

# Working for Free: A New Tax Dodge for the Wealthy Magnifies Employment Tax Defects

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## I. Introduction

Congress often enacts tax laws in order to affect people's behavior in one way or another. However, tax legislation frequently produces outcomes that Congress may neither foresee nor desire. This article describes how the temporary cut in the tax on corporate dividends has produced just such an unanticipated outcome.<sup>1</sup> The law was promoted as a way to reduce undesirable tax planning by corporations.<sup>2</sup> However, it has also created an opportunity for the rich to improperly avoid tax when they work for a corporation they also own and control.

An individual who owns and works for a corporation has at least two ways to access the earnings of the business. As a shareholder, he can access the earnings by receiving a dividend on his stock. Alternatively, as an employee, he can withdraw earnings in the form of compensation, such as a salary or bonus. Before the cut in the tax on dividends, such an employee-shareholder almost always had an incentive to access the earnings as compensation. However, the cut in the dividend tax reversed the incentives for many employee-shareholders. There is now a substantial economic incentive for high income employee-shareholders to substitute dividends for the compensation they would have otherwise paid themselves. Ironically, certain rich individuals can get richer by working for free.

Although the cut in the dividend tax created an incentive for some to substitute a dividend for a bonus, the tax cut itself is not the source of the

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<sup>1</sup> See P.L. 108-27, Sec. 301(a)(1).

<sup>2</sup> Fact Sheet: "The President's Proposal to the End of the Double Tax on Corporate Earnings," Office of Public Affairs, Department of Treasury, Jan 14, 2003, KD-3762. According to the release "Corporations will have good reason to pay taxes and not to engage in aggressive tax sheltering. A dollar in taxes saved by a corporation no longer translates into more cash for their shareholders." Elsewhere, the release stated that the proposal ". . . will reduce huge distortions and inefficiencies, allowing corporations to make decisions based on what makes good business sense instead of what makes good tax sense."

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problem. Rather, the tax cut has merely cast a light on the inconsistent and problematic way that federal employment tax rules apply to individuals who work for a business they also own and control. Such employee-owners currently are subject to a different set of rules depending on the legal form used to operate the business. In addition, if the business operates as a partnership, an employee-owner's employment tax liability also depends on whether he is a general partner or a limited partner. To make matters worse, it is not clear what rules apply to an employee-owner of a business operated through a limited liability company.

It is widely acknowledged that the employment tax rules should be made more clear and consistent. However, all past proposals for correcting this problem have not addressed it in a comprehensive way, focusing instead on adjustments that would make the rules apply uniformly only to individuals who work for a business they conduct through an entity other than a taxable corporation.<sup>3</sup> Such business forms generally include partnerships, S corporations and limited liability companies. These proposals are an improvement over the current situation. However, because they fail to address an advantage enjoyed by individuals who own and work for a business conducted through a taxable corporation, these proposals represent only a partial solution to the problem.

This article will propose a uniform set of employment tax rules that should apply to all individuals who work for a business they own and control. Before doing so, the article will examine the current rules that determine how the earnings of a business are taxed when received by an owner who also works for the business. This will require an examination of two sets of rules. First, there are rules that tax the owner's share of the profits of the business. Second, there are rules that tax amounts paid to the owner as compensation for services rendered to the business. This discussion will reveal how the use of different business entities, different ownership interests and different payout forms can affect what an employee-owner pays as tax and what he keeps after tax. The article will then describe and critique a widely endorsed proposal for eliminating the inconsistencies in the current system of tax rules that apply to employee-owners of non-taxable business entities.

Next, the article shows how a shareholder who works for a solely owned corporation enjoys a significant opportunity to avoid employment tax that other employee-owners do not enjoy. Among other things, the discussion will demonstrate how the temporary dividend tax cut has created an incentive for an employee-shareholder to access the earnings of the business by substituting dividends for any compensation he would otherwise want to receive in the absence of the tax cut. Moreover, the discussion reveals how this outcome has a considerable class bias in two respects. First, high income individuals are

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<sup>3</sup> E.g., Thomas E. Fritz, *Flowthrough Entities and the Self-Employment Tax: Is it Time for a Uniform Standard?*, 17 Va. Tax Rev. 811 (1998).

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considerably more likely to be in a position to make this tax-saving substitution. Second, when they do take advantage of it, these high-income employee-shareholders save far more tax dollars than their lower income counterparts would. The article concludes by advancing a proposal that would make employment tax rules apply uniformly to all individuals who work for a business they also own.

## **II. Taxation of Business Profits to an Employee-Owner**

When an individual works for a business that he also owns, several federal laws may apply to extract a tax on the earnings of the business. The total tax extracted will determine how much the employee-owner has left to spend on personal items unrelated to the business. There are two sets of tax rules to consider. First there are income taxes that apply. These taxes may be imposed on the employee-owner, the business, or both. Second, there are federal employment taxes that may also come into play to the extent the earnings of the business are treated as the employee-owner's income from labor. The following sections describe the pertinent aspects of each set of rules.

### **A. Income Taxes on the Profits of a Business**

State law recognizes several vehicles through which a business can be conducted, including the sole proprietorship, various forms of the partnership, the limited liability company, and the corporation. Each business form offers a different mix of features that may affect how suitable it may be for any given situation and how attractive it may be to the owners of the business. One factor that the owners of any business are likely to consider is the extent to which the earnings of the business will be subject to the income tax. The rules that apply in any given situation will depend in the first instance on the state law business form used to operate the enterprise. The state law business form will dictate the default tax rules that will govern how the profits of the business are taxed. However, in most cases, the business can choose whether it wants an alternative set of rules to apply.

