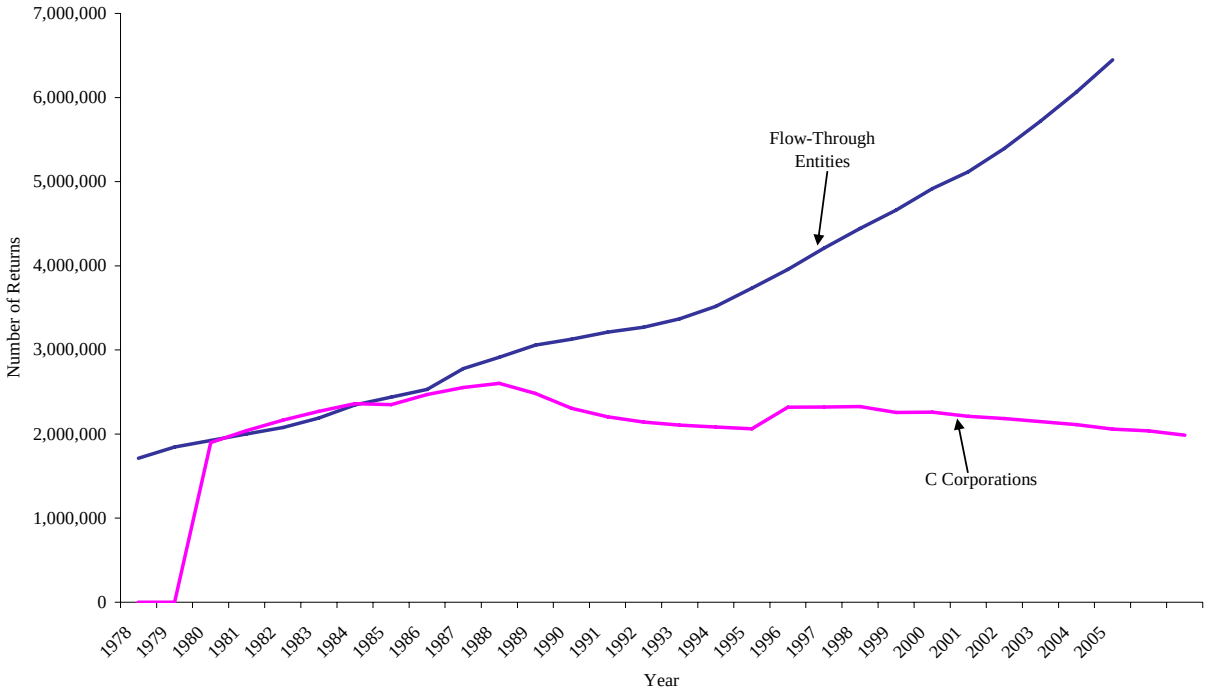
Year	Sole Proprietorships	C Corporations	S Corporations	Partnerships	Farms	Total
1978	8,908,289	1,898,100	478,679	1,234,157	2,704,794	15,224,019
1979	9,343,603	2,041,887	545,389	1,299,593	2,605,684	15,805,674
1980	9,730,019	2,165,149	545,389	1,379,654	2,608,430	16,428,641
1981	9,584,790	2,270,931	541,489	1,460,502	2,641,254	16,498,966
1982	10,105,515	2,361,714	564,219	1,514,212	2,689,237	17,234,897
1983	10,703,921	2,350,804	648,267	1,541,539	2,710,044	17,954,575
1984	11,262,390	2,469,404	701,339	1,643,581	2,694,420	18,771,134
1985	11,928,573	2,552,470	724,749	1,713,603	2,620,861	19,540,256
1986	12,393,700	2,602,301	826,214	1,702,952	2,524,331	20,049,498
1987	13,091,132	2,484,228	1,127,905	1,648,035	2,420,186	20,771,486
1988	13,679,302	2,305,598	1,257,191	1,654,245	2,367,527	21,263,863
1989	14,297,558	2,204,896	1,422,967	1,635,164	2,359,718	21,920,303
1990	14,782,738	2,141,558	1,575,092	1,553,529	2,321,153	22,374,070
1991	15,180,722	2,105,200	1,696,927	1,515,345	2,290,908	22,789,102
1992	15,495,419	2,083,652	1,785,371	1,484,752	2,288,218	23,137,412
1993	15,848,119	2,063,124	1,901,505	1,467,567	2,272,407	23,552,722
1994	16,153,871	2,318,614	2,023,754	1,493,963	2,242,324	24,232,526
1995	16,423,872	2,321,048	2,153,119	1,580,900	2,219,244	24,698,183
1996	16,955,023	2,326,954	2,304,416	1,654,256	2,188,025	25,428,674
1997	17,176,486	2,257,829	2,452,254	1,758,627	2,160,954	25,806,150
1998	17,398,440	2,260,757	2,588,081	1,855,348	2,091,845	26,194,471
1999	17,575,643	2,210,129	2,725,775	1,936,919	2,067,883	26,516,349
2000	17,902,791	2,184,795	2,860,478	2,057,500	2,086,789	27,092,353
2001	18,338,190	2,149,105	2,986,486	2,132,117	2,006,871	27,612,769
2002	18,925,517	2,112,230	3,154,377	2,242,169	1,995,072	28,429,365
2003	19,710,079	2,059,631	3,341,606	2,375,375	1,997,116	29,483,807
2004	20,590,691	2,039,631	3,518,334	2,546,877	2,004,898	30,700,431
2005	21,467,566	1,987,171	3,684,086	2,763,625	1,981,249	31,883,697

Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

Because C corporations, S corporations, and partnerships, which in these data generally include limited liability corporations, are formal legal entities, they most likely represent the entity choices that face individuals organizing business ventures, both new ventures and the re-organization of existing ventures. The major tax difference is that business ventures organized as C corporations are subject to tax at the entity level, with the owners subject to tax on subsequent distributions of income from the C corporation, while ventures organized as S corporations and partnerships are not subject to tax at the entity level. The income of S corporations and partnerships flows through to the individual owner or partner. Figure 2, below, reports the trend over the past 28 years of the number of C corporation returns filed compared to

the sum of S corporation and partnership returns.[17] 1986 was the last year in which the number of C corporation returns exceeded the number of returns from flow-through legal entities. As Figure 2 reports, while the number of C corporations has generally declined in the United States since 1986, the number of flow-through entities has more than doubled.

Figure 2.–Number of C Corporation Returns Compared to the Sum of S Corporation and Partnership Returns, 1978-2005

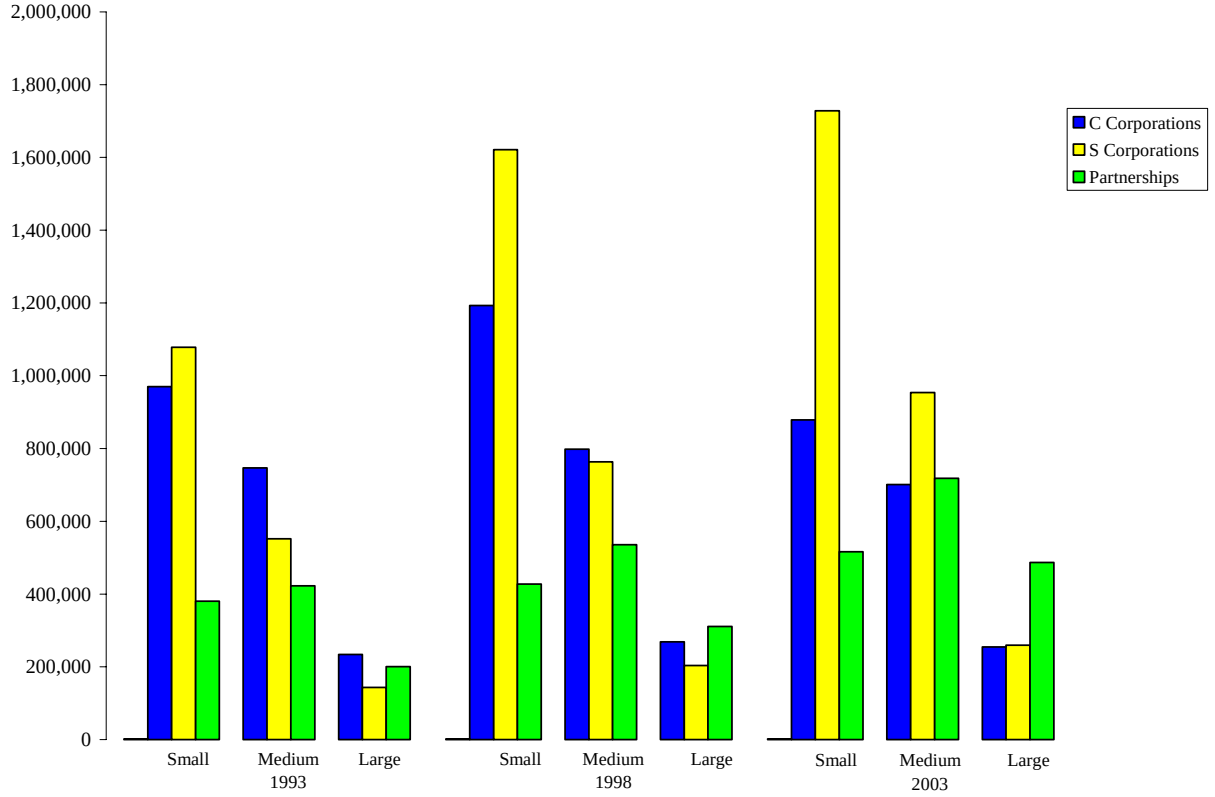


Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

[17] The data reported in this section comparing C corporations and partnerships are derived from entity-level returns filed with the Internal Revenue Service. Some partnerships are partnerships of C corporations, some are partnerships of other partnerships, and some are partnerships of individuals and C corporations or other partnerships. For this reason subsequent comparisons based either on assets size or gross receipt size includes some double counting of assets or gross receipts as such items would be flowed through to the returns of a C corporation partner or partnership partner.

Figure 3, below, reports the number of entities filing returns in 1993, 1998, and 2003, classified by asset size. The various business entities are grouped into those with less than $100,000 in assets (labeled "small" entities in Figure 3), those with between $100,000 and $1 million in assets (labeled "medium" entities in Figure 3), and those with more than $1 million in assets (labeled "large" entities in Figure 3). As Figure 3 reports there were modestly fewer C corporations in all three size classes in 2003 than in 1993. At the same time the number of S corporations in all size classes grew substantially in each year. Likewise, the number of entities filing returns as partnerships (including LLCs) grew substantially each year. The greatest growth in numbers of entities was among "small" S corporations, those with less than $100,000 in assets. The number of small S corporations increased by approximately 650,000 entities between 1993 and 2003. The number of "small" C corporations, those with assets less than $100,000, fell by approximately 90,000 over the same period.

Figure 3.–The Number of Small, Medium, and Large Business Entities by Type of Legal Entity, 1993, 1998, 2003



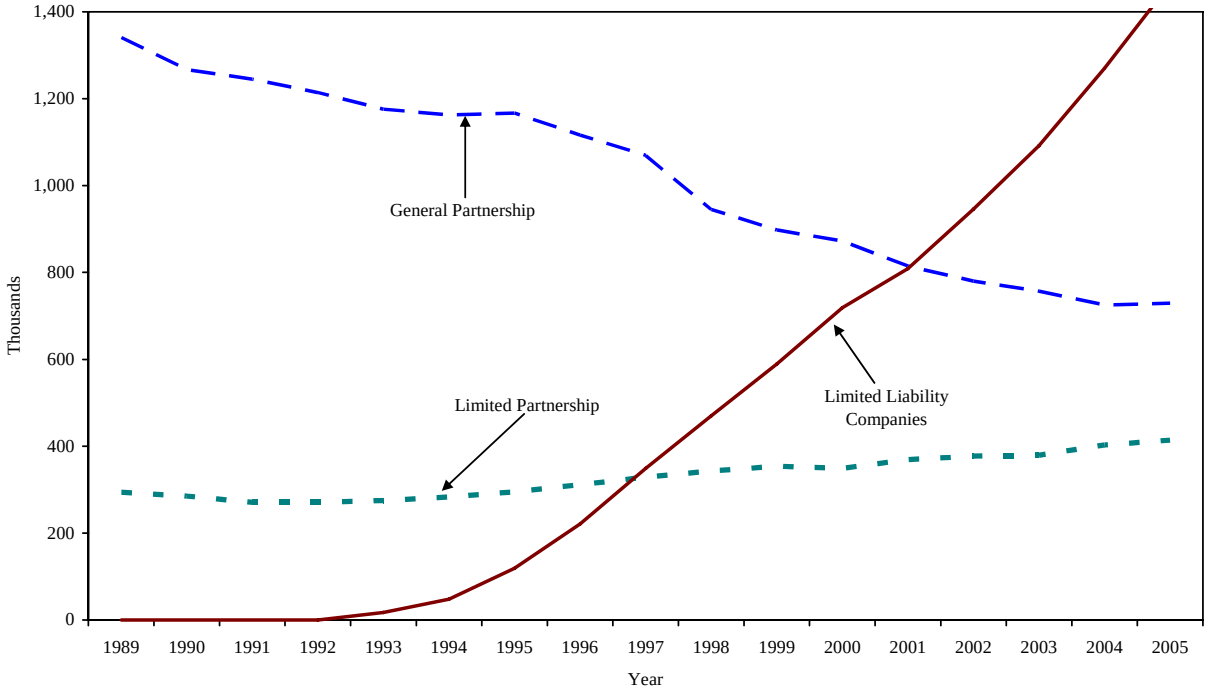
Source: Joint Committee on Taxation staff tabulations of Statistics of Income, published and unpublished data.

The growth of limited liability companies

The use of the limited liability company ("LLC") as an entity is a development of the past 15 years. Most LLCs elect to be taxed as partnerships for Federal reporting purposes and their numbers are counted among the partnership data reported in Table 1 and Figures 1, 2, and 3

above. Figure 4, below, decomposes the number of partnerships for the period 1990 through 2005 into general partnerships, limited partnerships, and LLCs.[18] Figure 4 documents the rapid growth of LLCs relative to other forms of business organization that are taxed as partnerships over the past several years.[19] Since 1996, LLCs have grown at a rate of approximately 23 percent per year. In addition to reporting numbers of general partnerships, limited partnerships, and LLCs, Table 2 provides information on the number of limited liability partnerships and foreign partnerships filing partnership returns.

Figure 4.–Domestic Partnership Returns by Type of Partnership, 1989-2005



Source: Bill Pratt, "Partnership Returns, 2000," *SOI Bulletin*, 22, Fall 2002, and Tim Wheeler and Nina Shumofsky, "Partnership Returns, 2005," *SOI Bulletin*, 27, Fall 2007, and Tim Wheeler and Nina Shumofsky, "Partnership Returns, 2005," *SOI Bulletin*, 27, Fall 2007.

[18] The data in Table 2 may not sum to the total number of partnerships reported in Table 1 because of rounding. Also, this decomposition excludes those businesses that checked the "other" box on Form 1065, Schedule B, line 1. See, Alan Zempel, "Partnership Returns, 1998," *SOI Bulletin*, 20, Fall 2000, Bill Pratt, "Partnership Returns, 2000," *SOI Bulletin*, 22, Fall 2002, Tim Wheeler and Nina Shumofsky, "Partnership Returns, 2003," *SOI Bulletin*, 25, Fall 2005. Tim Wheeler and Nina Shumofsky, "Partership Returns, 2005," *SOI Bulletin*, 27, Fall 2007.

[19] For ease of exposition, Figure 4 does not include domestic limited liability partnerships and foreign partnerships.

Table 2.–Number of Partnership Returns by Type, 1990-2005

Year	Type of Partnership				
	Domestic General Partnerships (thousands)	Domestic Limited Partnerships (thousands)	Domestic Limited Liability Companies (thousands)	Domestic Limited Liability Partnerships (thousands)	Foreign Partnerships (thousands)
1990	1,267	285	n.a.	n.a.	n.a.
1991	1,245	271	n.a.	n.a.	n.a.
1992	1,214	271	n.a.	n.a.	n.a.
1993	1,176	275	17	n.a.	n.a.
1994	1,163	283	48	n.a.	n.a.
1995	1,167	295	119	n.a.	n.a.
1996	1,116	311	221	n.a.	n.a.
1997	1,069	329	349	n.a.	n.a.
1998	945	343	470	26	n.a.
1999	898	354	589	42	n.a.
2000	872	349	719	53	3
2001	815	369	809	69	5
2002	780	377	946	78	3
2003	757	379	1,092	88	3
2004	725	403	1,270	89	4
2005	729	414	1,465	100	5

n.a. - not available.

Source: Bill Pratt, "Partnership Returns, 2000," *SOI Bulletin*, 22, Fall 2002, Tim Wheeler and Nina Shumofsky, "Partnership Returns, 2003," *SOI Bulletin*, 25, Fall 2005, Tim Wheeler and Nina Shumofsky, "Parterships Returns, 2005," *SOI Bulletin*, 27, Fall 2007.

Size distribution of C corporations, S corporations, partnerships, and non-farm sole proprietorships

While one may often associate small businesses with organization in the form of a sole proprietorship, a partnership, or an S corporation, there is no legal requirement of any correspondence between the size of the business and the form of business organization. While

many small businesses are organized as a sole proprietorship, a partnership, or an S corporation, not all businesses organized in those forms are small and not all businesses organized as C corporations are large. One can use SOI data on assets and gross receipts to measure the size of businesses in order to sort out how small businesses are arrayed across the different forms of organization.