The Internal Revenue Code employs two alternative models for taxing the profits of a business. The first is the corporate model, which treats the business entity and its owners as separate and distinct taxpaying units. As a result, the business itself is subject to tax on any profits it makes.<sup>4</sup> In addition, the owners are subject to tax on any profits that the business actually pays to them as a

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<sup>4</sup> See I.R.C. § 11(a). Unless otherwise indicated, all references to the "I.R.C." are references to the Internal Revenue Code of 1986 as amended (title 26 of the United States Code).

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return on their investment.<sup>5</sup> The corporate model is the default system of taxation that applies when a business operates through a corporation.<sup>6</sup>

The two-tiered structure embodied by the corporate model stands in contrast to the flow through model of taxation. It does not treat the business entity as a taxpaying unit. Instead, the owners of the business are taxed on their share of the profits of the enterprise, whether or not the business actually pays any of these profits to them. The Internal Revenue Code contains several versions of the flow-through model of taxation. This article will address three.<sup>7</sup> There are the rules that apply to sole proprietors, there are the rules that apply to partnerships and there are the provisions of subchapter S.

Federal tax law does not consider a sole proprietor to be a separate business entity.<sup>8</sup> As a result, any income or loss of the business is merely included in the computation of the owner's individual income tax liability.<sup>9</sup> Any limited liability company that has only one member is treated as a sole proprietor for federal income tax purposes.<sup>10</sup> However, such a single member limited liability company can choose to be treated as a corporation for federal income tax purposes, which would bring the corporate model of tax into play.<sup>11</sup> If a business operates through a partnership or a limited liability company that has more than one owner, the business profits are taxed under the partnership version of the flow through model.<sup>12</sup> However, any such business has the option to be treated as a corporation for federal income tax purposes.<sup>13</sup> When this option is chosen, the corporate model of taxation applies exclusively. If a corporation meets certain eligibility requirements, it can choose to be subject to the flow-through provisions of subchapter S.<sup>14</sup>

Unless indicated otherwise, the next several sections use the term corporation to refer to any business entity (other than an S corporation) that is treated as such for federal income tax purposes, regardless of the state law business form through which the enterprise is conducted. Likewise, the article uses the term partnership to refer only to those state law partnerships that have not elected to be treated as a corporation for federal income tax purposes. In addition, the term limited liability company refers to any such company with

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<sup>5</sup> I.R.C. § 61(a)(7).

<sup>6</sup> Treas. Reg. § 301.7701-2(b)(1).

<sup>7</sup> The other versions of the flow-through model address unique industries and situations that are of little relevance to the average self-employed individual. They include the regulated investment company rules, the real estate investment trust rules, and rules that apply to estates and trusts, common trust funds, and qualified electing funds.

<sup>8</sup> Treas. Reg. § 301.7701-1(a)(2).

<sup>9</sup> See I.R.C. § 61(a)(2).

<sup>10</sup> Treas. Reg. § 301.7701-3(b)(1)(ii).

<sup>11</sup> Treas. Reg. § 301.7701-3(a).

<sup>12</sup> Treas. Reg. § 301.7701-3(b)(1)(i).

<sup>13</sup> Treas. Reg. § 301.7701-3(a).

<sup>14</sup> I.R.C. §§ 1362(a)(1), 1363(a).

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more than one owner that has not elected to be treated as a corporation for federal income tax purposes. Finally, the term sole proprietor refers to any sole proprietor and any single owner limited liability company that has not elected to be treated as a corporation for federal income tax purposes.

### 1. Taxation of the Profits of a Corporation

As a general proposition, there are two separate income taxes that apply to the profits of a business conducted through a corporation. First, the corporation itself has to pay an income tax on what it earns.<sup>15</sup> Second, a shareholder must pay an income tax on any after tax profits that the corporation pays to him as a dividend.<sup>16</sup> This two-tiered tax structure is one of the hallmarks of the U.S. corporate tax scheme.

The corporate tax applies only to the taxable income of a corporation.<sup>17</sup> Taxable income refers generally to revenues, reduced by the firm's cost of goods sold and certain expenses allowed by law.<sup>18</sup> Among other things, a corporation can deduct amounts paid as compensation to any employee (including an employee-owner) for services rendered to the business.<sup>19</sup> The principal restriction is that the deduction is limited to amounts that are reasonable for the services performed.<sup>20</sup> Thus, a corporation's taxable income gets reduced to the extent it pays compensation to its employees, resulting in a lower tax bill.

The corporate tax itself is determined under a system of marginal rates that applies to the corporation's taxable income. Under this structure, a corporation's taxable income consists of several different layers of income, each of which is taxed at a different rate. The first layer consists of all income up to \$50,000, which is taxed at 15 percent.<sup>21</sup> The second layer consists of all income over \$50,000 and up to \$75,000, which is taxed at 25 percent.<sup>22</sup> Each successive layer covers a higher range of taxable income, starting where the preceding layer left off. And the statute prescribes a different rate that applies to each of these layers. The marginal rates range from a low of 15 percent to a high of 39 percent. The following table summarizes the range of taxable income covered by each layer and the tax rate that applies to each layer.<sup>23</sup>

#### Corporate Income Tax Rates

| Taxable Income | Tax |
|----------------|-----|
|----------------|-----|

<sup>15</sup> I.R.C. § 11.

<sup>16</sup> I.R.C. § 61(a)(7).

<sup>17</sup> See I.R.C. § 11(a).

<sup>18</sup> I.R.C. § 63(a).

<sup>19</sup> I.R.C. § 162(a).

<sup>20</sup> I.R.C. § 162(a)(1).

<sup>21</sup> I.R.C. § 11(b)(1)(A).

<sup>22</sup> I.R.C. § 11(b)(1)(B).

<sup>23</sup> See I.R.C. § 11(b)(1).

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| <u>Over</u>  | <u>Up to</u> | <u>Rate</u> |
|--------------|--------------|-------------|
| \$0          | \$50,000     | 15%         |
| \$50,000     | \$75,000     | 25%         |
| \$75,000     | \$100,000    | 34%         |
| \$100,000    | \$335,000    | 39%         |
| \$335,000    | \$10,000,000 | 34%         |
| \$10,000,000 | \$15,000,000 | 35%         |
| \$15,000,000 | \$18,333,333 | 38%         |
| \$18,333,333 | unlimited    | 35%         |

Thus, if a corporation has \$150,000 of taxable income, that income will consist of four layers. The first \$50,000 will be taxed at 15 percent, the next \$25,000 will be taxed at 15 percent, the next \$25,000 will be taxed at 34 percent, and the last \$50,000 will be taxed at 39 percent.

Any profits that remain after the corporate tax has been extracted will be subject to tax again if they are paid to the shareholder as a dividend.<sup>24</sup> The amount the shareholder pays in tax will depend on several factors. The first consideration is the year when the dividends are paid. Different rules apply depending on the year the dividend is paid.

Dividends paid before 2003 and after 2008 are taxed under the same rules that apply to all income of the shareholder other than gains from the sale of capital assets held for over a year.<sup>25</sup> Such ordinary income is subject to tax under a system of marginal rates, similar to the system of marginal rates that applies to corporations.<sup>26</sup> Thus, the tax only applies to the extent the shareholder has taxable income. The taxable income of an individual generally includes all income (other than those items that are expressly exempt from tax) reduced by any deductions, exclusions and exemptions allowed by law.<sup>27</sup> Dividends received on corporate stock are included in the computation of taxable income.<sup>28</sup>

An individual's taxable income consists of several different layers of income, each of which is taxed at a different rate. The personal income tax imposes a set of marginal tax rates that is different from the rates imposed under the corporate income tax. In addition, each marginal rate applies to a different range of income depending on an individual's filing status. There are four categories into which an individual tax return can fall: Married Individual's Filing a Joint Return, Heads of Households, Unmarried Individuals, and Married Individuals Filing a Separate Return. In each case, there are six marginal tax rates ranging from 10 percent to 35 percent. The following table summarizes the

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<sup>24</sup> I.R.C. § 61(a)(7).

<sup>25</sup> Cf. I.R.C. § 1(h).

<sup>26</sup> See I.R.C. § 1.

<sup>27</sup> See I.R.C. 63.

<sup>28</sup> I.R.C. § 61(a)(7).

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six ranges of taxable income and the tax rate that applies to each range in the case of married individuals who file a joint return in 2006.<sup>29</sup>

| 2006 Income Tax Rates<br>Married Individuals Filing Jointly |           |          |
|---|-----------|----------|
| Taxable Income  |           | Tax Rate |
| Over  | Up to     |          |
| \$0   | \$15,100  | 10%      |
| \$15,100  | \$61,300  | 15%      |
| \$61,300  | \$123,700 | 25%      |
| \$123,700   | \$188,450 | 28%      |
| \$188,450   | \$336,550 | 33%      |
| \$336,550   | unlimited | 35%      |

Thus, a married couple with \$100,000 of combined taxable income in 2006 will be taxed at 10 percent on the first \$15,100. A 15 percent tax will apply to the next \$46,200 of taxable income. And a 25 percent tax will apply to the last \$38,700 of taxable income. Those six separate rate categories are in effect through 2010. After 2010, the schedule will be replaced with the one that was in effect from 1993 to 2000.<sup>30</sup> That schedule contained the following five marginal rates: 15 percent, 28 percent, 31 percent, 36 percent and 39.6 percent.<sup>31</sup> There were transitory schedules that applied in 2001 and 2002, each one containing six marginal rates. For 2001, the marginal rates were 10 percent, 15 percent, 27.5 percent, 30.5 percent, 35.5 percent and 39.1 percent. For 2002, the marginal rates were 10 percent, 15 percent, 27 percent, 30 percent, 35 percent and 38.6 percent.<sup>32</sup>

If a shareholder receives a corporate dividend after 2003 and before 2008, the dividend can be taxed in one of two ways, depending on how long the shareholder owned the stock in the dividend paying corporation. If the shareholder owned the stock for less than 61 days, the dividend will comprise part of the shareholder's ordinary income, making it subject to tax under the marginal rates just described.<sup>33</sup> However, in most cases where the shareholder owned the stock for at least 61 days, dividends paid on the stock will be taxed at the same rate that applies to gains from the sale of stock and other capital assets held for over one year.<sup>34</sup> That rate varies depending on the top marginal tax rate that applies to the shareholder's ordinary income. If that rate is 25 percent or higher, the dividends are taxed at 15 percent. If that rate is below 25 percent, the dividends are taxed at 5 percent.

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<sup>29</sup> I.R.C. § 1(a) as modified by Rev. Proc. 2005-70 to reflect inflation adjustments required by law.

<sup>30</sup> P.L. 107-16 § 901(a)(91); P.L. 108-27, § 107.

<sup>31</sup> I.R.C. § 1.

<sup>32</sup> I.R.C. § 1(i), as amended by P.L. 108-27, sec. 105(a).

<sup>33</sup> Cf. I.R.C. § 1(h)(11)(B)(iii)(I).

<sup>34</sup> I.R.C. § 11(h).