Tables 3 through 6 display 2005 SOI data on C corporations, S corporations, entities taxed as partnerships (which category includes most LLCs), and nonfarm sole proprietorships. For the first three forms of organization, the tables classify all taxpayers using that form of organization both by the size of assets and gross receipts. For sole proprietorships (Table 6), there is no tax data on assets, so the table uses only gross receipts as a classifier. When businesses are classified by asset size, one can see that there are a significant number of C corporations of small size. More than 850,000 C corporations have assets under $50,000, approximately 40 percent of the total number of C corporations. For S corporations, approximately one-half have assets under $50,000.

The concentration of assets differs among the three entity forms. C corporations have the largest disparity in asset holding. Firms with over $100 million in assets, which represent one percent of all C corporations, hold 97 percent of the assets in C corporations. By comparison, partnerships with $100 million or more in assets constitute 0.5 percent of all entities classified for tax purposes as partnerships; these businesses own only 71 percent of all assets owned by partnerships. S corporations with $100 million or more in assets constitute only 0.07 percent of all S corporations and account for 30 percent of all assets owned by S corporations.

When businesses are classified by gross receipts, a picture emerges that is similar to that seen in the asset data. There are a substantial number of quite small C corporations (more than 460,000 corporations with gross receipts less than $25,000, approximately 23 percent of the number of C corporations). But across the other forms of organization there are higher percentages of businesses with small amounts of gross receipts. For nonfarm sole proprietorships, 68 percent have gross receipts under $25,000. For S corporations, 23 percent report gross receipts of $25,000 or less.

As with assets, the dispersion of gross receipts across the classifications is more skewed for C corporations and entities taxed as partnerships than for S corporations. C corporations with over $50 million in gross receipts, which represent approximately 0.86 percent of all C corporations, collect 85 percent of gross receipts of all C corporations. For partnerships, the approximately 0.2 percent of partnerships with gross receipts in excess of $50 million report 67 percent of all partnership gross receipts. For S corporations, 0.35 percent of S corporations with gross receipts in excess of $50 million report 34 percent of S corporation gross receipts. For non-farm sole proprietorships, fewer than 0.001 percent of such businesses report gross receipts in excess of $50 million, and these businesses report less than 2.5 percent of all non-farm sole proprietorship gross receipts.

Table 3.–Distribution of C Corporations, 2005

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent	
			Returns	Total Assets
$0 or less	268,039	0	13.49%	0.00%
$1 to $25,000	410,852	3,053	34.16%	0.00%
$25,001 to $50,000	174,077	5,929	42.92%	0.01%
$50,001 to $100,000	219,087	15,241	53.95%	0.04%
$100,001 to $250,000	293,110	46,009	68.70%	0.11%
$250,001 to $500,000	208,389	73,861	79.19%	0.23%
$500,001 to $1,000,000	152,728	107,160	86.87%	0.39%
$1,00,001 to $10,000,000	204,899	575,719	97.18%	1.30%
$10,000,001 to $50,000,000	29,157	634,622	98.65%	2.29%
$50,000,001 to $100,000,000	6,842	488,247	98.99%	3.06%
More than $100,000,000	19,991	61,758,607	100.00%	100.00%
Total	1,987,171	63,708,448		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent	
			Returns	Total Receipts
$0 or less	245,544	-113	12.36%	0.00%
$1 to $2,500	45,311	51	14.64%	0.00%
$2,501 to $5,000	27,024	102	16.00%	0.00%
$5,001 to $10,000	48,651	360	18.44%	0.00%
$10,001 to $25,000	99,489	1,684	23.45%	0.01%
$25,001 to $50,000	112,029	4,058	29.09%	0.04%
$50,001 to $100,000	175,270	12,953	37.91%	0.11%
$100,001 to $250,000	303,091	50,074	53.16%	0.40%
$250,001 to $500,000	247,417	88,672	65.61%	0.91%
$500,001 to $1,000,000	229,072	163,141	77.14%	1.85%
$1,000,001 to $10,000,000	384,936	1,120,368	96.51%	8.29%
$10,000,001 to $50,000,000	52,344	1,061,211	99.14%	14.39%
More than $50,000,000	16,993	14,891,626	100.00%	100.00%
Total	1,987,171	17,394,187		

* Details do not add to total due to rounding.

Table 4.–Distribution of S Corporations, 2005

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent	
			Returns	Total Assets
$0 or less	506,583	0	13.75%	0.00%
$1 to $25,000	976,860	7,724	40.27%	0.28%
$25,001 to $50,000	411,489	13,945	51.44%	0.79%
$50,001 to $100,000	440,846	30,506	63.40%	1.91%
$100,001 to $250,000	511,248	80,365	77.28%	4.84%
$250,001 to $500,000	316,318	111,767	85.87%	8.93%
$500,001 to $1,000,000	217,836	153,764	91.78%	14.54%
$1,00,001 to $10,000,000	267,918	745,361	99.05%	41.78%
$10,000,001 to $50,000,000	29,381	573,964	99.85%	62.75%
$50,000,001 to $100,000,000	3,044	210,843	99.93%	70.45%
More than $100,000,000	2,562	808,742	100.00%	100.00%
Total	3,684,086	2,736,982		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent	
			Returns	Total Receipts
$0 or less	479,818	-772	13.02%	-0.01%
$1 to $2,500	80,501	81	15.21%	-0.01%
$2,501 to $5,000	51,344	187	16.60%	-0.01%
$5,001 to $10,000	70,772	519	18.52%	0.00%
$10,001 to $25,000	172,129	2,929	23.20%	0.06%
$25,001 to $50,000	226,830	8,350	29.35%	0.22%
$50,001 to $100,000	368,144	27,209	39.35%	0.75%
$100,001 to $250,000	691,466	113,572	58.11%	2.95%
$250,001 to $500,000	508,854	183,217	71.93%	6.50%
$500,001 to $1,000,000	413,544	294,062	83.15%	12.19%
$1,000,001 to $10,000,000	544,938	1,485,648	97.94%	40.97%
$10,000,001 to $50,000,000	62,882	1,289,669	99.65%	65.96%
More than $50,000,000	12,862	1,757,427	100.00%	100.00%
Total	3,684,086	5,162,100		

* Details do not add to total due to rounding.

Table 5.–Distribution of Partnerships, 2005

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent	
			Returns	Total Assets
$0 or less	740,686	-76,017	26.80%	-0.55%
$1 to $25,000	304,895	2,514	37.83%	-0.54%
$25,001 to $50,000	103,404	3,722	41.58%	-0.51%
$50,001 to $100,000	150,497	11,010	47.02%	-0.43%
$100,001 to $250,000	302,951	50,483	57.98%	-0.06%
$250,001 to $500,000	269,433	97,827	67.73%	0.65%
$500,001 to $1,000,000	279,633	201,369	77.85%	2.12%
$1,00,001 to $10,000,000	516,593	1,552,724	96.54%	13.42%
$10,000,001 to $50,000,000	72,689	1,471,223	99.17%	24.14%
$50,000,001 to $100,000,000	10,169	708,778	99.54%	29.30%
More than $100,000,000	12,675	9,710,626	100.00%	100.00%
Total	2,763,625	13,734,256		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent	
			Returns	Total Receipts
$0 or less	1,713,788	0	62.01%	0.00%
$1 to $2,500	58,555	63	64.13%	0.00%
$2,501 to $5,000	32,827	124	65.32%	0.01%
$5,001 to $10,000	40,959	293	66.80%	0.01%
$10,001 to $25,000	88,812	1,485	70.01%	0.06%
$25,001 to $50,000	88,852	3,224	73.23%	0.16%
$50,001 to $100,000	121,719	8,926	77.63%	0.42%
$100,001 to $250,000	183,111	30,213	84.26%	1.33%
$250,001 to $500,000	134,754	48,159	89.14%	2.78%
$500,001 to $1,000,000	102,843	73,102	92.86%	4.98%
$1,000,001 to $10,000,000	168,440	479,532	98.95%	19.41%
$10,000,001 to $50,000,000	22,306	461,981	99.76%	33.31%
More than $50,000,000	6,658	2,216,659	100.00%	100.00%
Total	2,763,625	3,323,760		

* Details do not add to total due to rounding.

Table 6.–Distribution of Nonfarm Sole Proprietorships, 2005

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent	
			Returns	Total Receipts
$0 or less	930,491	0	4.33%	0.00%
$1 to $2,500	4,277,031	5,007	24.26%	0.41%
$2,501 to $5,000	2,362,789	8,586	35.26%	1.13%
$5,001 to $10,000	2,960,905	21,391	49.06%	2.90%
$10,001 to $25,000	4,015,877	64,841	67.76%	8.26%
$25,001 to $50,000	2,558,620	90,851	79.68%	15.79%
$50,001 to $100,000	1,957,208	138,143	88.80%	27.22%
$100,001 to $250,000	1,529,599	236,103	95.92%	46.77%
$250,001 to $500,000	526,512	182,465	98.38%	61.88%
$500,001 to $1,000,000	232,070	158,678	99.46%	75.02%
$1,000,001 to $10,000,000	113,811	231,815	99.99%	94.21%
$10,000,001 to $50,000,000	2,427	43,238	100.00%[1]	97.79%
More than $50,000,000	225	26,709	100.00%	100.00%
Total	21,467,566	1,207,827		

* Details do not add to total due to rounding.

Note: The actual figure is 99.9992 percent which rounds to 100.00 percent.

Distribution of C corporations, S corporations, and partnerships by primary business activity

Taxpayers filing returns as C corporations, S corporations, and partnerships are asked to self report the primary industry in which the business operates. Table 7, below, reports the distribution of entities by number of returns and by assets across various industry classifications. Distributing by assets, for C corporations, the three largest industries are finance and insurance, holding companies, and manufacturing. These three industries account for more than 80 percent of all assets reported by all C corporations. For S corporations, the three largest industries are construction, holding companies, and manufacturing. These three industries account for 37 percent of all assets reported by all S corporations. For partnerships, the three largest industries are finance and insurance, real estate, and information. These three industries account for more than 80 percent of all assets reported on all partnership returns.

Distributing by number of returns, for C corporations, the three most numerous industries are services, construction, and retail trade. These three industries account for approximately 35 percent of all C corporations. For S corporations, the three most numerous industries are services, construction, and real estate. These three industries account for approximately 41 percent of all S corporations. For entities taxed as partnerships, the three most numerous industries are real estate, finance and insurance, and construction. These three industries account for approximately 64 percent of all partnerships.

Table 7.–Distribution of Certain Business Entities and Assets by Industry, 2005

Industry	C Corporations		S Corporations		Partnerships	
	Percent of Returns	Percent of Total Assets	Percent of Returns	Percent of Total Assets	Percent of Returns	Percent of Total Assets
Agriculture, Forestry, Fishing and Hunting	3.18	0.11	2.15	1.96	4.62	0.81
Mining	0.75	0.82	0.48	1.44	1.02	1.26
Utilities	0.28	2.33	0.05	0.20	0.10	1.59
Construction	11.52	0.55	14.19	13.25	6.59	1.97
Manufacturing	6.37	15.88	4.10	11.85	1.62	3.07
Wholesale Trade	8.32	2.28	5.65	10.28	1.74	0.89
Retail Trade	11.13	1.73	10.71	11.76	5.13	0.79
Wholesale and Retail Trade not Allocable	0.06	0.00	0.06	0.01	0.00	0.00
Transportation and Warehousing	3.82	0.82	3.02	2.36	1.53	0.96
Information	2.50	4.49	1.99	2.07	1.35	3.96
Finance and Insurance	4.71	47.31	4.05	9.16	10.42	55.76
Real Estate and Rental and Leasing	10.41	0.73	11.81	10.94	46.89	22.58
Professional, Scientific, and Technical Services	11.86	0.86	14.94	3.51	6.16	0.96
Holding Companies	1.31	20.65	0.67	12.03	0.90	2.71
Administrative and Support and Waste Management and Remediation Services	3.86	0.37	4.91	1.66	1.74	0.26
Educational Services	0.73	0.03	0.83	0.19	0.38	0.02
Health Care and Social Services	6.90	0.33	6.62	1.58	2.17	0.58
Arts, Entertainment, and Recreation	1.78	0.11	2.20	1.15	1.78	0.48
Accommodation and Food Services	4.12	0.50	5.58	3.24	3.47	1.23
Other Services	6.28	0.10	5.97	1.36	2.23	0.11
Not Allocable	0.11	0.00	0.01	0.00	0.13	0.01
Total[1]	1,987,171	63,708,448	3,684,086	2,736,982	2,763,625	13,734,256

[1] The totals show the actual number of returns in the 'Percent of Returns' columns and the total assets in millions of dollars for the Percent of Total Assets columns.

Distribution of income by entity type and entity size

On average, in any given year small businesses are more likely to operate at a loss. Tables 8 and 9 below classify businesses by size of their reported gross receipts. The tables report the aggregate income, or loss, reported within a size class by entity type. Tables 8a and 8b report results for S corporations, partnerships, and sole proprietorships while Tables 9a and 9b report results for C corporations. Tables 8 and 9 are not directly comparable because the net income of C corporations may include investment income (e.g., interest income) while S corporations and partnership returns generally provide that investment income be reported separately on the owner's or partner's individual income tax return. Similarly, investment income of the owner of a sole proprietorship is not reported as part of schedule C.

Table 8a reports that in 2005, on average, S corporations and partnerships reporting $25,000 or fewer in gross receipts operated at a loss. Consistent with these data, Table 8b reports that among S corporations and partnerships reporting $10,000 or fewer in gross receipts more than 50 percent of such entities operated at a loss in 2005. Nonfarm sole proprietorships more consistently reported profits at all size classes but the very smallest.

Tables 9a and 9b report similar results for C corporations. For C corporations reporting $50,000 or fewer in gross receipts, 50 percent or more reported net operating losses in 2005. In contrast to comparably sized S corporations and partnerships, 36 to 45 percent of C corporations reporting gross receipts between $50,000 and $1 million reported net operating losses, and the losses were of sufficient magnitude that aggregate C corporate income in those size categories was a loss.

Table 8a.–Distribution of Net Income by Gross Receipts and Entity Type, 2005

Firms classified by receipts	Net Income (millions of dollars) S Corporations	Partnerships	Nonfarm Sole Proprietorships
$0 or less	881	38,596	-2,911
$1 to $2,500	-635	-604	-5,650
$2,501 to $5,000	-414	-382	79
$5,001 to $10,000	-642	-120	6,479
$10,001 to $25,000	-899	-774	24,084
$25,001 to $50,000	34	-575	32,235
$50,001 to $100,000	2,858	336	48,594
$100,001 to $250,000	12,425	1,704	69,274
$250,001 to $500,000	15,136	3,210	42,002
$500,001 to $1,000,000	22,763	5,475	28,665
$1,000,001 to $10,000,000	92,847	41,696	24,068
$10,000,001 to $50,000,000	62,762	43,151	2,216
More than $50,000,000	75,787	177,265	784
Total	282,904	308,977	269,920

Table 8b.–Percent of Firms with a Net Operating Loss by Gross Receipts and Entity Type, 2005

Firms classified by receipts	S Corporations	Partnerships	Nonfarm Sole Proprietorships
$0 or less	56	26	81
$1 to $2,500	82	78	42
$2,501 to $5,000	75	72	30
$5,001 to $10,000	54	58	23
$10,001 to $25,000	47	45	16
$25,001 to $50,000	39	44	12
$50,001 to $100,000	30	32	10
$100,001 to $250,000	27	35	9
$250,001 to $500,000	26	32	10
$500,001 to $1,000,000	24	30	11
$1,000,001 to $10,000,000	18	37	13
$10,000,001 to $50,000,000	17	23	25
More than $50,000,000	11	21	44
All Revenues	33	30	25

* Details do not add to total due to rounding.

Table 9a.–Distribution of Net Income by Gross Receipts of C Corporations, 2005

Firms classified by receipts	Net Income (millions of dollars)
$0 or less	293,635
$1 to $2,500	-403
$2,501 to $5,000	-342
$5,001 to $10,000	-533
$10,001 to $25,000	-1,047
$25,001 to $50,000	-2,249
$50,001 to $100,000	-831
$100,001 to $250,000	-1,468
$250,001 to $500,000	-369
$500,001 to $1,000,000	-1,363
$1,000,001 to $10,000,000	12,305
$10,000,001 to $50,000,000	22,955
More than $50,000,000	1,345,462
Total	1,665,752

9b.–Percent of C Corporations with a Net Operating Loss by Gross Receipts, 2005

Firms classified by receipts	C Corporations
$0 or less	64
$1 to $2,500	66
$2,501 to $5,000	63
$5,001 to $10,000	58
$10,001 to $25,000	57
$25,001 to $50,000	50
$50,001 to $100,000	45
$100,001 to $250,000	43
$250,001 to $500,000	38
$500,001 to $1,000,000	36
$1,000,001 to $10,000,000	28
$10,000,001 to $50,000,000	21
More than $50,000,000	23
All Revenues	43

* Details do not add to total due to rounding.

III. CHOICE OF BUSINESS ENTITY

A. Present Law

1. In general

Businesses may be organized under a number of different legal forms. Owners of a business sometimes conduct their activities as "sole proprietorships," which do not involve a legal entity separate from the owner. However, for a variety of business or other reasons, a business often is conducted through a separate legal entity. Common reasons to use a separate legal entity include the ability to pool the capital and other resources of multiple owners, the protection of limited liability accorded by State law to the owners of qualifying entities (but generally not to sole proprietors), and an improved ability to access capital markets for investment capital.

The tax consequences of using a separate entity depend on the type of entity through which the business is conducted. Partnerships, certain closely-held corporations that elect to be taxed under subchapter S of the Code, and limited liability companies that are treated as partnerships are treated for Federal income tax purposes as pass-through entities whose owners take into account the income (whether or not distributed) or loss of the entity on their own tax returns. Generally, an entity whose ownership interests are publicly traded is not entitled to be treated as a partnership.[20]

In contrast, the income of a C corporation[21] is taxed directly at the corporate level. Shareholders are taxed on dividend distributions of the corporation's after-tax income. Shareholders are also taxed on any gain (including gain attributable to undistributed corporate income) on the disposition of their shares of stock of the corporation. Thus, the income of a C corporation may be subject to tax at both the corporate and shareholder levels.[22]

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[20] There are some exceptions for certain activities that can be conducted as publicly traded partnerships and not taxed as C corporations. See "Publicly traded partnerships," infra.

[21] A C corporation is a corporation that is subject to subchapter C of the Code, which provides rules for corporate and shareholder treatment of corporate distributions and adjustments. C corporations generally are subject to the corporate-level tax rate structure set forth in section 11 of the Code.

[22] Specialized investment entities organized as C corporations, such as regulated investment companies and real estate investment trusts, and certain interests in debt instruments, such as real estate mortgage investment conduits, are effectively subject to only one level of tax notwithstanding that their ownership interests may be publicly traded. These, and other specialized entities such as cooperatives and tax-exempt organizations, are generally beyond the scope of this discussion but are briefly described at Section III.A.3 of this document.

2. Federal income tax rates

Individual tax rates

U.S. individuals (citizens and residents) are taxed at graduated statutory rates ranging from 10 percent (for taxable income of up to $7,550 for single filers and up to $15,100 for married taxpayers filing joint returns or surviving spouses) to 35 percent (for taxable income over $336,550) for taxable year 2008. The intermediate rates are 15 percent, 25 percent, 28 percent, and 33 percent. The maximum tax rate on net long-term capital gains generally is 15 percent.[23] Dividends received by an individual from domestic corporations and qualified foreign corporations are taxed at the same rates that apply to capital gains.[24]

C corporation tax rates

In general

C corporations are taxed at statutory rates ranging from 15 percent (for taxable income up to $50,000) to 35 percent (for taxable income over $10,000,000). The intermediate rates are 25 percent (for taxable income above $50,000 but not exceeding $75,000) and 34 percent (for taxable income above $75,000 but not exceeding $10,000,000). The benefit of graduated rates below 34 percent is phased out for corporations with taxable income between $100,000 and $335,000, and the benefit of the 34 percent rate is phased out for corporations with taxable income in excess of $15,000,000. Corporate long-term capital gains are taxed at the same rates as corporate ordinary income. Thus, the maximum tax rate for corporate net long-term capital gains is 35 percent.

Certain domestic production activities are effectively taxed at lower rates by virtue of a deduction equal to a percentage of the income from such activities.[25] The deduction is equal to six percent of the income from manufacturing, construction, and certain other activities specified in the statute, for taxable years beginning in 2008 and 2009. Thereafter, the deduction is increased to nine percent. Thus, when the deduction is fully phased in, the tax rate for a C corporation on its domestic production activities income is effectively 31.85 percent.[26] A similar reduction applies to the graduated rates applicable to individuals.

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[23] Net gain from the sale of collectibles is taxed at a maximum 28 percent rate, while certain gain from the sale or exchange of depreciable real estate (i.e., "unrecaptured section 1250 property") is taxed at a maximum 25 percent rate. Under present law, for taxable years beginning after 2010, the maximum tax rate applicable to net long-term capital gains (other than collectibles or unrecaptured section 1250 property) will increase from 15 percent to 20 percent.

[24] Under present law, for taxable years beginning after 2010, dividends received by an individual are taxed at ordinary income rates.

[25] Sec. 199.

[26] Because of the nine-percent deduction, the taxpayer is taxed at a rate of 35 percent on only 91 percent of income, resulting in an effective tax rate of 31.85 percent.

Special rules

A number of provisions attempt to address situations in which individuals have an incentive to direct income to corporations, or where there is an incentive to direct or divide business activity or income among a number of separate corporations, to take advantage of lower corporate graduated rates. Certain related corporations are treated as one for purposes of the graduated corporate rates.[27] Also, certain "personal service corporations" are not entitled to use the graduated corporate rates below the 35-percent rate.[28] Such a corporation is one substantially all the activities of which involve the performance of services in certain fields,[29] and substantially all the stock of which is held directly or indirectly by employees performing services for such corporation, retirees, or certain estates or heirs of such persons. A separate provision allows the Secretary of the Treasury to reallocate income, deductions and other items between a differently defined "personal service corporation" and its owners, to prevent the avoidance of Federal income tax.[30] The Code also imposes a separate excise tax, at the top individual rate, on certain excessive corporate accumulations of earnings (a generally subjective standard),[31] and on specifically defined undistributed personal holding company income (generally passive income) in the case of a "personal holding company."[32] (These latter two rules

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[27] Sec. 1561.

[28] Sec. 11(b)(2) and sec. 448(d)(2). Such corporations are also, however, entitled to use the cash method of accounting.

[29] The fields are health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. Sec. 448(d)(2).

[30] Sec. 269A. A "personal service corporation" for this purpose is a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners (persons who own, or by attribution are deemed to own, more than 10 percent of the stock of the corporation). If substantially all the services of a personal service corporation are performed for or on behalf of one other entity, and the principal purpose of forming or availing of such personal service corporation is the avoidance or evasion of Federal income tax, the Secretary may reallocate items of income or deduction. The provision is in addition to the general provision of section 482 that permits reallocation of income, deductions or other items among related parties. See also section 1551.

[31] Secs. 531- 537. The accumulated earnings tax standard is subjective in that it requires a determination regarding the reasonable needs of the business. A significant amount of case law has developed around this standard. A credit generally permits accumulations of at least $250,000. This amount is reduced to $150,000 in the case of a corporation the principal function of which is the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

[32] Secs. 541-547. The personal holding company tax standard is very specific. The tax is not imposed unless at least 60 percent of gross income is from specified generally passive sources and more than 50 percent of the corporate stock is owned directly or indirectly by no more than 5 individuals (with specified attribution rules).

also would apply to encourage distributions and consequent shareholder tax, regardless of the corporate tax rate).

Alternative minimum tax

In addition, present law imposes a minimum tax on individuals and corporations to the extent their minimum tax liability exceeds their regular tax liability. The alternative minimum tax ("AMT") is imposed on corporations at the rate of 20 percent on the alternative minimum taxable income ("AMTI") in excess of a $40,000 phased-out exemption amount. The exemption amount is completely phased out for a corporation with AMTI in excess of $310,000.

A corporation with average gross receipts of less than $7.5 million for the prior three taxable years is exempt from the corporate minimum tax. The $7.5 million threshold is reduced to $5 million for the corporation's first three-taxable year period.

The AMT is imposed on individuals at a rate of 26 percent for the first $175,000[33] of AMTI in excess of a phased-out exemption amount and at a rate of 28 percent for amounts in excess of such amount. For taxable years beginning in 2007, the exemption amounts are: (1) $66,250 in the case of married individuals filing a joint return and surviving spouses; (2) $44,350 in the case of unmarried individuals other than surviving spouses; and (3) $33,125 in the case of married individuals filing a separate return.[34] The exemption amount is completely phased out for married individuals filing a joint return with AMTI in excess of $415,000. Similar phaseouts apply to other individual taxpayers.

AMTI is the taxpayer's regular taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. In general, the AMT applies a lower tax rate to a broader tax base. Specifically, the regular tax base is increased for AMT purposes by adding back certain items treated as tax preferences, and disallowing certain deductions and credits.

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[33] $87,500 in the case of married individuals filing a separate return.

[34] For years beginning after 2007, the exemption amounts are $45,000; $33,750; and $22,500, respectively.

3. Choice of entity

In general

As a general matter, it is not possible to relate the differences in the tax consequences that attend doing business in different legal entity forms to any substantive non-tax attributes of those legal forms, except that access to the public equity markets must generally be through a C corporation. The Code generally affords business enterprises and their owners the effective flexibility to elect one form or another without varying any of the meaningful non-tax substantive relationships among an enterprise and its owners.

In practice, this results in considerable variation in the choice of entity structure. For example, in 2005, there were approximately 2.0 million C corporation tax returns, 3.7 million S corporation tax returns, 2.8 million partnership returns, and 21.5 million non-farm sole proprietorship returns.

C corporations

The Code taxes a C corporation[35] as an entity separate from its shareholders. A C corporation's income generally is taxed when earned at the corporate level and is taxed again at the individual level when distributed as dividends[36] to its shareholders. Corporate deductions and credits reduce only corporate income and are not passed through to shareholders.

Corporate income that is not distributed to shareholders generally is subject to current tax at the corporate level only.[37] To the extent that income retained at the corporate level is reflected in an increased share value, the shareholder may be taxed at capital gains rates upon sale or

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[35] A corporation is a business entity organized under a Federal or State statute, or under a statute of a Federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation. Treas. Reg. sec. 301.7701-2(b)(1). A "C" corporation is one that is subject to all the provisions of subchapter C of the Code.

[36] Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock which, in general, are taxed to the shareholder at capital gains rates.

[37] In addition to the regular corporate tax, the Code provides for an additional tax paid by the corporation at the top individual rate, imposed on certain corporate earnings that are not distributed to shareholders. An "accumulated earnings tax" can be imposed on certain earnings in excess of $250,000 ($150,000 for certain service corporations in certain fields) accumulated beyond the reasonable needs of the business (secs. 531-537). A "personal holding company tax" is imposed on certain undistributed personal holding company income, generally where the corporation meets certain closely held stock requirements and more than 60 percent of the adjusted ordinary gross income (as defined) consists of certain passive-type income such as dividends, interest, and similar items (secs. 541-547). These and other special rules affecting the corporate tax rates are described in section III.A.2. of this document.

exchange (including certain redemptions) of the stock or upon liquidation of the corporation.[38] Foreign investors generally are exempt from U.S. income tax on capital gains, but are subject to withholding tax on dividends. Tax-exempt investors are not generally subject to tax on corporate distributions or on sales or exchanges of corporate stock.

The gain on appreciated corporate assets is generally subject to corporate level tax if they are distributed to the shareholders, yielding the same tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders.

In general, amounts paid as reasonable compensation to shareholders who are also employees are deductible by the corporation,[39] and are taxed as ordinary income at the individual level (unless a specific exclusion applies). On the other hand, amounts paid as dividends to shareholders generally are not deductible by the corporation and are taxed as income to the shareholders (generally at the same preferential rates as apply to capital gains, for dividends received prior to 2011). However, amounts paid to corporate shareholders as dividends are generally eligible for a dividends-received deduction for the recipient corporation that results in the recipient corporation being taxed on at most 30 percent and possibly on none of the dividend received.[40]

Investors in a C corporation receive different treatment depending upon whether an instrument is characterized as equity or debt for tax purposes.[41] Also, at the entity level, in

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[38] If stock is held until the death of the shareholder, the stock is given a fair market value basis at death, resulting in no shareholder level income tax on appreciation prior to death if the heirs sell the stock to a third party, or receive corporate distributions in the form of a redemption–i.e. a sale of their stock to the corporation. Present law is scheduled to provide a modified carryover basis rule in the case of estates of decedents dying in the year 2010.

[39] Annual compensation in excess of $1 million that is payable to the chief executive officer or the four other most highly compensated employees of a public corporation is not deductible unless the compensation qualifies as performance-based compensation or another exception applies. Sec. 162(m).

[40] The recipient corporation can generally claim a 100 percent dividends-received deduction if the recipient corporation owns 80 percent or more of the distributing corporation. If the recipient corporation owns less than 80 percent but at least 20 percent of the distributing corporation, the dividends-received deduction is 80 percent. If the recipient corporation owns less than 20 percent of the distributing corporation, the dividends-received deduction is 70 percent. There is no corporate exclusion with respect to interest received.

[41] Debt and equity investments also provide different consequences to certain investors in the pass-through regimes of partnerships and S corporations. For example, tax-exempt and foreign investors are generally not taxed on interest income from a partnership if they are debt investors, but generally would be taxed in their share of partnership income from business activity of the partnership if they are equity investors. The subchapter S rules do not permit foreign investors or certain tax-exempt investors to own stock of an S corporation. Those tax-exempt investors that may own S corporation stock, with the exception of ESOPs, are subject to an unrelated business income tax on their share of S corporation income. These factors can lead to a preference for structuring partnership or S corporation investment by such investors as debt.

general, interest paid by a C corporation is deductible but dividends paid are not.[42] The latter rule (especially when coupled with the ability of many tax exempt or foreign investors to exclude interest income) creates a tax incentive that generally favors debt over equity in a corporation's capital structure. However, in some special situations equity may be preferred to debt. For example, an issuing corporation with losses may prefer to issue preferred stock with characteristics similar to debt, effectively passing through some of the benefit of its losses to shareholders.[43] Foreign shareholders may prefer either dividend or interest income, depending on the tax treatment in their country of residence and the applicable U.S. corporate income tax and withholding tax rates.

The distinction between debt and equity depends on a number of factors. This determination requires an examination of the substance of the instrument. Generally, debt requires a promise to pay a fixed sum by a date certain, with a reasonable expectation that payment is made. Debt instruments can be constructed to have features of both debt and equity, including (1) contingent payments up to a high yield or (2) a significant economic risk that all payments may not be made. Similarly, equity instruments can be constructed to have features of debt, including increasing or decreasing dividends requirements and put-call arrangements, under which an issuer may be encouraged or expected to pay specified dividends and return the initial investment by a date certain.[44] Section 385 authorizes the Treasury Department to issue rules distinguishing debt from equity. Several sets of regulations have been proposed over the years, but none has been finalized and retained, and there are today no such proposed regulations.

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[42] If certain requirements are satisfied, dividends paid on stock held by an employee stock ownership plan are deductible by the corporation. Sec. 404(k).

[43] Distributions to shareholders by a loss corporation are taxed as dividends, with accompanying dividend treatment to shareholders, if the loss corporation had prior year earnings and profits that have not yet been distributed. If all earnings and profits have been distributed, distributions to shareholders would be nontaxable return of capital distributions, reducing the shareholders' basis in the stock.

[44] The Code limits the corporate interest deduction in specified situations. The Code provisions are based in part on case-law factors that distinguish debt from equity, but each Code provision turns on different facts and is narrowly applied to specific situations. The provisions include the following sections of the Code: Section 163(i) denies interest deductions on certain high-yield deferred payment discount obligations. The disallowed portion is treated as a dividend. Section 163(j) denies interest deductions for certain payments to tax-exempt related parties that exceed 50 percent of income if there is a greater than 1.5 to 1 debt to equity ratio. A carryover is allowed. Section 163(l) denies interest deductions on certain debt if a substantial amount of the principal or interest of the debt is payable in, or determined by reference to, equity of the issuer at the option of the issuer or a related party. The rules also apply if the choice to receive equity or amounts determined by reference to equity is at the option of the holder of the debt or a related party, if there is "substantial certainty" that the option will be exercised. Section 172(h) denies net operating loss carrybacks attributable to interest after certain corporate equity reduction transactions (generally, if there has been an acquisition of 50 percent of corporate stock, or an "excess" distribution). Carryforwards are allowed. Section 279 denies interest deductions for certain narrowly defined "corporate acquisition indebtedness."

The analysis of whether an instrument is debt or equity for Federal income tax purposes is not identical to the analysis of whether such instrument is characterized as debt or equity for financial reporting purposes. As a result, financial instruments are sometimes specifically structured to obtain differing treatment for tax and financial reporting purposes.

Shareholders receive different treatment depending on whether a corporate equity distribution is characterized as a dividend or as a payment in exchange for stock that is entitled to both capital gain treatment and basis recovery. While the tax rates for dividends and capital gains on stock are generally the same under present law, capital gain treatment permits basis recovery.[45] A number of Code provisions have attempted to provide guidance in this area. For example, section 302 provides rules to determine whether a shareholder whose stock has been partially redeemed has experienced a sufficient contraction in his or her interest to be treated as having sold the stock rather than as having received a dividend. Section 304 provides additional rules intended to deal with sales of stock to commonly controlled corporations.

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns.[46] A condition of electing to file a consolidated return is that all corporations that are members of the affiliated group must consent to all the consolidated return regulations prescribed prior to the last day prescribed by law for filing the consolidated return. The Treasury department has issued extensive consolidated return regulations under its authority to provide such rules. The regulations are generally directed toward preventing double taxation of income earned within the group, while preserving tax if assets or corporations that were members leave the group and preventing avoidance of tax due to shifting of attributes in the course of intragroup transactions.[47]

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[45] Foreign shareholders, in addition, may not be subject to tax at all on capital gains, though they are taxed (often at a reduced rate under tax treaties) on dividends. On the other hand, some corporate shareholders may prefer dividend treatment if they are eligible for the dividends-received deduction.

[46] An affiliated group for this purpose includes a parent corporation that directly owns 80 percent of the vote and value of the stock (excluding certain nonvoting preferred stock) of at least one subsidiary (causing that subsidiary to be a qualified member of the group) and other corporations of which qualified upper tier members in turn hold such stock ownership. Foreign corporations and certain other entities are not eligible to be members of such a group.

[47] Section 1502 of the Code states that "The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability, and in order to prevent the avoidance of such tax liability. In carrying out the preceding sentence, the Secretary may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns."