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If a shareholder receives a corporate dividend in 2008, the 61-day minimum holding still applies to determine whether the dividend will comprise part of the shareholder's ordinary income or if it will be taxed as a long term capital gain. In addition, the tax imposed in the latter situation will still vary depending on the marginal tax rate that applies to the shareholder's ordinary income. The only difference is that the rates will change. The tax will be 15 percent if the shareholder's ordinary income is subject to tax at the marginal rate of 25 percent or higher. However, the dividend will be exempt from tax if the shareholder's ordinary income is subject to tax at a marginal rate below 25 percent. The following table summarizes by year how dividends are taxed to individual shareholders.<sup>35</sup>

**Tax on Corporate Dividends  
Received by Individuals**

| Minimum Holding Period Met | Year Dividend Received                                |  |  |  |  |  |   |
|----------------------------|---|--|--|--|--|--|---|
|                            | Before 2001   | 2001   | 2002   | 2003 – 2007  | 2008   | 2009 – 2010  | After 2010  |
| <b>Yes</b>                 | N/A   | N/A  | N/A  | 15% or 5%  | 15% or 0%  | N/A  | N/A   |
| <b>No</b>                  | Ordinary Income:<br>15%<br>28%<br>31%<br>36%<br>39.6% | Ordinary Income:<br>10%<br>15%<br>27.5%<br>30.5%<br>35.5%<br>39.5% | Ordinary Income:<br>10%<br>15%<br>27%<br>30%<br>35%<br>38.6% | Ordinary Income:<br>10%<br>15%<br>25%<br>28%<br>33%<br>35% | Ordinary Income:<br>10%<br>15%<br>25%<br>28%<br>33%<br>35% | Ordinary Income:<br>10%<br>15%<br>25%<br>28%<br>33%<br>35% | Ordinary Income:<br>15%<br>28%<br>31%<br>36%<br>39.6% |

Although the rules subject the profits of a business to tax at the corporate level and also at the shareholder level, there are many situations in which only one of the two taxes will apply. For instance, the shareholders will not have to pay tax on any profits that are not actually paid to them as dividends. In such a case only the corporation will be subject to tax on the earnings. Alternatively, only a shareholder will be taxable on amounts paid to him as reasonable compensation for services rendered to the firm. The corporation will pay no tax on these amounts because they are a deductible item that reduces the corporation's taxable income.

Because shareholders of (primarily closely held) corporations have an incentive to employ such strategies to avoid tax, there are rules designed to either penalize or outlaw such behavior. A practice of not paying dividends to

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<sup>35</sup> Different rules apply when dividends are paid to shareholders that are corporations. See I.R.C. §§ 243 – 246A.

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shareholders could trigger the accumulated earnings tax. The Internal Revenue Service is authorized to assess this penalty tax when it determines that the corporation has accumulated profits beyond the reasonable needs of the business.<sup>36</sup> The tax is generally computed at a rate that corresponds to the rate that would apply to any dividends paid to a shareholder. Thus, the current rate is 15 percent.<sup>37</sup>

Aside from the accumulated earnings penalty tax, the personal holding company tax would apply if two conditions are met. First at least 60 percent of the corporation's gross income must come from certain passive sources, like interest and dividends.<sup>38</sup> Second, five or fewer individuals must own over half of the stock in the corporation.<sup>39</sup> If these two conditions are met in any given year, a penalty tax is imposed on virtually all taxable income of the corporation from that year, other than amounts distributed to shareholders as a dividend.<sup>40</sup> Unlike the accumulated earnings tax, the personal holding company tax applies in a mechanical fashion. It cannot be avoided by showing the absence of an intention to evade tax.<sup>41</sup>

Like the accumulated earnings tax, the penalty is computed at a rate that generally corresponds to the rate that would apply to dividends paid to a shareholder. Thus, the current penalty rate is 15 percent. After 2008, when the temporary tax cut on dividends expires, the rate will be adjusted to reflect the highest marginal tax rate that applies to individuals. That rate currently stands at 35 percent, but it is due to revert to 39.6 percent after 2010.

In cases where the corporation uses its profits to pay a shareholder compensation for services rendered to the business, there is only one restriction on the firm's ability to do so: the amount must be reasonable.<sup>42</sup> No bright line rule applies to determine whether a salary is reasonable. Instead, the courts use a variety of tests. Furthermore, in the event the corporation claims a deduction for compensation that is not reasonable, the corporation will still benefit from that deduction unless it is adjusted after being challenged by the Internal Revenue Service. Because unreasonable compensation is difficult to detect, many such overstated deductions go unchallenged.

## 2. Taxation of the Income of an S Corporation

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<sup>36</sup> I.R.C. §§ 531, 532(a), 533(a).

<sup>37</sup> I.R.C. § 531.

<sup>38</sup> I.R.C. § 542(a)(1).

<sup>39</sup> I.R.C. § 542(a)(2).

<sup>40</sup> I.R.C. §§ 541, 545.

<sup>41</sup> *Cf.* I.R.C. §§ 532(a), 533. When the personal holding company tax applies, the accumulated earnings tax will not. I.R.C. § 532(b)(1).

<sup>42</sup> I.R.C. § 162(a)(1).

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Federal tax law permits any corporation that satisfies certain eligibility requirements to elect to be treated as a small business corporation for federal tax purposes.<sup>43</sup> As a result, the corporation would be subject to the rules of subchapter S of the Internal Revenue Code. Under subchapter S, the corporation does not pay any corporate tax on the income of the business.<sup>44</sup> Instead, the business profits are taken into account by each shareholder to determine their individual income tax liabilities.<sup>45</sup> The amount that any shareholder takes into account is referred to as the shareholder's pro rata share and reflects his percentage interest in the corporation.<sup>46</sup> Thus, an individual who owns half the stock in an S corporation in any given year is taxable on half of any income (or loss) generated by the corporation in that year.