A C corporation is generally the entity of choice if a corporation anticipates a public offering, because publicly traded partnerships are generally taxed as corporations, and S corporations (discussed below) are not permitted to have more than 100 shareholders.[48]

Partnerships

Pass-through treatment

Business owners may choose to operate or invest through a "pass-through" entity, such as a partnership (including a State-law limited liability company or "LLC" that is considered a partnership for Federal tax purposes) or S corporation, either to avoid corporate tax treatment or for non-tax business reasons. Noncorporate tax treatment may be preferred because: (1) owners may not wish business earnings to be subject to two levels of tax (once when earned, and again when distributed); (2) the average or marginal tax rates for the individual shareholders may be lower than that of the corporation; and (3) owners may wish to use losses generated by the business to offset income from other sources.

Federal income tax treatment of partnerships

Partnerships generally are treated for Federal income tax purposes as pass-through entities, not subject to tax at the entity level.[49] Items of income (including tax-exempt income), gain, loss, deduction and credit of the partnership are taken into account in computing the tax of the partners (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners). Each partner takes into income such partner's distributive share of the partnership's taxable income and the separately allocable items of income, gain, loss, deduction, and credit.[50] A partner's deduction for partnership losses is limited to the amount of the partner's adjusted basis in his or her partnership interest.[51] To the extent a loss is not allowed due to a limitation, it generally is carried forward to the next year. A partner's basis in the partnership interest generally equals the sum of (1) such partner's capital contribution to

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[48] In some circumstances, it is possible that non-publicly traded entities also might choose to operate as C corporations, for example in order to obtain the benefit of a separate corporate rate bracket or the benefit of special corporate treatment (e.g., the dividends-received deduction) for earnings that are to be retained in the corporation. Appreciation in corporate assets generally is subject to corporate level tax when the assets are distributed to shareholders, and there is no lower rate for corporate capital gains. These factors generally would be a deterrent to placing assets into a C corporation. Nevertheless, there may be situations where lower effective corporate rates could provide benefits.

[49] Sec. 701.

[50] Sec. 702(a). The recognition of income under this rule does not necessarily correspond with any distribution of cash from the partnership to cover the tax liabilities of individual partners.

[51] Sec. 704(d). In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by partnership deductions (secs. 469 and 465). These limitations do not apply to corporate partners (except certain closely held corporations) and may not be important to individual partners who have partner level "passive income" from other investments.

the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) such partner's distributive share of losses allowed as a deduction and (2) any partnership distributions.[52]

Partnerships provide partners with a significant amount of flexibility to vary their respective shares of partnership income. Unlike corporations, partnerships may allocate items of income, gain, loss, deduction and credit among the partners, provided the allocations have substantial economic effect. In general, an allocation is permitted to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation, and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.

Limited liability companies

In the last 30 years,[53] States have enacted laws providing for another form of entity, the limited liability company ("LLC"). LLCs are generally treated as partnerships for Federal income tax purposes. They are neither partnerships nor corporations under applicable State law, but they generally provide limited liability to their owners for obligations of the business. Under regulations promulgated in 1996, any domestic non-publicly traded unincorporated entity with two or more members generally may elect to be treated as either a partnership or a corporation for Federal income tax purposes, while any single-member unincorporated entity may elect to be treated as a corporation or to be disregarded (i.e., treated as not separate from its owner[54]) for Federal income tax purposes.[55] These regulations, known as the "check-the-box" regulations, were a response, in part, to the growth of LLCs.

Publicly traded partnerships

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes (sec. 7704(a)). For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income (sec. 7704(c)(2)). However, this exception does not apply to any partnership that would be described in section

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[52] Sec. 705.

[53] The first LLC statute was enacted in Wyoming in 1977. All States (and the District of Columbia) now have an LLC statute, though the tax treatment of LLCs for State tax purposes may differ.

[54] Thus, where the single member is an individual, such a disregarded LLC will be treated as a sole proprietorship. Where the single member is a corporation, the LLC will be treated as a branch.

[55] Treas. Reg. sec. 301.7701-3.

851(a) if it were a domestic corporation, which includes a corporation registered under the Investment Company Act of 1940 as a management company or unit investment trust.

Qualifying income includes interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) in the case of a partnership, a principal activity of which is the buying and selling of such commodities, futures, options or forward contracts.

S corporations

An S corporation provides the Federal income tax advantage of pass-through treatment, and also retains the non-tax advantages of corporate status under Federal securities laws and State law. An S corporation and its shareholders are generally treated, for Federal income tax purposes, more like a partnership and its partners than like a C corporation and its shareholders. In order to make an election to be treated as an S corporation, a corporation must meet certain requirements primarily regarding its capital structure and the identity of its shareholders.

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock. Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock.[56] Although there are limitations on the types of shareholders and stock structure an S corporation may have, there is no limit on the asset size of such a corporation (as there is no limit on the size of a C corporation or partnership). Banks are permitted to be S corporations. And some formerly publicly traded corporations have been taken "private" as S corporations.

For Federal income tax purposes, an S corporation is generally not subject to tax at the corporate level.[57] Items of income (including tax-exempt income), gain, loss, deduction and credit of the corporation are taken into account in computing the tax of the shareholders (under the corporation's method of accounting and regardless of whether the income is distributed to the shareholders). A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in the S corporation stock and the indebtedness of the corporation to such shareholder. To the extent a loss is not allowed due to this limitation, the loss generally is

[56] Sec. 1362.

[57] Secs. 1363 and 1366.

carried forward to the next year. The shareholder's basis in the S corporation stock (and debt) is reduced by the shareholder's share of losses and (in the case of stock) by distributions and is increased by the shareholder's share of the corporation's income and contributions to capital.[58]

There are two principal exceptions to the general pass-through treatment of S corporations. Both are applicable only if the corporation was previously a C corporation and are generally intended to prevent avoidance of otherwise applicable C corporation tax consequences. First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if the corporation has subchapter C earnings and profits and has gross receipts more than 25 percent of which are passive investment income for the year.[59] Second, for the first 10 years after a corporation that was previously a regular C corporation elects to be an S corporation, certain net "built-in" capital gains of the corporation attributable to the period in which it was a C corporation are subject to tax at the corporate level.[60]

In general, an S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder's basis in the stock of the corporation or the corporation was formerly a C corporation and has undistributed earnings and profits.[61] To the extent of such earnings and profits, corporate distributions are treated as dividends of C corporations and generally are subject to tax as such in the hands of the shareholders.

Comparison of certain pass-through entities

Notwithstanding that they both provide for pass-through treatment, there are several significant Federal tax differences between S corporations and partnerships. First, corporate liabilities (other than those owed to its shareholders) are not included in a shareholder's basis of an interest in an S corporation. Thus, unlike a partner who can take deductions supported by certain partnership indebtedness, S corporation shareholders who wish to obtain similar types of deductions are required to borrow individually and contribute or re-lend such amounts to the S corporation to provide basis against which losses of the S corporation may be taken by the shareholder. Further, S corporations may have only one class of stock and, thus, do not offer the same flexibility as partnerships to allocate income and losses to different investors. In addition, if a tax-exempt entity (including any IRA or pension plan) is a equity investor in a partnership,

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[58] Sec. 1367.

[59] Sec. 1375. C corporation earnings and profits generally refers to the earnings of the corporation prior to its subchapter S election which would have been taxable as dividends if distributed to shareholders by the corporation prior to its subchapter S election. If the S corporation continues to have C corporation earnings and profits and has gross receipts more than 25 percent of which are passive investment income in each year for three consecutive years, the S corporation election is automatically terminated (sec. 1362(d)(3)).

[60] Sec. 1374.

[61] Sec. 1368.

its share of business income of the partnership is subject to unrelated business income tax. An S corporation likewise is not generally permitted to have a tax-exempt shareholder that is not subject to unrelated business income tax on S income, except that an ESOP is permitted to be a shareholder in an S corporation without unrelated business income tax. Below is a list of the principal differences in the taxation of the two types of entities and their owners:

Table 10.–Principal Differences in Taxation of Partnerships and S Corporations

Item	Partnerships	S Corporations
Maximum number of equity interests	No maximum number. (Partnerships with over 100 partners may elect a special pass-thru regime.)	Maximum number of shareholders is 100. Family members treated as one shareholder for this purpose.
Classes of equity interests	No limitation.	One class of stock. (Voting rights disregarded in making this determination.)
Ineligible entities	Generally, partnerships with equity interests that are publicly traded.	Foreign corporations; financial institutions using reserve method of accounting; insurance companies; possessions corporations; DISCs and former DISCs.
Eligible shareholders	All persons eligible.	Eligible shareholders include individuals, estates and certain trusts, charities, and qualified retirement plans.
Foreign taxpayers	Eligible to be a partner; effectively connected income subject to withholding tax.	Ineligible to be a shareholder.
Tax-exempt taxpayers	Eligible to be a partner; income subject to generally applicable unrelated business income tax	Tax-exempt taxpayers (other than charities and qualified retirement plans) ineligible to be a shareholder. All items of income and loss of charities and qualified retirement plans (other than ESOPs) included in unrelated business taxable income; items of income and loss of ESOPs not included in unrelated business taxable income.
Trusts	Eligible to be a partner; usual trust taxation rules apply.	Only qualified subchapter S trusts and electing small business trusts eligible as shareholders; special taxation rules apply.
Allocation of income and losses	Allocation in accordance with partnership agreement so long as allocation has substantial economic effect.	Pro rata among shares on a daily basis.
Limitation on losses	Losses limited to basis in partnership interest, which includes partner's share of partnership debt.	Losses limited to basis in stock and indebtedness of corporation to shareholder; no inclusion of corporate debt in shareholder basis.
Contributions of property to entity	Tax-free; built-in gain or loss allocated to contributing partner.	Tax-free (if control requirement met); no special allocation rules.

Item	Partnerships	S Corporations
Distributions of property (liquidating or otherwise)	Generally tax-free; carryover or substituted basis to partner; partnership may elect to make basis adjustment in partnership property to reflect adjustments to distributee partner.	Gain taxed to corporation; fair market value basis to shareholder; no basis adjustments to corporate property.
Transfer of equity interests	Gain treated as ordinary income to extent of ordinary income on assets held by partnership; partnership may elect to adjust basis of its assets with respect to transferee partner to reflect purchase price.	No ordinary income look-thru provision; no adjustments to basis of corporate property.
Termination of entity	Termination if sale or exchange of 50 percent or more of partnership interests within 12 months.	No provision.
Treatment of C corporation converting to partnership or S corporation.	Corporation must liquidate and gain or loss is recognized to corporation and shareholders.	Generally no taxation upon election; corporate tax is imposed on built-in gain if assets sold during 10 year period after election effective; distribution of subchapter C earnings and profits taxable as a dividend; special rules applicable to a corporation with accumulated earnings and excess net passive investment income.
Mergers, etc. with corporations	Not eligible to engage in tax-free reorganization with corporation.	Eligible party to a tax-free corporate reorganization.
Corporate tax rules of subchapter C	Rules inapplicable.	Rules generally applicable.
Wholly owned corporation	Corporation treated as separate entity.	Wholly owned subsidiary corporation may elect to be treated as part of parent S corporation.
Application of employment taxes	Except in the case of a limited partner, each partner's share of net business income is net earnings from self-employment.	Amounts paid as compensation are wages; no amounts are net earnings from self-employment.

Other entities

In general

In addition to partnerships, the Code provides for several other types of entities that generally are not taxed at the entity level.[62] However, those that allow public shareholders to invest in a vehicle that is not subject to entity-level tax generally are subject to restrictions regarding their structure, nature of income, nature of assets, and ownership of other entities. These limits reduce the potential for indirectly deriving non-permitted types of income through a related or controlled entity. Some of the restrictions limit the potential for extracting earnings of a taxable corporation as deductible amounts that reduce corporate-level tax when paid to the non-taxed entity.

Trusts

Regulations governing the classification of entities as trusts or corporations provide that trusts generally do not have associates (for example, shareholders) or an objective to carry on business for profit. Thus, a trust cannot generally conduct an active business of any kind, nor can it engage in the purchase and sale of assets for profit.

A grantor trust is a trust whose grantor has retained the right to exercise certain powers over the trust. A grantor trust is not treated as a separate taxable entity. Instead, the grantor is treated as the owner of the trust's property and is subject to tax on trust income.

Regulated investment companies

A regulated investment company ("RIC") is an entity that receives most of its income from passive investments in stock and securities, currencies and similar instruments; in common parlance, a mutual fund. A RIC must be an electing domestic corporation that, at all times during the taxable year, is registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or that has elected to be treated as a business development company under that Act. A RIC also is subject to specific requirements with respect to the source of its income and the nature of its assets.

A RIC is an untaxed entity because it deducts dividends paid to shareholders in computing its taxable income. The dividends generally are included in the RIC shareholders' income. Thus, distributed income of a RIC is taxed only at the shareholder level, not at the RIC level. A RIC generally is required to distribute at least 90 percent of its income during the

[62] The mechanisms for eliminating tax at the entity level differ among the types of entities. The entities are referred to here generally as "non-taxed" entities. They do not all pass through the character of the income received; and some are subject to corporate level tax to the extent they do not either distribute their income or designate undistributed income as currently taxable to their beneficial interest holders.

taxable year as dividends to shareholders. A RIC is subject to detailed restrictions on permitted assets and investments.[63]

If RIC stock is "stapled" to the stock of another entity (such that an interest in one changes hands together with the interest in the other) and if such "stapled" stock represents more than 50 percent in value of the beneficial ownership of each of the entities, then the two entities are treated as one.[64] These rules limit the degree to which the shareholders of the RIC may derive income that would not be qualifying income for the RIC indirectly through a related entity, while retaining RIC status for the amounts of income that do qualify. These rules also provide a limit on the extent to which a RIC that is commonly owned with a taxable corporation might extract business income from the corporation in the form of interest or other deductible payments, or by causing the corporation to bear expenses of the RIC's operations.

Real estate investment trusts

A real estate investment trust ("REIT") is an entity that derives most of its income from passive real-estate-related investments. A REIT must satisfy a number of tests on an annual basis that relate to the entity's organizational structure, the source of its income, and the nature of its assets. If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its investors each year generally is treated as a dividend deductible by the REIT and includible in income by its investors. In this manner, the distributed income of the REIT is not taxed at the entity level. The distributed income is taxed only at the investor level. A REIT generally is required to distribute 90 percent of its income (other than net capital gain) to its investors before the end of its taxable year.

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent income test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent income test"), including rents from real property (as defined) and gain from the sale or other disposition of real property. Amounts received as impermissible "tenant services income" are not treated as rents from real property.[65] In general, such amounts are for services

[63] At least 50 percent of the assets of a RIC must consist of (i) cash and cash items, Government securities, securities of other RICs, and (ii) any other securities, provided that for purposes of this 50-percent calculation, they must be securities as to which the RIC owns not more than 10 percent of the outstanding voting securities of any one issuer and that are not greater in value than 5 percent of the assets of the RIC. Not more than 25 percent of RIC assets may be invested in (i) the securities of any one issuer (other than certain government securities or securities of other RICs), (ii) securities (other than of other RICs) of two or more issuers which the taxpayer controls (defined as 20 percent of the voting power or value of the issuer) and that are engaged in the same or similar lines of business, or (iii) securities of one or more qualified publicly traded partnerships.

[64] Sec. 269B. These stapled stock restrictions also generally apply to real estate investment trusts (REITs).

[65] A REIT is not treated as providing services that produce impermissible tenant services income if such services are provided by an independent contractor from whom the REIT does not derive or receive any income. An independent contractor is defined as a person who does not own, directly or

rendered to tenants that are not "customarily furnished" in connection with the rental of real property.

Rents from real property, for purposes of the 95-percent and 75-percent income tests, generally do not include any amount received or accrued from any person in which the REIT owns, directly or indirectly, 10 percent or more of the vote or value.[66] An exception applies to rents received from a taxable REIT subsidiary ("TRS") if at least 90 percent of the leased space of the property is rented to persons other than a TRS or certain related persons, and if the rents from the TRS are substantially comparable to unrelated party rents.[67] A TRS may conduct business or receive income from activities that would generate non-qualifying income if conducted by the REIT that owns the TRS securities. However, a REIT may hold no more than 20 percent of the value of its total assets in securities of a TRS.[68] Transactions between a TRS and a REIT are subject to a number of specified rules that are intended to prevent the TRS (taxable as a separate corporate entity) from shifting taxable income from its activities to the non-taxed REIT, or from absorbing more than its share of expenses. Under one such rule, a 100-percent excise tax is imposed on rents, deductions, or interest paid by a TRS to a REIT, to the extent such items would exceed an arm's length amount as determined under section 482.[69]

Real estate mortgage investment conduits

A real estate mortgage investment conduit is an entity used for securitizing mortgages on real estate.[70] A real estate mortgage investment conduit is not subject to tax at the entity level (except for a 100-percent excise tax on prohibited transactions, which include the receipt of compensation for services or other non-permitted income). Income or loss of the real estate mortgage investment conduit is taken into account by the holders of interests in the real estate mortgage investment conduit. Real estate mortgage investment conduits are subject to restrictions on organizational structure, income, assets, and permitted transactions.

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indirectly, more than 35 percent of the shares of the REIT. Also, no more than 35 percent of the total shares of stock of an independent contractor (or of the interests in net assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35 percent or more of the interests in the REIT.

[66] Sec. 856(d)(2)(B).

[67] Sec. 856(d)(8).

[68] Sec. 856(c)(4)(B)(ii). For certain timber REITs, the 20 percent limit is increased to 25 percent, for a one-year period, under the Heartland, Habitat, Harvest, and Horticulture Act of 2008 (H.R. 2419, sec. 15314).

[69] If the excise tax applies, then the item is not reallocated back to the TRS under section 482.

[70] Sec. 860A.

Cooperatives

There are several types of cooperatives, including tax-exempt farmers' cooperatives and other corporations operating on a cooperative basis. In determining its taxable income, a cooperative does not take into account the amount of patronage dividends to patrons of the cooperative. The cooperative deducts other distributions, including dividends paid on capital stock, and amounts distributed on a patronage basis to patrons during the taxable year. Patrons of the cooperative include in their income the amount of patronage dividends and other distributions made on a patronage basis. Thus, these amounts are subject to tax in the hands of the patrons, but not in the hands of the cooperative. To this extent, a cooperative is treated as a passthrough entity.

A cooperative can be a publicly traded entity; however, only patrons are entitled to the benefits of the pass-through treatment through the dividends paid deduction. To the extent the earnings of the cooperative are allocated or distributed to public shareholders that are not dealing with the cooperative patrons, the cooperative is subject to corporate level tax.

B. Issues and Analysis

Background

In very general terms, it is not possible to relate the differences in the present tax treatment of different legal forms of doing business to any substantive non-tax attributes of these different legal forms.[71] Indeed, the Code generally affords business enterprises and their owners the effective flexibility to elect one tax regime or another without varying any of the meaningful non-tax substantive relationships among the enterprise and its owners. The availability of multiple entity types with different tax treatments may induce taxpayers to alter their behavior, at the possible cost of other economic business considerations, to obtain the maximum tax benefits or avoid adverse consequences of one or another form. The question therefore arises whether simplification and efficiency might be achieved by reducing the number of permitted tax regimes. A significant consideration in this regard would be the treatment of conversions from one form to another, including questions parallel to those that exist under present law as business owners operating through one form seek to convert to another.[72]

Clues to the historical understanding of the non-tax legal characteristics thought to justify entity level tax treatment may be found in the Treasury regulations (known as the Kintner regulations) that applied to determine whether a business entity was taxable as a corporation or a partnership, prior to the current "check the box" regulations.[73] Those regulations identified as the most fundamental corporate characteristics limited liability, continuity of life, centralization of management and free transferability of interests.[74] However, as practice and state laws subsequently evolved, most of these characteristics could in fact be achieved along with pass-

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[71] One exception, discussed below, is that a business that wishes to access the public capital markets generally must be taxed as a regular C corporation.

[72] Issues relating to entity conversions are discussed in Section IV of this document.

[73] Former Treas. Reg. sec. 301.7701-2. These regulations were a response to the decision in *U.S. v. Kintner*, 216 F.2d 418 (9th Cir. 1954). The classification issue arose in that case because of favorable pension plan rules applicable, at that time, to corporate employees but not to partners. The Kintner regulations generally made it more likely than did the previous entity classification rules that a business entity would be classified as a partnership rather than a corporation.

[74] The Kintner regulations provided that whether a business entity was taxed as a corporation or a partnership depended on which form of enterprise the entity "more nearly" resembled (former Treas. Reg. sec. 301.7701 2(a)). The regulations listed six corporate characteristics, two of which are common to corporations and partnerships: the presence of associates and an objective to carry on business and divide the gains therefrom. Whether an unincorporated organization was classified as a partnership or a corporation depended on whether the entity had more than two of the remaining four corporate characteristics: (1) continuity of life, (2) centralization of management, (3) limitation of liability for entity debts to entity property, and (4) free transferability of interests. The effect of the regulations generally was to classify an unincorporated entity as a partnership if it lacked any two or more of the four corporate characteristics, without further inquiry as to the strength or weakness of a particular characteristic or any evaluation of how the factors might affect overall resemblance to a partnership or a corporation. Former Treas. Reg. sec. 301.7701-(2) and (3).

through treatment for Federal income tax purposes. For example, limited partnerships could establish a single corporate general partner (effecting a large degree of limited liability)[75], and could use contractual arrangements among partners to continue the partnership in the event of a partner's withdrawal, or to require that consent to a partnership interest transfer could not be "unreasonably" withheld. The advent of LLCs, now available under the law of every State, offered a further level of limited liability without the use of a corporate partner. With these developments, tax classification under the Kintner regulations became largely elective, as a practical matter, for business entities other than traditional state law corporations. The Treasury Department replaced the Kintner regulations effective in 1997 with the check-the-box regulations, under which tax classification is elective for entities other than domestic state law corporations and their foreign equivalents.[76]

In fact, however, active businesses legally organized as corporations have long been able to obtain pass-through tax treatment, without regard to the limitations imposed by the former Kintner regulations or the current check-the-box regulations.[77] The S corporation rules, enacted in 1958, permit a corporation and its shareholders to elect one level of tax on business income.[78] The S corporation rules were provided for the purpose of allowing business owners both limited liability and pass-through tax treatment. Originally, the S corporation was conceived as a simple structure that did not permit potential shifting of tax benefits and thus did not require the more elaborate rules attending partnership structure. Only one type of shareholder was permitted (U.S.

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[75] A corporate general partner, even though itself a limited liability entity, would not cause a partnership to be treated as a corporation, under the IRS ruling position, if that partner had assets equal to or greater than 10 percent of the total contributions to the partnership. Rev. Rul. 92-88, 1992-2 C.B. 496. Some taxpayers successfully contended that even this capitalization requirement was not necessary so long as the corporate general partner was not a "dummy" acting as the agent of the limited partners. See *Larson v. Commissioner*, 66 T.C. 158 (1976), acq. 1979-1 C.B.1.

[76] Treas. Reg. sec. 301.7701-3.

[77] Federal tax law also provides for one level of tax on the income of corporations with specialized types of assets and income, such as securities income (regulated investment companies or RICs), or real estate income (real estate investment trusts or REITs), provided limitations and requirements are met. In general, however, these entities are not permitted to conduct an active business. Cooperatives are an additional form that is permitted to conduct an active business but that are subject to entity level tax if their business is conducted beyond the scope of their "members." The present-law rules governing RICs and REITs, as well as other specialized types of business entities whose income is subject to one level of tax, are described in section III.A.3 of this document.

[78] The present-law rules governing S corporations are described in section III.A.3 of this document. The purposes of the provisions were said to be to remove the influence of taxes on the selection of legal forms, to allow corporate income to be taxed at the individual level, and to permit losses to pass through to shareholders for use against other income. At the time, partnership form did not provide the same limited liability protection as corporate form, and individual rates were generally lower than the corporate rates. See Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, Seventh Edition (2006) par. 6.01; S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958), reprinted at 1958-3 C.B. 922, 1137.

individuals), the number of such shareholders was restricted (originally no more than 10 shareholders), and no more than one class of stock could be issued. Over the years, however, some of the shareholder restrictions on S corporation use have been relaxed. Most of the changes have simply expanded the number of permitted shareholders (today, 100, with expanded attribution rules), or have permitted the accommodation of certain family trust situations that are thought to approximate individual shareholders.[79] However, one very significant change now permits S corporations to offer a unique benefit, in which one specific type of tax-exempt shareholder (an ESOP) can be attributed business profits without the usual unrelated business income tax that would occur in a partnership.[80]

In light of the developments described above, the principal remaining circumstance in which the tax treatment of a business entity bears a direct relationship to a non-tax characteristic is the treatment of publicly traded entities. Under present law, access to public capital markets generally requires use of the C corporation form with entity level tax. This result may be of practical administrative importance, since the IRS need not depend upon accurate filing by potentially thousands of partners whose interests may be constantly changing through public trading (and some of whom may be tax-exempt or foreign), nor must the IRS separately deal with each of these partners to collect any taxes due. The situation also may provide some element of convenience to investors, who are not required to file separate partnership returns for each state in which the enterprise conducts business, and who need not separately identify on their returns each item of deduction or credit, or of the various categories of income with potentially different tax treatments.

A significant aspect of the check-the-box regulations is that they make the rules treating publicly traded partnerships as corporations more important. Under the check-the-box regulations, the four factors set forth in the prior regulations -- centralized management, continuity of life, free transferability of interests, and limited liability of owners -- generally are irrelevant. To a much greater degree, the issue of whether an entity must be treated as a corporation for Federal tax purposes now depends on whether interests in the partnership are publicly traded.[81] Whether the entity is a corporation for State law purposes is not part of this determination.

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[79] Also, in recognition of the fact that banks can be S corporations, special rules were provided for certain bank directors shares, to assure these would not be considered a second class of stock that could jeopardize S qualification.

[80] The following statement appears in the First Quarter 2008 10-Q of the Tribune Company with respect to the S election and ESOP shareholding of the Company: "As a result of the election and in accordance with FASB Statement 109, 'Accounting for Income Taxes', the Company has eliminated approximately $1,819 million of net deferred tax liabilities as of Dec. 31, 2007, and has recorded such adjustment as a reduction in the Company's provision for income tax expense for the first quarter of 2008." Tribune Company Form 10-Q, First quarter 2008, p.7, n. 3, available on the internet at http://www.sec.gov/Archives/edgar/data/726513/000072651308000018/firstquarter10q2008.htm.

[81] Sec. 7704. These rules are described in section III.A.3 of this document. When the publicly traded partnership rules were enacted in 1987, the Kintner entity classification rules were still in effect.

The rules generally treating publicly traded partnerships as corporations were enacted in 1987 to address concern about long-term erosion of the corporate tax base. At that time, Congress stated, "[t]o the extent that activities would otherwise be conducted in corporate form, and earnings would be subject to two levels of tax (at the corporate and shareholder levels), the growth of publicly traded partnerships engaged in such activities tends to jeopardize the corporate tax base."[82] Referring to recent tax law changes affecting corporations, the Congress stated, "[t]hese changes reflect an intent to preserve the corporate level tax. The committee is concerned that the intent of these changes is being circumvented by the growth of publicly traded partnerships that are taking advantage of an unintended opportunity for disincorporation and elective integration of the corporate and shareholder levels of tax."[83]

Possible simplification

Reduction in the number of different tax regimes for business entities arguably could achieve greater neutrality and greater simplicity.[84] For example, if it were determined that fundamental non-tax distinctions between corporate-type entities, and non-corporate entities (such as public trading of interests) merit retention of the corporate tax regime, neutrality and simplicity might be improved by having only one other tax regime permitting single-level taxation of business entities. Such a regime for non-publicly traded entities might resemble the partnership regime in its ability to distinguish among labor income and capital income of

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Within the narrow context of the Kintner regulations, the publicly traded partnership rules could be viewed either as a backstop to the entity classification rules as they existed in 1987, or as a fundamental policy determination that public trading (and the resulting access to public capital markets) is the most important factor in deciding whether an entity should be taxed as a corporation. The publicly traded partnership rules also implicitly acknowledge the administrative difficulty of maintaining fungibility of publicly traded interests in a passthrough entity.

[82] H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1065.

[83] H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1066.

[84] See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System,* JCS 3-01, April 2001, at 269-277, discussing options for reducing the number of passthrough tax regimes in the law, and describing proposals to modify existing regimes, including a unified passthrough entity regime and repeal of the S corporation rules. A number of the types of pass-through entities provided under present law do not overlap. Many of them are special-purpose vehicles designed for particular lines of business or types of transactions. These regimes provide not only pass-through treatment, but also special rules targeted to particular economic activity. In addition, the rules governing cooperatives, although not exclusively limited to a particular line of business, provide certainty for a particular method of doing business, that is, in cooperative form, with distributions or allocations to patrons of the cooperative. The provisions governing cooperatives might be viewed as a further example of a targeted type of pass-through entity. Also, one type of pass-through entity provided under present law differs from all the rest, in that a trust generally is not used for the purpose of conducting business activities.

partners and allocate such income in accordance with the nature of the partner's interest in the partnership.

Possible unified pass-through entity regime

Under a hypothetical unified pass-through regime, any domestic business entity, whether a corporation, partnership or limited liability company, could elect to be treated as a pass-through entity. The two-tier system for taxing income of a corporation under subchapter C of the Code would be retained for non-electing entities. Either the present-law partnership rules, or the present-law S corporation rules, could be selected as the pass-through paradigm.

Selecting the partnership rules would have the advantage of permitting taxpayers greater flexibility than is available under the S corporation rules. While the partnership regime has been criticized as complex and opaque, a partnership need not be complex. Using the flexible partnership tax rules, taxpayers either can establish a very simple venture along the lines of an S corporation, with per-interest, per-day allocations to owners, or can set up a complex business arrangement with different classes of interests and special allocations of particular items to match the tax results to the business arrangement. In either case, so long as the partnership tax rules are observed, the entity through which the venture is conducted can be treated as a pass-through for tax purposes.

The partnership regime has also been criticized as manipulable and susceptible of tax avoidance, and these administrability concerns would have to be addressed in devising a single pass-through regime. In addition, allowing existing corporations to elect partnership status would raise administrative, revenue and equity concerns that might outweigh the simplification benefit for taxpayers. For example, because it may not be feasible to allocate entity income among existing stock interests, this approach might require a corporation to formally liquidate and reorganize as an unincorporated business. Under present law, many corporations have not undergone such transactions because of the applicable corporate and shareholder taxes. To address revenue concerns, a toll charge could be imposed on a corporate-to-partnership conversion based upon a portion of the gain that would be recognized on a fully taxable liquidation. Different toll charges could apply to electing C corporations and S corporations. In addition, it would be necessary to consider whether the election should be limited, e.g., to non-publicly traded domestic corporations or to corporations below a certain size, or by allowing existing corporations to elect only for a limited time.

Further, significant transitional issues would result from adopting a unified passthrough entity regime based on the partnership rules. For example, currently approximately 3.7 million S corporations are in existence, many of them the vehicle for small business ventures. Forcing these businesses to adopt a new business form, even after a waiting period of several years, would not constitute simplification for those taxpayers. Alternatively, maintaining the S corporation rules indefinitely for these existing corporations, but not allowing the formation of new S corporations, would not achieve the simplification goal of reducing the number of pass-through regimes in the tax law. Preventing the formation of new S corporations while permitting the continuation of existing ones might be perceived as unfair or arbitrary, as well as maintaining the complexity of current law.

It is also argued that both the S corporation and the partnership tax rules are too complex for small businesses, and that a new, much simpler pass-through regime just for small businesses should be added to the tax law. Partnership and S corporation tax treatment would be reserved for larger or more sophisticated business ventures. Under this view, repeal of the S corporation rules would not achieve simplification for unsophisticated taxpayers.[85] In addition, more taxpayers would be exposed to the partnership rules, which some argue can be complex in certain circumstances.

[85] *See* George K. Yin and David J. Shakow, *Reforming and Simplifying the Income Taxation of Private Business Enterprises,* Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Vol. III, Academic Papers Submitted to the Joint Committee on Taxation,* JCS-3-01, April 2001, p. 220.

IV. CONVERSIONS OF ENTITY FORM

A. Present Law

Conversion from C corporation to other entity forms

In general

Present law makes the S corporation an attractive vehicle to convert from the potential double tax regime of a C corporation to a single tax regime, for future corporate earnings and for C corporation net built-in gain that is not recognized within the 10 years after conversion. Transition to an S corporation allows a C corporation engaged in business to move to a single level of tax on future earnings, while retaining the C corporation consequences for some built-in gain and for retained earnings that existed at the time of the conversion. If a C corporation converts to a different entity form that is not subject to corporate-level tax, various rules prevent the elimination of corporate level tax on the corporate-level gains that existed at the time of the conversion.

Conversion from C corporation to partnership

If the conversion is to a partnership or LLC form, the C corporation is treated as liquidating and all corporate-level built-in gain is subject to tax at the time of the conversion. In addition, the shareholders obtain a fair market value basis of any property deemed distributed to them, and recognize gain to the extent the value received exceeds their basis in the C corporation stock.

Conversion from C corporation to S corporation

However, if the C corporation conversion is to S corporation form, there is no immediate tax consequence. A corporate level tax is imposed on net built-in gains that are recognized within the 10-year period following the conversion.[86] Also, undistributed earnings and profits of the C corporation at the time of conversion are subject to shareholder level tax as a dividend when distributed. However, such earnings and profits are generally not deemed to be distributed until total distributions exceed the distribution of all new S corporation earnings that have been treated as income of the shareholders following the conversion.[87]

An additional rule tracks certain passive investment income of an S corporation with former C corporation earnings and profits. If more than 25 percent of the gross receipts of such an S corporation consist of certain types of passive investment income, the excess passive investment income is subject to tax at the highest corporate rate. In addition, if there is excess

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[86] Sec. 1374. Certain corporate level attributes from prior C corporation status, such as otherwise permitted loss or business credit carryforwards, can be used to the extent C corporation rules would generally have permitted such use, against any such built in corporate level gains.

[87] Sec. 1368.

passive investment income and prior C corporation earnings and profits for three consecutive years, the S corporation loses its S status.[88]

Conversion from S corporation to partnership

In general, if an S corporation becomes a partnership, the transaction is treated as a liquidation of the S corporation that produces a single level of tax on gain in corporate assets. Under the rules of subchapter C that apply to S corporations, the S corporation's distribution of gain assets in liquidation gives rise to a corporate-level gain (as if the assets had been sold).[89] This gain is passed through to the shareholders and results in stock basis step-up to the shareholders under the S corporation rules.[90] Shareholders recognize gain or loss based upon the difference between the value of the assets received and their basis in the stock. The assets have a fair market value basis in the hands of the shareholders (and the new partnership).[91]

If the S corporation has built-in gain assets from its own prior C corporation status or from a tax free combination with a C corporation, and such assets do not satisfy the 10-year holding period of section 1374, then a built-in gain tax at corporate rates under section 1374 is imposed.