The actual tax that an S corporation shareholder pays on any income allocated to him will depend on the source of the income.<sup>47</sup> Thus, any item of income that the corporation derives from a tax exempt source will be tax exempt to the shareholder. Similarly, any item of income that the corporation derives from the sale of a capital asset that the corporation held for over a year will be taxed at the rate that applies to long term capital gains.<sup>48</sup> Meanwhile, any item of income that the corporation derives from a source other than one that is subject to a special rate of tax is treated as ordinary income, making it subject to tax at the marginal rates that apply to all of the shareholder's ordinary income.<sup>49</sup> An S corporation is commonly referred to as a flow-through entity precisely because any income generated by the corporation retains its character when allocated to the shareholders as pro rata shares. Moreover, this income is taxed to the shareholders in the year earned by the corporation, not the year received from the corporation.

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<sup>43</sup> Under current law, an S corporation can have no more than 100 shareholders, all of whom must be individuals (other than nonresident aliens), certain trusts or estates. I.R.C. § 1361(b)(1)(A), (B) and (C). In addition, there can only be one class of stock in the corporation. I.R.C. § 1361(b)(1)(D). Finally, the S election is not available to certain financial institutions, insurance companies, domestic international sales corporations, or corporations that have made an election under section 936. I.R.C. § 1361(b)(2).

<sup>44</sup> I.R.C. § 1363(a). There are two very narrow exceptions to this general rule. In certain cases where an S election has not been in effect throughout the life of the corporation, an S corporation may be liable for two different taxes. A tax on built-in gains could apply if an S corporation realizes a gain on the sale of an appreciated asset it owned at the time the S election took effect. I.R.C. § 1374. Second, if the S election took effect before the time the corporation distributed any accumulated profits to its shareholders, a tax on excess passive investment income could apply until the corporation actually distributes those accumulated profits to its shareholders. I.R.C. § 1375.

<sup>45</sup> I.R.C. § 1366(a).

<sup>46</sup> I.R.C. § 1377(a)(1).

<sup>47</sup> I.R.C. § 1366(b).

<sup>48</sup> I.R.C. § 1(h).

<sup>49</sup> See discussion accompanying notes 26 et seq.

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A shareholder in an S corporation is taxable on amounts he actually receives from the corporation depending on the reason for the payment. To the extent the payment is a distribution of the business profits previously allocated to the shareholder, the payment will not be taxable to him.<sup>50</sup> (The tax was already imposed when the corporation allocated its income to the shareholder as a pro rata share.) However, if the shareholder receives a payment that constitutes compensation for services rendered to the corporation, the payment will be taxable as income to him, just as compensation from any other source would.<sup>51</sup> Such compensation will also be a deductible expense to the corporation, provided the amount is reasonable for the services rendered.<sup>52</sup> Like any other deductible expense, the payment will reduce the amount of business profits that are left to be allocated to the shareholders as taxable pro rata shares.<sup>53</sup> The net effect is that the income tax of a shareholder in an S corporation is based partly on amounts that the corporation pays to him as compensation, and partly on the profits (net of compensation expense) the corporation allocates to him as a pro rata share.

### 3. Taxation of the Income of a Partnership or Multi-Member Limited Liability Company

Subchapter K contains the default rules that determine the extent to which the profits of a business are taxed when the business is conducted as a partnership or limited liability company that has more than one member. As discussed above, both such business entities are treated as a partnership for federal income tax purposes.<sup>54</sup> As a general rule, the profits of a business conducted are not taxed at the partnership level.<sup>55</sup> Instead, the partners are taxed on their respective shares of the taxable profits of the business.<sup>56</sup> In any given tax year, a partner will be allocated a share of the partnership's business profits and other items.<sup>57</sup> Such an allocation is referred to as the partner's distributive share.<sup>58</sup> To the extent a partnership has made an allocation of profits to a partner, the partner will not pay tax on those profits when he actually receives them in the form of a distribution from the partnership.<sup>59</sup> Thus, if a 50-50

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<sup>50</sup> I.R.C. § 1368(b)(1).

<sup>51</sup> I.R.C. § 61(a)(1).

<sup>52</sup> I.R.C. § 162(a)(1).

<sup>53</sup> I.R.C. §§ 1363(b); 1366(a), (c).

<sup>54</sup> See discussion accompanying note 12.

<sup>55</sup> I.R.C. § 701.

<sup>56</sup> *Id.*

<sup>57</sup> I.R.C. § 702.

<sup>58</sup> I.R.C. § 702(a).

<sup>59</sup> I.R.C. § 731(a)(1). The statute specifically permits a partner to receive a distribution tax free up to the partner's basis in the partnership. A partner acquires (or loses) basis as a result of an allocation of profits (or losses) to the partner in the form of distributive shares. I.R.C. § 705(a).

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partnership makes \$100,000 in taxable income in one year, each partner will be allocated and taxable on \$50,000. However, neither partner will be subject to tax when they actually receive a distribution of that money from the partnership.

Like an S corporation, a partnership derives its flow-through qualities from the fact that only the partners, not the business, are taxable on the profits of the business.<sup>60</sup> In addition, a partner's actual tax liability will depend in part on the source of any income item allocated to him.<sup>61</sup> Thus, if the partnership derives income from a tax exempt source, the partners will pay no tax on their respective allocations of that item. Similarly, any item of income that the partnership derives from the sale of a capital asset that the partnership held for over a year will be taxable to the partner at the rate that applies to long term capital gains.<sup>62</sup> Meanwhile, any item of income that the partnership derives from a source other than one that is subject to a special rate of tax is treated as ordinary income, making it subject to tax at the marginal rates that apply to all of the partner's ordinary income.<sup>63</sup>

A partner is taxable on amounts he actually receives from a partnership depending on the reason for the payment. To the extent the payment is a distribution of the business profits previously allocated to the partner, the payment will not be taxable to the partner.<sup>64</sup> (The tax was already imposed when the partnership allocated its income to the partner as a distributive share.) However, if the partner receives a payment that constitutes compensation for services rendered to the partnership, the payment will be taxable as income to the partner, just as compensation from any other source would.<sup>65</sup> Referred to as a form of "guaranteed payment", such compensation paid to a partner will also be a deductible expense to the partnership, provided it is reasonable for the services rendered.<sup>66</sup> Like any other deductible expense, the payment will reduce the amount of business profits that are allocated to the partners as taxable distributive shares.<sup>67</sup> The net effect is that the income tax of a partner will be based partly on amounts that the partnership pays to him as a guaranteed payment of compensation, and partly on the profits (net of compensation expense) the partnerships allocates to him as a distributive share.