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[88] Sec. 1375 and sec. 1362(d)(3).

[89] Sec. 336 and sec. 1371.

[90] Sec. 1366 and sec. 1367.

[91] If a shareholder had a fair market value basis in the S corporation stock immediately prior to the liquidation (for example, because of recently purchasing the stock), and the inside assets still had unrealized built-in gain, then the basis step up in the stock from any corporate level gain would generally create an offsetting loss in the stock on the liquidation. However, it is possible that some of the gain items from the deemed sale of corporate assets might be ordinary in character (as one example, under section 1245 recapture rules), while the loss would be capital. In such a case, the loss could be subject to limitations with respect to offsetting the ordinary income gain. In such a case, the shareholder who had sold to the new shareholder would also presumably have recognized a capital gain on the sale of his or her stock.

B. Issues and Analysis

Conversion from C corporation to S corporation

Proposals to reduce built in gain holding period

Some have suggested shortening the 10-year period after conversion from C corporation to S corporation status, during which the built-in gains tax is imposed. For example, several bills have been introduced that would shorten the time period to 7 years following a conversion to S corporation status.[92]

The present-law 10-year period was intended to provide a sufficiently long holding period that conversion to S corporation form would not be an immediate escape from corporate level tax on asset sales. The same ten-year period currently applies (by reference to the S corporation rules of section 1374) under Treasury regulations for situations in which a C corporation merges with or otherwise becomes a REIT or RIC, special entity types that are required to make certain types of investments and that are not subject to corporate level tax provided they distribute or make deemed distributions of taxable income each year to their shareholders.[93] In cases involving S corporations that are owned by ESOPs, any sales of built in gain property after the 10 years may be subject to no tax at all at the time of sale (rather than one level of tax at the time of sale).

Proposals to change the passive investment income rules

Other proposals would (i) eliminate the rule that causes loss of S corporation status if certain passive income exceeds 25 percent of gross income for three consecutive years and if the S corporation had C corporation earnings and profits, and (ii) increase the amount of passive investment income that could be received in any year without corporate level tax.[94]

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[92] See, e.g., S. 3063 (introduced in the Senate on May 28, 2008); H.R. 4840 (introduced in the House of Representatives on Dec. 19, 2007); and H.R. 3874 (introduced in the House of Representatives on October 17, 2007).

[93] Treas. Reg. sec. 1.337(d)-7. The regulations permit an election to have immediate recognition of all built in gain in such cases, if desired. Such an election might be desirable if the acquiring entity wants to obtain a stepped up basis in the assets and avoid having to track or delay their sale, especially if the C corporation had losses or other attributes that might reduce the impact of the immediate recognition event.

[94] The Joint Committee on Taxation staff presented options that would (i) eliminate the provision that S corporation status can terminate due to excess passive investment income, and (ii) impose corporate tax on excess passive investment income only when passive investment income exceeds 60 percent (as opposed to 25 percent) of gross receipts. Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (April 2001) Vol. II, at pp. 295-296. S. 3063, introduced May 22, 2008, contains similar provisions.

Prior to the early 1980's, the corporate tax rates historically had been substantially lower than the maximum individual tax rate, so that earnings that had been accumulated by a C corporation had not been subject to tax at the higher individual rates. The excess passive income rules were generally intended to prevent a C corporation that had accumulated earnings at low corporate rates from electing S status and thereafter allowing distributions of current earnings with only one level of tax,[95] (rather than becoming subject to the personal holding company tax, or liquidating and incurring capital gains tax for shareholders).[96] Since 1981, however, the corporate tax rates and the maximum individual tax rate have become much closer, and the capital gains tax rate on individuals has been reduced, thereby lessening the need for these rules.

Conversion from S corporation to partnership or LLC status

Some have suggested that an S corporation should be permitted to convert to partnership or LLC status without immediate tax consequences.[97] Such a tax-free conversion would permit greater flexibility to provide different types of interests to different investors or employees (since an S corporation may only have one class of stock and may have no more than 100 shareholders). It would also permit the subsequent distribution of built-in-gain property to investors without the immediate tax required by the corporate rules, and could provide additional flexibility for certain estate planning structures that depend on creating different classes of

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[95] Although the S corporation rules tax distributions of accumulated earnings and profits, they are stacked last after distributions of current earnings. Also, on liquidation of an S corporation and distribution of all its assets, there is only one level of tax, at shareholder rates, to the extent the amount distributed exceeds the basis of the shareholder's stock.

[96] See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (April 2001) Vol. II, at pp. 295-296.

[97] See, e.g., H.R. 2337 (introduced on June 27, 2001). This bill would have applied only to S corporations that have had a valid S election in effect for at least ten taxable years. See also, for example, S. 1904, introduced in the Senate in 1999 (requiring a valid S election for all taxable years of the corporation beginning on or after January 1, 1990); as well as reported comments of a Clinton administration official ("Samuels Suggests Giving Converting S Corporations 'Check the Box' Partnership Election," Tax Notes Today, 95 TNT 146026 (July 27, 1995) reported in New York State Bar Association Tax Section comments on H.R. 2337, May 17, 2002 (hereafter, "NY State Bar Report"). The NY State Bar Report also states that "a majority of our Committee supports legislation to permit certain S corporations to convert to partnerships on a tax-free basis…" but also expresses caution about certain "significant policy and technical issues that must be carefully analyzed…"(pp 2-3).

interests in an entity: for example, interests with different participations in future appreciation.[98] Such proposals raise a number of policy issues.[99]

First, even if an S corporation has never been a C corporation, the change of form will occur at a time when it is likely that certain elements of the partnership rules cannot be implemented directly and certain presumptions would have to be substituted. As one example, the partnership rules generally attribute any built-in gain in property, at the time of a property contribution to a partnership, to the contributing partner when that gain is later realized by the partnership. The partnership rules also treat certain contributions and distributions of property as constructive sales of property among the partners. S corporation rules do not have comparable provisions. It might be necessary to adopt certain tracing rules to prevent the use of S corporation status, followed by a partnership election, from circumventing the partnership rules.

Some have suggested allowing a conversion election to be made only by S corporations that have been in existence for at least 10 years, possibly on the theory that this time period might deter certain types of planning. Moreover, it has been argued that State LLC entity forms and the "check the box" Treasury regulations first become effective in the 1990's, so that more recently electing entities would presumably have chosen S status because of their preference for that form, rather than because they were otherwise prevented by State law and Treasury regulations from choosing pass-through form with limited liability at their inception. This type of limitation has been criticized on grounds of fairness and lack of direct relationship to the timing of either the "check the box" regulations or of the increased commercial acceptance of doing business in non-corporate form.[100] Furthermore, whether before or after the "check the box" Treasury regulations, there has been significant flexibility in choice of form, and there may have been advantages to S corporation status (for example, the ability to engage in a tax free reorganization a later date, or to dispose of entity stock without any potential for ordinary income treatment under the partnership rules,[101] or to offer corporate incentive stock options to employees) that motivated the taxpayer's original choice of form.

The case of an S corporation that was previously a C corporation presents additional issues.[102] The ability of a partnership to distribute appreciated property to owners without

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[98] S corporations might be able to become partners in partnerships that approximate some of the results relating to number of owners, types of interests, and estate planning techniques; however, there may be limitations on the degree of flexibility that would be attained by this structure as compared to the pure partnership or LLC treatment.

[99] Absent a special rule, conversion of an S corporation to a partnership form would generally result in a single level of tax on gain in corporate assets, as well as an additional level of tax if the corporation had previously been a C corporation subject to the 10-year built in gain rule of section 1374.

[100] See NY State Bar Report, *supra*., pp 3-6.

[101] Compare section 751(a).

[102] See NY State Bar Report, *supra.*, pp. 5-8.

current tax is a significant shift from corporate tax principles. Some argue that if the 10-year holding period of section 1374 has been satisfied then there is no inconsistency with the C corporation rules. However, even the S corporation rules impose a single level of tax on distributions of gain property, which would not occur in a partnership.[103] Further issues include tracking previous C corporation earnings and profits, and imposing shareholder level tax on distributions of such earnings and profits with some appropriate interface with the partnership rules that generally permit tax-free distributions.

[103] One possibility might be the imposition of a toll charge of some sort on the conversion of an S corporation that was previously a C corporation.

V. PAYROLL TAXES

A. Present Law

In general

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act (the FICA tax).[104] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act (the SECA or self-employment tax).[105]

FICA tax

In general

The FICA tax has two components. Under the old-age, survivors, and disability insurance component (OADSI), the rate of tax is 12.40 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[106] The amount of wages subject to this component is capped at $102,000 for 2008. Under the hospital insurance component (HI), the rate is 2.90 percent, also split equally between the employer and the employee. The amount of wages subject to the HI component of the tax is not capped. The wages of individuals employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax.

S corporation shareholders

An S corporation is treated as a pass-through entity for Federal income tax purposes, and its income generally is taxed to the shareholders. A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages, but generally is not subject to FICA tax on amounts that are not wages (such as distributions to shareholders).[107] Nevertheless, an S corporation employee is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized as other than wages. A significant body of case law has addressed the issue of whether amounts paid to shareholder-employees of S corporations constitute reasonable

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[104] See Chapter 21 of the Code.

[105] Sec. 1401.

[106] Secs. 3101 and 3111.

[107] Though unrelated to the FICA tax, present law provides that an S corporation is treated as a partnership and a two-percent shareholder is treated as a partner, for purposes of applying rules relating to employee fringe benefits. Sec. 1372.

compensation and therefore are wages subject to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.[108]

In cases addressing whether payments to an S corporation shareholder-employee were wages for services or were corporate distributions, courts have recharacterized a portion of corporate distributions as wages if the shareholder performing services did not include any amount as wages.[109] In recent cases involving whether reasonable compensation was paid (not exclusively in the S corporation context), courts have applied a multi-factor test to determine reasonable compensation, including such factors as whether the individual's compensation was comparable to compensation paid at comparable firms.[110] The Seventh Circuit, however, has adopted an "independent investor" analysis differing from the multi-factor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he was compensated.[111] The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.[112]

Self-employment tax

In general

The self-employment tax rate has two components. Under the OASDI component, the rate of tax is 12.40 percent. Under the HI component, the rate is 2.90 percent. The amount subject to self-employment tax under the OASDI component is capped at $102,000 of self-employment income (for 2008). However, the amount of self-employment income subject to the HI component is not capped.

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[108] See, e.g., *Renewed Focus on S Corp. Officer Compensation*, AICPA Tax Division's S Corporation Taxation Technical Resource Panel, Tax Advisor, May 2004, at 280.

[109] *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, e.g., *Joseph M. Grey Public Accountant, P.C., v. U.S.*, 119 T.C. 121 (2002), *aff'd*, 93 Fed. Appx. 473, 3d Cir., April 7, 2004, and *Nu-Look Design, Inc. v. Comm'r*, 356 F.2d 290 (3d Cir. 2004), in which an officer and sole shareholder of an S corporation argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to employment tax.

[110] See, e.g., *Haffner's Service Stations, Inc. v. Commissioner*, 326 F.3d 1 (1st Cir. 2003).

[111] *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

[112] In *Metro Leasing and Dev. Corp. v. Commissioner*, (9th Cir. 2004) at 10-11, the Ninth Circuit court noted that it is helpful to consider the perspective of an independent investor, and pointed to other Circuits that apply the multi-factor test through the lens of the independent investor test, citing *RAPCO Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996).

In the case of an individual with self-employment income, the income subject to self-employment tax is the net earnings from self-employment.[113] This equals the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules. Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

Partners (including LLC members)

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership. This rule applies to individuals who are general partners. Specified types of income or loss are excluded from net earnings from self-employment of a partner, such as rentals from real estate in certain circumstances, dividends and interest, gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers, and retirement payments from the partnership if the partner rendered no services for the partnership and certain other requirements are met.

A special rule applies for limited partners of a partnership.[114] In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services. This special rule reflects State law at the time it was enacted in 1977, under which limited partners ordinarily were not permitted to participate in management of the partnership's activities without losing their limited liability protection.[115] In recent years, State law has been

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[113] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes (sec. 164(f)).

[114] Sec. 1402(a)(13). For this purpose, limited partner status is determined under State law.

[115] Social Security Amendments of 1977 (Pub. L. No. 95-216). The exclusion of limited partners from the self-employment tax (except with respect to guaranteed payments for services) reflects the perception at that time that the value of accruing benefits under the Social Security system outweighed the tax cost, and that limited partnerships were used for investment rather than for service businesses. See

changing, with the result that individuals who are limited partners under applicable State law may participate in the management and operations of the partnership without jeopardizing their limited liability.[116] This change in the State law rules for limited partners parallels the expansion of limited liability companies.

Historical background

Limited liability companies are a relatively new form of business entity provided under State law, in which members generally may participate in the management and operations of the business, though they are protected from liability for its debts and obligations. Limited liability companies generally may choose to be classified as partnerships rather than as corporations for Federal income tax purposes. The owners of a limited liability company that is classified as a partnership for tax purposes are treated as partners for Federal income tax purposes. However, under State law, limited liability company owners are not defined as either general partners or limited partners.

In 1997, the Treasury Department issued proposed regulations defining a limited partner for purposes of the self-employment tax rules.[117] These regulations provided, among other things, that an individual is not a limited partner if the individual participates in the partnership business for more than 500 hours during the taxable year.

In response, in the Taxpayer Relief Act of 1997, the Congress imposed a moratorium on regulations regarding employment taxes of limited partners. The moratorium provided that any regulations relating to the definition of a limited partner for self-employment tax purposes could not be issued or effective before July 1, 1998. No regulations have been proposed or finalized since then.

Patricia E. Dilley, *Breaking the Glass Slipper - Reflections on the Self-Employment Tax*, 54 Tax Law. 65 (Fall 2000), at note 91.

[116] See, e.g., Revised Uniform Limited Partnership Act (2001), sec. 303, providing, "[a]n obligation of a limited partnership, whether arising in contract, tort, or otherwise, is not the obligation of a limited partner. A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership."

[117] Prop. Treas. Reg. sec. 1.1402(a)-2 (January 13, 1997).

B. Description of Proposals for Modification of Payroll Tax Rules

2005 Joint Committee on Taxation staff proposal ("2005 proposal")[118]

Treatment of partners

In 2005, the Joint Committee on Taxation staff proposed a change to the payroll tax rules for partners and S corporation shareholders. Under the proposal, the present-law rule for general partners generally applies to any partner for determining net earnings from self-employment. Thus, all partners are subject to self-employment tax on their distributive share (whether or not distributed) of partnership income or loss. As under present law, specified types of income or loss are excluded from net earnings from self-employment of a partner, such as certain rental income, dividends and interest, certain gains, and other items. However, under the proposal, in the case of a service partnership, all of the partner's net income from the partnership is treated as net earnings from self-employment. A service partnership is a partnership, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to sec. 448(d)(2)).

If, however, any partner (regardless of whether he or she is a general partner, limited partner, or neither a general nor limited partner, such as a limited liability company member) does not materially participate in the trade or business of the partnership, a special rule provides that only the partner's reasonable compensation from the partnership is treated as net earnings from self-employment. Thus, some general partners who would be subject to self-employment tax on their distributive share of partnership income under present law will be subject to tax only on reasonable compensation from the partnership under the proposal.

Treatment of S corporation shareholders

Under the proposal, for purposes of employment tax, an S corporation is treated as a partnership and any shareholders of the S corporation are treated as general partners. Thus, S corporation shareholders are subject to self-employment tax on their shares of S corporation net income (whether or not distributed) or loss. As under the present-law self-employment tax rules, specified types of income or loss are excluded from net earnings from self-employment of a shareholder, such as certain rental income, dividends and interest, certain gains, and other items. However, under the proposal, in the case of a service business, all of the shareholder's net income from the S corporation is treated as net earnings from self-employment. A service S corporation is an S corporation, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to sec. 448(d)(2)).

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[118] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05, January 27, 2005, 95.

If a shareholder does not materially participate in the trade or business activity of the S corporation, a special rule provides that only reasonable compensation from the S corporation is treated as net earnings from self-employment.

The 2005 proposal is effective for taxable years of partners or S corporation shareholders (as the case may be) beginning after the date of enactment.

One commentator has suggested that the 2005 proposal be expanded to closely held C corporations (in addition to partnerships and S corporations), in order to achieve parity in the way that the employment tax rules apply to all individuals who perform services in a business conducted through a business entity, particularly in light of the 2003 reduction to 15 percent in the top rate applicable to qualified dividends paid by a C corporation.[119]

2006 Joint Committee on Taxation staff proposal ("2006 proposal")[120]

In 2006, the Joint Committee on Taxation staff proposed a modified version of the 2005 proposal, above. The 2006 proposal takes a more targeted approach, more narrowly focussing on income from labor, and concentrating on income from service businesses conducted through passthrough entities (i.e., partnerships and S corporations). This approach, limited to service businesses, provides that the present-law rule for general partners applies to any partner for determining net earnings from self-employment, provided the partnership is a service partnership. For this purpose, a service partnership is a partnership (including an LLC or other entity that is treated as a partnership for Federal income tax purposes), substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to sec. 448(d)(2)). Similarly, for purposes of employment tax, an S corporation that is a service business is treated as a partnership and shareholders of the S corporation are treated as general partners. Wages paid to a shareholder employee of an S corporation would not be treated as deductible by the S corporation for employment tax purposes. Regulatory authority is provided under the proposal to prevent avoidance of the provision through the aggregation of business activities within entities or the recharacterization of income as other than service income (e.g., as rent, interest, or gain).

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[119] Richard Winchester, *Working for Free: It Ought to be Against the (Tax) Law*, 76 Mississippi Law Journal 227, 261 (Fall 2006).

[120] Letter of George K. Yin, Chief of Staff, Joint Committee on Taxation, to Senators Grassley and Baucus, August 3, 2006, available on the internet at http://www.senate.gov/~finance/press/Gpress/2005/prg101906.pdf.

ABA / AICPA proposal[121]

The ABA / AICPA proposal addresses the employment tax treatment of partners. Under the proposal, the same self-employment tax treatment applies to any partner of a partnership (whether a general partner, a limited partner, or a member of an LLC that is a partnership for Federal income tax purposes). The proposal retains the present-law definition of net earnings from self-employment, including the present-law exceptions for specified types of income including rent, dividends, interest, and capital gain. The proposal adds two alternative safe harbors in computing any partner's net earnings from self-employment. Under the first safe harbor, the amount in excess of what would constitute reasonable compensation for services rendered by the partner to the partnership is excluded from net earnings from self-employment. Under the second safe harbor, the amount equal to a reasonable rate of return on the partner's share of partnership capital is excluded from net earnings from self-employment. Under the proposal, this rate is deemed to be 150 percent of the applicable Federal rate (AFR) determined at the beginning of the partnership's taxable year. The proposal provides for Treasury regulatory authority.

TIGTA proposal[122]

The Treasury Inspector General for Tax Administration (TIGTA) proposal addresses the employment tax treatment of S corporation shareholders. This proposal would subject to employment tax all ordinary operating gains of an S corporation that accrue to a shareholder (including the shareholder's spouse and dependent children) holding more than 50 percent of the stock in the S corporation. The proposal would provide that self-employment (SECA) tax does not apply to officer compensation on which employment (FICA) taxes are paid. No employment tax would apply if S corporation has no operating gains. The proposal would make no change to the present-law employment tax treatment of S corporation shareholders not meeting the 50 percent ownership threshhold.

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[121] Doc 1999-23633, 1999 TNT 133-23. In July, 1999, The American Bar Association Tax section submitted the recommendation, on which it worked together with the AICPA. In a statement dated February 20, 2002, the ABA Tax Section confirmed that it still supported the 1999 legislative proposal.

[122] Treasury Inspector General for Tax Administration, *Actions are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations*, May 2005, Reference No. 2005-30,080, at 18-19.

C. Issues and Analysis

Labor income and capital income under the payroll tax[123]

Historically, labor income of individuals has generally been taxed under the Federal income tax system at ordinary rates, while some forms of capital income[124] have generally been taxed at lower rates.[125] In addition, labor income generally is subject to employment tax (generally 2.9 percent for amounts over $102,000, in 2008). In 2008, for individuals generally, the top rate of tax on capital gain is 15 percent, while the top rate on ordinary income is 35 percent. When the employment tax is added, the top rate on ordinary compensation income is 37.9 percent. This rate differential is thought to be a motivating factor in taxpayers' choice to structure income of a small business in the form of capital income rather than labor income. This behavior gives rise to discontinuity of payroll tax treatment of labor income as between owner-employees, on the one hand, and other workers and employees, on the other hand.

Separating labor income from capital income is the task of the payroll tax system. While a tax system for funding government-provided benefits that is independent of the character of the taxed amounts could be devised, the current Federal system is premised, at least conceptually, on

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[123] The issue of separating labor income from capital income arises in many contexts under the income tax as well. For example, identifying labor income arose as an issue in connection with Congressional hearings on partnership carried interests in 2007. For background on the 2007 Senate Finance Committee hearings on this topic, see Joint Committee on Taxation, "*Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests*" (JCX-41-07), July 10, 2007, and "*Present Law and Analysis Relating to Selected International Tax Issues*" (JCX-85-07), September 24, 2007. For background on the 2007 House Ways and Means Committee hearings on this topic, see Joint Committee on Taxation, "*Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I*" (JCX-62-07), September 4, 2007, and "*Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II*" (JCX-63-07), September 4, 2007. These documents are available on the internet at www.jct.gov.

[124] In general, capital income taxed at lower rates has historically included capital gain. Qualifying dividend income of individuals has been taxed at the same maximum rate as capital gain since 2003. This treatment is scheduled to expire at the end of 2010, as are the current maximum rates for both ordinary income and capital gain. However, during the 1970's, income from services was taxed at a maximum rate of 50 percent while investment income, including dividends, but not including capital gain, was taxed at a higher maximum rate of 70 percent. As an exception to the generalization that capital gains have historically been taxed at a rate lower than labor income, for taxable years beginning in 1988, 1989, and 1990, the maximum tax rate of individuals on all income, ordinary as well as capital gain, was 28 percent.

[125] When labor income and capital income are taxed at the same rates, then issues of the character of income (i.e., whether capital or ordinary) are much less significant. Some distinctions between capital and ordinary income would remain, however, even if the tax rate differential were eliminated. Unlike ordinary income treatment, capital gain treatment entitles investors to tax-free return of basis to the extent of basis in the asset. Another difference between ordinary and capital gain treatment is that capital losses are subject to a limitation on deductibility against ordinary income. Issues of timing (i.e., when income is taxed) are not affected by setting capital and ordinary income rates at the same level.

identifying and taxing labor income. Unrelated changes in the tax law and in State laws have made the current payroll tax system somewhat less efficient at identifying labor income and ensuring that tax is collected, particularly in the context of small business in which the same individual is both a worker in the business and an owner of the business. Several options for modifying the payroll tax rules have been proposed,[126] based on perceived flaws in the current rules. In analyzing these proposals, a variety of considerations arise.

The rate of tax under the employment and self-employment tax is 15.3 percent on amounts through $102,000, whereas the rate is 2.9 percent for amounts over $102,000.[127] Thus, the marginal rate of tax imposed on workers with earnings below the cap is substantially larger than the marginal employment tax rate of workers above the cap. This higher marginal tax rate is likely to cause a greater work disincentive for workers below the cap, though this should be ameliorated to some extent by the fact that such a worker may accrue additional Social Security benefits as a result of additional earnings. The taxpayer above the cap faces a lower marginal employment tax rate on additional earnings, but accrues no additional benefits as a result of additional earnings. Because of the progressive nature of the joint tax and benefit structure, a taxpayer with earnings below but near the cap faces a higher marginal employment tax rate even when the additional accrual of benefits is taken in to consideration.

The self-employment tax (and the earlier-instituted FICA tax) were originally designed both to measure Social Security benefit accruals by determining whether individuals earned income from working, and to collect revenues to fund such benefit accruals.[128] However, taxpayers' incentives have changed as the wage base and the resulting tax cost to individual taxpayers of accruing benefits has risen, and the value of Social Security benefits to high-income taxpayers has become relatively lower as a percentage of income. A portion of Social Security benefits became taxable to higher-income individuals in 1984.[129] The motivation of higher-income taxpayers to avoid the employment tax was further increased by the elimination of the

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[126] Proposed options are described in section V.B. of this document.

[127] $102,000 is the dollar cap on the amount subject to the OASDI component of both the employment and self-employment tax for 2008. The 2.9 percent rate applies to determine the HI component of the tax, which is not subject to the dollar cap. The rate applicable to amounts under the dollar cap is 15.3 percent, composed of the 2.9 percent rate on the HI component and the 12.4 percent rate on the OASDI component (including both the employer's and the employee's share, in the case of the FICA tax). These rules are described in more detail in section V.A. of this document.

[128] See Patricia E. Dilley, *Breaking the Glass Slipper - Reflections on the Self-Employment Tax, supra*, at notes 23-30.

[129] Social Security Amendments of 1983, Pub. L. No. 98-21, sec. 121(a) (1983). Both the FICA and the SECA tax bases have two components, OASDI and HI. Under the OASDI component, the rate of tax is 12.40 percent. Under the HI component, the rate is 2.90 percent. The amount subject to employment tax under the OASDI component is capped at $102,000 of wages (under FICA) or self-employment income (under SECA) (for 2008). However, the amount subject to the HI component is not capped.

cap on the HI component of the tax by the Revenue Reconciliation Act of 1993.[130] Benefits under the HI component that may be paid to the taxpayer in the future generally do not increase as the tax cost of the HI component to the taxpayer increases.

Rather than having an incentive to accrue benefits, many taxpayers now have the opposite incentive: to avoid or reduce the tax cost, which may exceed the value to them of the social insurance benefit. The tax rules are not currently designed to prevent avoidance, and indeed, may facilitate it because the rules apply unevenly depending on whether the taxpayer chooses to do business through an S corporation, partnership, sole proprietorship, or C corporation. Eliminating this unevenness, at least with respect to service businesses, not only increases the fairness of the tax as between similarly situated taxpayers, but also is consistent with a purpose to raise revenue from labor income among all workers comparably.

Choice of entity and payroll tax

There are significant differences in the employment tax treatment of individuals who are owners of interests in entities and who perform services in the entity's business. S corporation shareholder-employees are treated like other employees (i.e., subject to FICA), whereas a broader category of income of some partners (other than limited partners) is subject to self-employment tax. The current rules create a bias toward the use of S corporations to minimize employment tax. Further, uncertainty in the self-employment tax treatment of LLC members under the rules for partners may motivate some taxpayers to exploit the uncertainty, choosing LLCs rather than general partnerships. These discontinuities cause taxpayers' choice-of-business form decisions to be motivated by a desire to avoid or reduce employment tax, rather than by nontax considerations.

The IRS National Research Program (NRP) updated estimate of the gross tax gap for 2001 included an estimated $39 billion of the tax gap attributable to self-employment tax and an estimated $20 billion of the tax gap attributable to FICA and unemployment taxes.[131] A report of the Treasury Inspector General for Tax Administration (TIGTA) asserts that "billions of dollars in self-employment taxes are being avoided each year as sole proprietors increasingly choose to incorporate," particularly as S corporations.[132]

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[130] Because eligibility for hospital insurance under Medicare is based on an individual's quarters of coverage, not the amount of the individual's wages, paying HI tax on higher wages does not increase the individual's Medicare benefits.

[131] Internal Revenue Service and Department of the Treasury, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, Aug. 2, 2007, 2007 TNT 150-15, at Figure 3, "Gross Tax Gap by Type of Tax and IRS Operating Division."

[132] Treasury Inspector General for Tax Administration, *Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations*, May 2005, *supra*.

Payroll tax issues relating to partners

Source and nature of issues

The employment tax treatment of partners who are neither limited nor general partners is uncertain. In particular, owners of a limited liability company (LLC) may view themselves as comparable to limited partners, even though they are not limited partners under applicable State law. This uncertainty makes compliance with the law difficult for taxpayers and administration of the law difficult for the IRS. The uncertainty in treatment creates an opportunity for abuse by taxpayers willing to make the argument that they are not subject to any employment tax (FICA or self-employment), even though this argument may be viewed as contrary to the spirit and intent of the employment tax rules.

The current rule excluding limited partners' distributive share of partnership income from self-employment tax was enacted at a time when individuals' incentives were to seek eligibility for benefits, not to avoid the tax cost of eligibility for benefits.[133] At that time, 1977, many States' laws prohibited limited partners from participating in management of the partnership's business; thus, identifying limited partners as not subject to self-employment tax worked as a proxy for eliminating those partners who did not have significant labor income from the partnership. State laws providing for LLCs had not become prevalent at that time,[134] and the IRS had not yet ruled that it would treat LLCs as partnerships for Federal tax purposes.[135]

By 2008, however, every State provides for LLCs, which are generally treated as partnerships for Federal tax purposes. State LLC laws do not limit LLC members' provision of services to the LLC or participation in management of the LLC in the same way as did State laws

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[133] Social Security Financing Amendments of 1977, H.R. Rep. 95-702, part I, 95th Cong., 2d Sess. (1977), at 40-41, stating, "Under the bill the distributive share of the income or loss received by a limited partner from the trade or business of a limited partnership would be excluded from social security coverage. However, the exclusion from coverage would not extend to guaranteed payments . . . , such as salary and professional fees, received for services actually performed by the limited partner for the partnership. . . . In these situations the investor in the limited partnership performs no services for the partnership and the social security coverage which results is, in fact, based on income from an investment. This situation is of course inconsistent with the basic principle of the social security program that benefits are deigned to partially replace lost earnings from work." Note that the 1977 statutory change for limited partners provided that guaranteed payments for services are included in determining the partner's self-employment tax. This legislative change appears to have superseded then-existing regulations (Treas. Reg. 1.1402(a)-1(b)) providing that limited partners' guaranteed payments for capital, as well as for services, were included in determining the partner's self-employment tax: further evidence of Congressional intent in 1977 to narrow eligibility for benefits.

[134] Wyoming was the first State to provide for LLCs. Wyo. Stat., secs. 17-15-101 through 17-15-136 (1977).

[135] Rev. Rul. 88-76, 1988-1 C.B. 260 (Wyoming LLC ruling). More recently, the IRS has made clear that LLCs under all States' laws may be treated as partnerships for Federal tax purposes (provided applicable criteria are met).

governing limited partners, even though LLC members may have limited personal liability for debts and obligations of the LLC. Some State laws governing limited partnerships, meanwhile, have changed to permit limited partners to perform services for the partnership or to participate in management of the partnership's business, so limited partner status is no longer a workable proxy for determining that a partner does not have significant labor income from the partnership.[136]

The employment tax rules have not been updated to reflect the changed landscape and the reversal of taxpayer incentives.[137] In fact, following the 1997 legislative moratorium on Treasury regulations relating to administration of the self-employment tax treatment of limited partners, no regulations on this point have been issued (even though the moratorium expired July 1, 1998).

Thus, the employment tax law in force today does not provide clear guidance to LLC owners. While some LLC owners may determine their self-employment tax liability by reliance on the proposed 1997 regulations as a guideline, those rules are not actually in effect. Other LLC owners may take the position that they owe little, if any self-employment tax, perhaps by analogy to the statutory language governing limited partners, or by structuring their business to interpose an S corporation, distributions from which they argue do not constitute labor income.[138] Others may seek to restructure their compensation as rent or interest, applying the exclusions from self-employment under the statute.[139] In addition, it is possible that some

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[136] See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification*, JCS-3-01, April, 2001, at 277-287, recommending that references in the Internal Revenue Code to "general partners" and "limited partners" be modernized consistently with the purpose of the reference. Among these is the section 1402(a)(13) reference to limited partners.

[137] See David C. Culpepper, Sanford Holo, Robert R. Keatinge, Thomas C. Lenz, Bahar A. Schippel, Richard A. Shapack, and Thomas E. Yearout, *Self-Employment Taxes and Passthrough Entities: Where Are We Now?*, Tax Notes, October 12, 2005, concluding, "The foregoing history, discussion, and analysis indicate that the existing regime for taxing a partner's allocable share of partnership income or loss for Self-Employment Tax purposes is inappropriate. Not only are the rules unclear and their application uncertain, but the apparent loss of legitimate tax revenue is disturbing, if not alarming."

[138] See websites cited, *infra*, and see James B. Sowell, *Partners and the SECA Tax: LLC Members and Beyond*, 43 Tax Management Memorandum 347, August 26, 2002. Under a structure recommended by some advisors, an individual performing services forms an S corporation to hold an interest in an LLC; the S corporation employs the individual and "leases" the individual to the LLC, so that distributions from the S corporation as a distribution of corporate income arguably are not subject to employment or self-employment tax.

[139] Sowell, *supra*, describes a structure recommended by some advisors in which the service-providing and capital-intensive portions of a business are segregated in two separate entities. For example, doctors engaged in a radiology practice provide personal services through a medical partnership, and own the x-ray equipment through a separate S corporation, distributions from which are treated as not subject to self-employment tax because the doctors do not provide services relating to the management, maintenance, and operation of the x-ray equipment. Such an arrangement may involve disguising labor

limited partners are not subject to self-employment tax on partnership income that actually constitutes labor income to them, in real economic terms, even though it does not take the form of a guaranteed payment for services.[140]

Comparison of proposals[141]

The 2005, 2006, and ABA / AICPA proposals to revise the self-employment tax rules applicable to individuals who are treated as partners in partnerships for Federal tax purposes have sought to eliminate any distinction between general partners, limited partners, and partners in partnerships that are LLCs under applicable State law, thereby eliminating the outdated reference to limited partners. Each of these proposals has the effect of clarifying the self-employment tax treatment of members of LLCs, providing that any member of an entity that is treated as a partnership for Federal tax purposes is subject to tax under the rules currently applicable to general partners. Similarly, the proposals tend to minimize the opportunity for individuals who are limited partners to avoid self-employment tax on labor income.

The proposals differ in their scope: the 2005 and 2006 proposals apply both to partners and to S corporation shareholders, whereas the ABA / AICPA proposal applies only to partners.[142] Arguably, the narrower ABA / AICPA proposal could be criticized as not fully addressing the problem of uneven, perhaps unfair, application of the employment and self-employment tax rules to individuals who work in a business owned by an entity. None of the proposals applies to closely held C corporations, though one commentator argues that failure to do so does not fully address the problem of unequal employment tax treatment of individuals who work in a business they own through an entity.[143] On the other hand, it can be argued that even a narrow proposal that addresses only partners represents an improvement over the uncertainty and lack of guidance in present law for LLC members and limited partners who perform services.