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<sup>60</sup> I.R.C. § 701.

<sup>61</sup> I.R.C. § 702(b).

<sup>62</sup> I.R.C. § 1(h).

<sup>63</sup> See discussion accompanying footnote 26 et seq.

<sup>64</sup> I.R.C. § 731(a)(1).

<sup>65</sup> I.R.C. § 61(a)(1). The payment is taxable income to the partner only if the amount of the payment does not depend on the income of the partnership. I.R.C. § 707(c). Otherwise, the transaction is treated as an allocation of partnership profits to the partner, followed by an actual payment of those profits to the partner. Cf. I.R.C. § 707(a)(2)(A).

<sup>66</sup> I.R.C. § 162(a)(1). The deduction is only available if the amount of compensation does not depend on the income of the partnership. I.R.C. § 707(c).

<sup>67</sup> I.R.C. §§ 707(c); 703(a).

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Although the rules that apply to partnerships and S corporations are similar in many ways, the partnership rules generally allow for more flexibility. First, there are several restrictions on the number and the type of shareholders that a corporation can have in order to be eligible to convert to (and remain) an S corporation.<sup>68</sup> These restrictions stand in contrast to the absence of any limitations on the types and number of investors that can be partners in a partnership. In addition, in an S corporation, all items of income, loss and deduction and credit must be allocated among the shareholders each year pro rata, based on the number of shares they own and the length of time they owned the shares.<sup>69</sup> By contrast, in a partnership, virtually any allocation that the partners choose will be respected as long as the allocation tracks the economic relationship between the partners.<sup>70</sup> This generally means that the allocations of partnership income and other items control what the individual partners are entitled to receive in the form of actual payouts.<sup>71</sup> Moreover, because an S corporation can only have one class of stock, it cannot single out any individual shareholder for the payment of dividends.<sup>72</sup> Rather, any distribution of business profits must be shared by all shareholders on the basis of the number of shares owned. By contrast, if a partnership wants to make a distribution to just one partner, it can do so. Similarly, if it wants to make a distribution to several partners, there is no requirement that the distribution be allocated among its recipients in any particular way.

### **B. Federal Taxes on an Employee-Owner's Income from Labor**

There are two sets of federal employment tax statutes that may apply to an individual who works for a business he also owns. The first is the Federal Insurance Contribution Act ("FICA"), which imposes a tax that is commonly referred to as the social security tax. The second is the Self-Employment Contribution Act ("SECA"), which imposes a tax that is often referred to as the self-employment tax. The amounts collected under both acts are earmarked for funding social security and Medicare benefits.<sup>73</sup> The two acts are mutually exclusive so that only one set of rules will ever apply to any given dollar of earnings. Thus, when the FICA rules apply, the SECA rules will not, and vice versa.

The statutes are intended to impose a tax on income from labor, as opposed to any returns on capital. As a result, each statute attempts to define the

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<sup>68</sup> See footnote 43.

<sup>69</sup> I.R.C. §§ 1366(a), 1377(a)(1).

<sup>70</sup> I.R.C. § 704(b).

<sup>71</sup> Treas. Reg. § 1.704-1(b)(2)(ii)(b).

<sup>72</sup> I.R.C. § 1361(b)(1)(D).

<sup>73</sup> 42 U.S.C. § 401 (2005).

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tax base in a way that isolates such labor income.<sup>74</sup> However, because it can be difficult to distinguish such income from what an employee-owner receives as a return on capital, the line that separates the two can often appear arbitrary.<sup>75</sup>

### 1. FICA

The tax imposed by FICA has two components. The first is the old-age, survivors, and disability insurance component, often referred to as OASDI. It is a 12.4 percent levy on amounts that constitute “wages from employment.”<sup>76</sup> One half of the tax is deducted from the employee’s compensation.<sup>77</sup> The employer pays the other half.<sup>78</sup> This component of the FICA tax is earmarked to cover social security benefits. There is a limit on the amount of wages that can be taxed.<sup>79</sup> Referred to as the contribution and benefit base, this limit is \$94,200 for 2006.<sup>80</sup> Thus, any wages from employment beyond that limit are exempt from the FICA-OASDI tax. The contribution and benefit base is adjusted each year to reflect increases in average wages of the U.S. economy.<sup>81</sup>

The second component of the FICA tax is the hospital insurance component. It is a 2.9 percent levy on an individual’s “wages from employment.” As with the OASDI component, one half of this tax is deducted from the employee’s compensation, while the employer pays the other half. However, unlike the OASDI component, there is no limit on the amount of wages from employment that is subject to the tax. Thus, the hospital insurance tax applies to all amounts that qualify as wages from employment, even amounts that exceed the OASDI contribution and benefit base. The hospital insurance component of the FICA tax is earmarked to cover Medicare benefits.

The FICA tax will apply to a self-employed individual only when he operates the business through either a C corporation or an S corporation. In those instances, only amounts that the corporation pays to the employee-owner as remuneration for employment count as wages from employment.<sup>82</sup> Thus, only those amounts are subject to the FICA tax. The individual’s share of any other profits of the business simply is not subject to the FICA tax, even if it could be considered the product of the employee-owner’s labor. As a result, earnings that the corporation retains are not subject to the FICA tax. Nor are amounts paid to

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<sup>74</sup> Patricia E. Dilley, *Breaking the Glass Slipper – Reflections on the Self-Employment Tax*, 54 *Tax Law.* 65 (2000).

<sup>75</sup> Lester B. Snyder, *Taxation with An Attitude: Can We Rationalize the Distinction Between “Earned” and “Unearned” Income?*, 18 *Va. Tax Rev.* 241 (1998).

<sup>76</sup> I.R.C. §§ 3101(a), 3111(a).

<sup>77</sup> I.R.C. § 3102(a).

<sup>78</sup> I.R.C. § 3111(a).

<sup>79</sup> I.R.C. § 3121(a)(1).

<sup>80</sup> Notice 2005-85, 2005-46 I.R.B. 961.

<sup>81</sup> 42 U.S.C. § 430 (2005).

<sup>82</sup> I.R.C. § 3121(a).

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an employee-shareholder as a dividend. By defining the tax base in this way, FICA presents the opportunity for individuals to manage or control their employment tax liability when they own and control a business conducted through an S corporation or a C corporation. In such cases, the individual can determine whether compensation is paid, when it gets paid, and how much is paid. By exercising this power, the individual necessarily controls whether he must pay the FICA tax, when he must pay the FICA tax, and how much tax he must pay.

A limited liability company that is treated as a corporation enjoys additional tax planning opportunities. Because shares in a state law corporation belong to designated classes, all owners of shares in a given class must share in any distribution paid to one class member; the corporation cannot single out an individual shareholder to receive a dividend distribution. No such restriction applies to a limited liability company. Thus, the company is entirely free to single out one of its members for a distribution. Similarly, the company could make a distribution to several members and not be obligated to allocate the payment in any particular way. This flexibility presents the opportunity for an employee-member to receive a distribution as disguised compensation for services rendered to company, potentially avoiding the member's employment tax liability.

## 2. SECA

The SECA tax operates as the FICA tax counterpart for self-employed individuals. Accordingly, like the FICA tax, the SECA tax has two components. The first component is a 12.4 percent tax earmarked to finance social security benefits. Its counterpart is the OASDI component of the FICA tax. The second component is a 2.9 percent tax earmarked to fund the Medicare insurance program.<sup>83</sup>

The contribution and benefit base that applies to the OASDI component of the FICA tax also applies to the OASDI component of the SECA tax. Thus, the OASDI tax applies to no more than \$94,200 in 2006. The SECA and FICA statutes are designed so that the OASDI component of the taxes will never apply to more than the FICA contribution and benefit base in effect for any year.<sup>84</sup> Thus, if an individual has \$100,000 of wages from employment in 2006, the FICA-OASDI tax would apply to the first \$94,200, leaving no portion of any self-employment income to be taxed under SECA. Conversely, if an individual has no wages from employment in 2006, there would be nothing to tax under FICA, while the SECA-OASDI tax would apply to up to \$94,200 of any income the individual may have from self-employment. If, however, an individual has \$40,000 of wages from

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<sup>83</sup> I.R.C. § 1401(b).

<sup>84</sup> See I.R.C. § 1402(b).

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employment in 2006, the entire amount would be subject to the FICA-OASDI tax, while up to \$54,200 of self-employment income would be subject to the SECA-OASDI tax, resulting in a tax on no more than the \$94,200 contribution and benefit base in effect for the year. By operating in this way, the rules ensure that anyone whose income includes both wages from employment and income from self-employment will never be at a disadvantage to someone who has income does not have income from both sources.<sup>85</sup>

Both components of the SECA tax apply to an individual's "income from self-employment."<sup>86</sup> The term does not include any amounts that are subject to the FICA tax.<sup>87</sup> In addition, in order to count as income from self employment, an item must qualify as net earnings from self-employment ("NESE").<sup>88</sup> What counts as NESE for a self-employed individual will depend on the kind of legal entity used to conduct the business enterprise. It will also depend on the kind of ownership interest the individual may have in the business. However, in no event will the SECA tax ever apply to amounts generated by a self-employed individual who conducts his business through either a C corporation or an S corporation. In those cases, the payments they receive as compensation will be subject to the FICA tax.<sup>89</sup> Any dividends received by a shareholder in a C corporation are expressly excluded from the reach of the SECA tax.<sup>90</sup> Furthermore, SECA has no provision that would count as part of the tax base an individual's the pro rata share from an S corporation.

Because the S corporation is a flow-through entity, one would expect that the SECA rules would control to determine the employment tax liability of any shareholder, just as they do to the owner of all other flow through business entities. The fact that it does not is largely a relic of a bygone era. When the self-employment tax was enacted, the S corporation did not exist, so the tax base could not be defined by reference to amounts earned through such a business. Furthermore, when subchapter S was adopted, a shareholder's pro rata share

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<sup>85</sup> The fact that the OASDI component of the employment tax does not apply to amounts in excess of the annually contribution and benefit base distinguishes it from the generally progressive way in which the federal income tax operates. The income tax applies only to the extent an individual has income that exceeds certain amounts that are either excluded, exempt, or deducted from gross income. I.R.C. § 63. The two federal employment taxes have been widely criticized for being regressive. *E.g.*, Deborah A. Geier, Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income, 22 Va. Tax Rev. 1 (2002).

<sup>86</sup> I.R.C. § 1401(a), (b).

<sup>87</sup> I.R.C. § 1402(b)(1).

<sup>88</sup> I.R.C. § 1402(b).