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income as capital income, or may represent a real economic division of capital income from labor income, though a fact-specific, taxpayer-by-taxpayer inquiry may be necessary to ascertain this. Other arrangements involving the characterization of labor income as rent or interest are described on the internet. For example, one website advocates, "In addition, the LLC owner can avoid the self-employment tax if payments are made by the LLC to the owner as lease payments and loan repayments. The Internal Revenue Code imposes the self-employment tax on profits derived from ownership of the business, plus any guaranteed payments for salary. The owner will not be "in the business" of leasing real estate (or equipment, furniture, etc) or making loans. Thus, the tax will not apply to these receipts. (In addition, the Code also specifically exempts lease payments received from anyone except a real estate dealer)." http://www.toolkit.com/small_business_guide/sbg.aspx?nid=P12_4876.

[140] Guaranteed payments for services are subject to self-employment tax in the hands of limited partners, under present-law section 1402(a)(13).

[141] The proposals are described in section V.B. of this document.

[142] The TIGTA proposal applies only to S corporation shareholders.

[143] Richard Winchester, *Working for Free: It Ought to be Against the (Tax) Law*, *supra*, at 261.

The 2005 proposal provides that if any partner (or S corporation shareholder) who does not materially participate in the trade or business activity of the partnership, then only the partner's reasonable compensation from the partnership is treated as net earnings from self-employment. Similarly, the ABA / AICPA proposal provides a safe harbor for amounts in excess of the partner's reasonable compensation. Thus, neither proposal abolishes the difficult-to-administer, case-by-case inquiry required under the present-law reasonable compensation standard. By contrast, the 2006 proposal, applicable solely to service businesses conducted through partnerships and S corporations, does not retain the reasonable compensation standard in that context (though outside the scope of the 2006 proposal, the standard remains applicable). The 2005 proposal arguably places the least reliance on the reasonable compensation standard of the three proposals, in that it applies only to partners (and S shareholders) who do not materially participate in the entity's business, whereas the ABA / AICPA proposal applies the standard in all cases, and the 2006 proposal retains outside the service business context. Arguably, then, the 2005 proposal is the most successful at reducing the reliance of the employment tax rules on the difficult-to-administer reasonable compensation standard.

The 2005 and 2006 proposals apply new rules in the case of service businesses, whereas the ABA / AICPA proposal does not include special rules for service businesses. The 2005 proposal provides that in the case of a service business, all of a partner's distributive share is subject to the self-employment tax unless the partner does not materially participate in the business (then, only his reasonable compensation for services is taxed). Arguably, elimination of exclusions for rent, dividends, interest and gains -- which are capital income, not labor income -- is inconsistent with the fundamental concept that self-employment tax applies to labor income. Elimination of these exclusions from the self-employment tax base, even for service businesses, could be considered lacking in justification on theoretical grounds. While lacking theoretical consistency, one pragmatic justification may be to prevent abusive recharacterization of labor income as capital income such as rent or interest[144]; further, as most service businesses are not likely to have a high proportion of capital income, the rule would not have effect beyond abuse prevention in many service business situations.

The narrower 2006 proposal does not eliminate the exclusions for these types of capital income in the case of service businesses. In that regard, the 2006 proposal does not raise the issue of whether it would impose self-employment tax on amounts in the nature of capital income that are not subject to self-employment tax under present law. On the other hand, the 2006 proposal would not curtail attempts to characterize partners' labor income as rent or interest, types of capital income that are excluded from the self-employment tax base under the 2006 proposal (as under present law).

[144] See Sowell, *supra*, describing recharacterizing labor income as rent or interest.

The proposals differ in the determination of what elements or portion of the income of a partner is not considered to be labor income, or is, alternatively, explicitly considered to be capital income that is not subject to self-employment tax, an issue discussed below.[145]

Payroll tax issues relating to S corporation shareholders

There has been very substantial growth in the number of S corporations in recent years,[146] which some attribute to the widespread use of S corporations to avoid self-employment tax. The 2005 TIGTA report stated that "the S corporation form of ownership has become a multibillion dollar employment tax shelter for single-owner businesses."[147]

Individuals who perform services in businesses that they own commonly choose the S corporation form to seek to reduce their FICA taxes. S corporation shareholders may pay themselves wages below the wage cap, while treating the rest of their compensation as a distribution by the S corporation in their capacity as shareholders. They may take the position that no part of the S corporation distribution to them as shareholders is subject to FICA tax.[148] Because the HI component of the tax has no wage cap, this S corporation approach may be viewed as a tax planning opportunity with respect to HI tax at high income levels as well as below the cap.

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[145] The issue of separating labor income from capital income of a partner by means of a specific carveout for an amount determined by applying a set rate to a defined capital base is discussed below.

[146] See the economic data section of this document, particularly Table 2, showing the growth in the total number of annual S corporation tax returns from 478,679 returns in 1978 to 3,684,086 returns in 2005.

[147] Treasury Inspector General for Tax Administration, *Actions are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations*, *supra*, at 2. The report discusses options for addressing the compliance problem, including an option to apply employment tax generally to the operating income of an S corporation in which any one individual (including his or her family members) owns more than 50 percent of the stock. *Id.* at 18-19.

[148] Websites advocating this method of avoiding employment and self-employment tax for small business owners abound. For example, one website advises, "If structured and implemented properly, an S corporation could save you thousands of tax dollars per year. As an employee-shareholder of your S corporation, you pay yourself wages just like you would any other employee. But instead of taking profits out through payroll, you take cash distributions called 'nontaxable dividends'. . . . You're still paying taxes on the net income of your S corporation when you file your personal tax return, but the tax is federal tax and not the self-employment tax." Alex Goumakos, *How to Legally Save Thousands of Dollars a Year in Taxes by Incorporating*, http://www.powerhomebiz.com/vol81/taxincorporating.htm. Another website states, "Your business can reduce its self-employment tax obligation by creating an S-corporation. S-corporation profits are not subject to employment taxes. The owners wages, however, will be subject to employment taxes like any other employee. . . . Now you realize that you can maximize your tax savings by creating an S-corporation and paying yourself the smallest wage that qualifies as "reasonable." So what is reasonable? The IRS does not give specific figures. Also, there is very little case law to provide guidance by example." http://searchwarp.com/swa40075.htm.

The entire amount of an S corporation shareholder's reasonable compensation is subject to FICA tax in this situation, under present law. However, enforcement of the "reasonable compensation" standard by the government may be difficult because it involves factual determinations on a case-by-case basis, requiring taxpayer audits and potentially involving costly, resource-consuming litigation.

The 2005 and 2006 proposals aim to reduce the use of S corporations to avoid the employment tax by recharacterizing wages from service businesses as some other type of S corporation distribution. Under these proposals, an S corporation is treated as a partnership and its shareholders as general partners, for self-employment tax purposes (under the 2006 proposal, this applies only to S corporation service businesses). Either the 2005 or the 2006 proposal would achieve greater uniformity of employment tax treatment as between partnerships and S corporations than does present law, reducing tax-motivated choice-of-entity decisions and improving the neutrality of the tax law.

The narrower TIGTA proposal applies only to shareholders of S corporations who, directly or through relatives, have a 50 percent or greater interest in the S corporation. By contrast to the 2005 and 2006 proposals, the TIGTA proposal would be less effective in improving tax neutrality as between partnerships and S corporations, though it would serve to reduce the relative attractiveness of S corporations as employment tax planning vehicles.

By treating the S corporation shareholders similarly to partners of a partnership (taking into account the modifications made by the partnership portion of the proposals), the 2005 and 2006 proposals reduce the need to apply the cumbersome, difficult-to-administer "reasonable compensation" standard. Although the TIGTA proposal does not cover partners, it could be said that a proposal addressing only S corporation shareholders' attempts to avoid the reasonable compensation standard is likely to be more enforceable and efficient than continuing to apply the reasonable compensation standard to those shareholders.

The 2005 proposal has the effect of applying the self-employment tax collection system to S corporation shareholder-employees, rather than the withholding regime that applies to them (along with other employees) under the present-law FICA tax rules. There are both drawbacks and advantages to this approach. One drawback is that withholding may be a more effective and faster collection mechanism than self-assessment as under the self-employment rules. Another is that the income tax deduction for wages or compensation paid by an S corporation would have to be added back or disallowed for purposes of calculating self-employment tax of the S corporation shareholder.

Other disadvantages would arise from retaining the FICA withholding system from some compensation while imposing the self-effecting SECA rules on other compensation of the same individual. For example, preserving a withholding regime on S corporation shareholder wages, and imposing self-employment tax only on the portion of the shareholder's distributive share that exceeds previously taxed wages, would require a mechanism to prevent double-counting from one taxable year to the next, which could impose additional administrative and recordkeeping burdens on the S corporation. Imposing two separate employment tax regimes on S corporation compensation payments to one individual could be criticized as complex.

Payroll tax issues relating to C corporation shareholders

Employees of C corporations, like S corporation employees, are subject to FICA tax. C corporations, unlike S corporations, however, are tax-paying entities, not pass-throughs, for Federal income tax purposes, and distributions from corporate earnings and profits are subject to tax in the hands of shareholders. Because distributed income of a C corporation is subject to two levels of taxation, it may seem unlikely that tax savings could be achieved by recharacterizing labor income of C corporation shareholder-employees as a distribution of corporate earnings.[149]

Nevertheless, under present income and employment tax rules, the effective tax rate on distributed corporate earnings may in some circumstances be less than the effective tax rate on labor income that is subject to income and employment tax. For example, if the effective rate of tax on corporate income is low (because it has offsetting losses or has relatively low income taxed at the low end of the graduated rate scale), and if corporate distributions are qualified dividends eligible for the 15-percent tax rate, the total tax paid by the corporation and a shareholder-employee may be less than the total tax paid if the amount is paid as wages subject to both income and employment tax.[150] In this situation, the combined application of several unrelated tax rules create an incentive for individuals to recharacterize labor income as distributed corporate earnings. This tax incentive is particularly apparent in the case of a C corporation over which the shareholder-employee has effective control, including control over the ratio of wages paid to dividends paid.

It has been argued that any proposal to equalize employment tax treatment of individuals who work in a business that they own through an entity is incomplete without applying parallel rules to closely held C corporations. None of the proposals specifically address the employment tax treatment of closely held C corporation shareholder-employees.

Definition of service business for payroll tax purposes

The 2005 and 2006 proposals are based on the conceptual premise that the base for the employment and self-employment tax should be labor income. Historically, the employment tax has applied to labor income, relating very roughly to the rules for accruing benefits under the Social Security system, which require the individual to perform quarters of labor.[151] The 2005

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[149] By contrast, undistributed corporate earnings may be taxed at a lower rate than amounts paid to shareholders, resulting in tax rules such as the accumulated earnings tax and the personal holding company tax that were designed to prevent individuals from maintaining C corporations as "incorporated pocketbooks."

[150] See Richard Winchester, *Working for Free: It Ought to be Against the (Tax) Law*, *supra*, 278: "Clearly any tax savings to be realized by substituting dividends for a bonus will be enjoyed primarily by high income individuals. As the charts and tables show, the most tax savings occur when the employee-shareholder is in the highest tax brackets and the corporation is in the two lowest tax brackets."

[151] *See* Patricia E. Dilley, *Breaking the Glass Slipper - Reflections on the Self-Employment Tax*, *supra*, at note 18. Benefit accruals have historically been tied to performance of labor (quarters of service), but the amount of FICA taxes collected does not necessarily relate to the individual's Social Security benefits.

proposal has a broad impact, capturing all income from service businesses, the same items as for present-law general partners in any other type of business in which the owner materially participates, and reasonable compensation of owners who do not materially participate. While the 2006 proposal applies the notion that labor income should be the tax base more uniformly than does present law, nevertheless, focussing on service businesses could be viewed as an incomplete capture of labor income earned through passthrough entities. Labor income is also earned by employee-owners of passthrough entities conducting capital-intensive businesses. Nevertheless, the 2006 proposal, though limited to service businesses, has the advantage that it is not very likely to affect non-labor income, and is at the same time likely to address some FICA or SECA tax avoidance opportunities in which taxpayers now may attempt to engage.

Limiting the proposal to service businesses provides several simplification benefits. Focussing on service businesses may eliminate any need for a bifurcated approach to income from labor and from capital. In the case of a service business, it is assumed that the income is generally from personal services. Previous proposals have suggested that the self-employment tax not apply to income from a business that is from capital rather than from labor. For example, one way to attempt to limit employment tax to labor income would be to provide a special rule to exclude from the employment tax base some measure of the return on capital, in the case in which a business pays a worker-owner a return that represents income both from his or her labor, and from his or her capital invested in the business.[152] This type of approach raises administrability concerns, as rates of return (including return on capital) can vary significantly among different types of businesses, at different times in the life of a business activity, and with different management of the business, among other factors.[153] By way of comparison, no such special rule is provided under present law for sole proprietors subject to the self-employment tax.

Another simplification benefit of limiting the proposal to service businesses is to eliminate the need for the present-law inquiry into whether the individual's compensation from the service business is reasonable, for employment tax purposes.[154] This inquiry is inherently

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[152] An AICPA proposal suggested this type of approach to modernize the self-employment tax reference to limited partners in section 1402(a)(13). See Letter of David A. Lifson, Chair, Tax Executive Committee of AICPA, to the Honorable William V. Roth, Chairman, Senate Committee on Finance, dated June 22, 2000, enclosing such a recommendation originally made by letter dated July 6, 1999. The AICPA proposal would provide that if the partner works less than a minimum number of hours in the partnership's business, none of his income would be treated as subject to the self-employment tax. This AICPA proposal would provide that a limited liability company owner's income would be treated as subject to the self-employment tax, except for a defined rate of return on his capital in the partnership.

[153] Alternatively, this approach might specify a definition for a reasonable rate of return on capital. It could be based, for example, on a percentage or multiple of the applicable Federal rate, as defined under present law. While this approach may conceptually take account of a partner's return on capital, it may not represent the simplest and most direct approach, nor would it be accurate in most cases.

[154] Reasonable compensation has also been suggested as a standard for determining the net earnings from self-employment of all limited partners and LLC members, but the administrative concerns with the standard could make this approach less attractive than the more mechanical approach taken under the proposal.

factual and can cause uncertainty in some cases, encourage taxpayer noncompliance, and give rise to disputes and litigation. The question of whether an individual's compensation is reasonable is one that has been repeatedly addressed in case law. The addition of the independent investor test used in the Seventh Circuit and partially adopted in some other Circuits has changed the previously predictable analysis under the multi-factor test applied in many judicial decisions to determine reasonable compensation.

Structuring a carveout for capital income

The ABA /AICPA proposal provides that the amount equal to a reasonable rate of return on a partner's share of partnership capital is not subject to self-employment tax. The deemed reasonable rate of return is 150 percent of the applicable Federal rate (AFR) at the beginning of the partnership's taxable year. The 2005 and 2006 proposals do not provide for an exclusion for a return on capital. The 2006 proposal, however, retains the present-law exclusions for amounts in the nature of capital income: rents, dividends, interest, and capital gains.

Because the ABA / AICPA proposal also retains these present-law exclusions in addition to the new safe harbor for returns on partnership capital, it could be argued that one or the other exclusion is redundant. Rents, dividends and interest are specific types of returns on partnership capital, so a further exclusion double-counts returns on partnership capital. Furthermore, the amount of the rents, dividends, interest and gains represents the real economic return on partnership capital, whereas the deemed rate of return does not take into account the partnership's real economic rate of return. On the other hand, these passive types of capital income may not include returns on the partnership's capital invested in its business that exceeds returns on labor; if the partnership has such returns, arguably the exclusion for returns on partnership capital is not redundant.

A further issue arising from a safe harbor for returns on partnership capital is how to determine partnership capital. The amount of cash contributions by partners may be straightforward, but in more complex fact situations involving contributions of appreciated or depreciated property, distributions of cash or property, debt capital, loans or guarantees between the partner and the partnership, and other similar situations, it could be complex to determine partnership capital for purposes of calculating a rate of return on capital. An argument could be made for selecting an existing system used for determining partnership capital, such as partner capital accounts, tax basis, or book basis. However, in each case, opportunities to manipulate, dispute, mismeasure, or reallocate capital among partners would add to the complexity and potential inaccuracy to which this aspect of the ABA / AICPA proposal gives rise.

The specific provision of a deemed rate of return on partnership capital in the ABA / AICPA proposal can be criticized as inaccurate and tending to give rise to factual disputes. A deemed rate of return does not likely reflect a real economic rate of return on capital in any particular business, creating the perception that it is both inaccurate and unfair. Such a perception could lead to increased challenges to the application of the rule, depending on how it is administered and what leeway for Treasury interpretation is provided. At its worst, arguably the rule could engender as many factual inquiries, audits, and opportunities for litigation as the "reasonable compensation" standard of present law, if exceptions are provided to the deemed rate of return.

Furthermore, provision for a return on business capital, apart from any passive capital income, arguably focuses on a concern that is not the central function of the employment tax: that is, identifying labor income as the tax base. Structuring the tax rule as a carveout for capital income focuses the inquiry on what is not in the employment tax base, rather than what is in the employment tax base. A detailed inquiry about what is not in the tax base arguably would tend to make the rules difficult to administer. Particularly in the case of a service business, which is the case addressed by the 2006 proposal, it can be argued that retention of the present-law exclusion for specific types of capital income covers the majority of situations relatively accurately while not relying on an inquiry about exclusions from the base that could give rise to complexity and administrative burdens on the government and taxpayers.