<sup>89</sup> See discussion accompanying note 82. See also I.R.C. § 1402(c)(2).

<sup>90</sup> I.R.C. § 1402(a)(2). The Internal Revenue Service has had limited success convincing courts to treat dividends as disguised remuneration for services rendered, causing such amounts to be subject to the FICA tax. *E.g.*, Nu-Look Design, Inc. v. Comm'r, 356 F.3d 290 (3d Cir. 2004); Radtke v. U.S., 712 F.Supp. 143 (E.D. Wis. 1989); Spicer Accounting, Inc. v. U.S., 918 F.2d 90 (9th Cir. 1990). See also Burgess J.W. Raby and William L. Raby, Shareholder Compensation: How Low Can You Go?, Tax Notes Today, June 13, 1996, 96 TNT 116-62.

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was treated as a dividend.<sup>91</sup> The SECA statute expressly states that net earnings from self employment do not include dividends.<sup>92</sup> However, subchapter S was later revised to modify the tax character of an S corporation's pro rata share. Today, a pro rata share is no longer regarded as a dividend. Instead, the individual items of S corporation taxable income flow through to the shareholders, retaining their character in the hands of the shareholder.<sup>93</sup> Even though this made a shareholder's pro rata share virtually identical to a partner's distributive share, Congress never updated the self-employment statute establish parity in the way the law applies to the two situations. Thus, today the statute does not define net earnings from self-employment to include an S corporation shareholder's pro rata share, while it does expressly include a partner's distributive share of partnership income as such.<sup>94</sup> Clearly, Congress could update the law if it could. It has been suggested that Congress has not done so partly because it views the separate existence of the S corporation as a sufficient basis for treating pro rata share allocations as investment income, not income from labor.<sup>95</sup>

### a. Partner in a Partnership

The employment tax base of a partner in a partnership depends on whether the partner is a general partner or a limited partner. If a partner is a general partner, the self employment tax will apply to the partner's distributive share allocation of partnership income.<sup>96</sup> The tax will also apply to any guaranteed payment the partner receives, whether for the use of capital or for the performance of services.<sup>97</sup> For a limited partner, the self employment tax applies

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<sup>91</sup> I.R.C. § 1373(b) (1959).

<sup>92</sup> I.R.C. § 1402(a)(2). In addition, the Internal Revenue Service concluded that such an item did not count as part of the shareholder's net earnings from self-employment. Rev. Rul. 59-221, 1959-1 C.B. 225.

<sup>93</sup> I.R.C. § 1366(b), as amended by Subchapter S Revision Act of 1982, P.L. No. 97354, 96 Stat. 1669 (1982).

<sup>94</sup> I.R.C. § 1402(a).

<sup>95</sup> Fritz, *supra* note 3 at 825.

<sup>96</sup> I.R.C. § 1402(a). Certain adjustments are made to the partner's distributive share to determine the amount that is subject to the self-employment tax. The adjustments generally prevent the tax from applying to certain passive items of income that do not represent income from labor. Thus, in computing the self-employment income of a partner, the distributive share is adjusted to exclude, among other things, interest and dividends, and gains and losses from the sale of capital assets. I.R.C. § 1402(a)(2), (3).

<sup>97</sup> Treas. Reg. § 1.1402(a)-1(b). The regulation predates a 1977 amendment that redefined what counts as self-employment income to a partner. I.R.C. § 1402(a)(13), added by the Social Security Amendments of 1977, P.L. 95-216, § 313(b). (This paragraph was originally added as paragraph 12. However, P.L. 98-21, § 124(c)(2) redesignated paragraph 12 as paragraph 13.) The change only affected what counts as self-employment income to a limited partner. The legislative history does not elaborate on the intended scope of the change. See H.R. Rep. No. 8-702, 95<sup>th</sup>

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only to the guaranteed payments received for the performance of services.<sup>98</sup> It does not apply to their distributive share of income of the partnership.<sup>99</sup> If a partner owns both a general partnership interest and a limited partnership interest, the self-employment tax applies to that portion of the partner's distributive share associated with the general partnership interest only.<sup>100</sup>

There are no provisions in the self-employment tax statute or regulations that specify what distinguishes a limited partner from a general partner for purposes of the statute.<sup>101</sup> This stands in contrast to standard articulated in the Revised Uniform Partnership Act. Under those rules, a limited partner is not liable for the debts and obligations of the partnership, while a general partner is. Moreover, a limited partner risks losing the protection of the limited liability if he participates in the control of the partnership.<sup>102</sup> Thus, under current law, a partner's exposure for the self-employment tax is purely a matter of the nature of the interest the partner owns in the partnership.

One might expect that amounts received by a partner in exchange for the performance of services would count as wages from employment for FICA purposes. However, the legislative history indicates that Congress expected that it would not be appropriate to treat the partnership as a separate taxpaying entity (as opposed to an extension of the partner) in certain situations.<sup>103</sup> In addition, the Internal Revenue Service long ago concluded that it is inappropriate to treat a partnership as an employer of one of its members.<sup>104</sup> As a result, payments that are considered to be made by the partnership to a partner who is not acting in his capacity as a partner will not count as wages that are subject to the FICA tax. Instead, the amounts are treated as self-employment income to the partner.<sup>105</sup>

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Cong., 2d Sess. 85 (1977). Thus, it appears that general partners remain subject to employment tax on guaranteed payments received both for services performed and for the use of capital.

<sup>98</sup> I.R.C. § 1402(a)(13).

<sup>99</sup> I.R.C. § 1402(a)(13).

<sup>100</sup> Prop. Reg. § 1.1402(a)-2(h).

<sup>101</sup> However, there are proposed regulations which would consider the degree to which a limited partner participates in the operations of the partnership. Prop. Reg. § 1.1402(a)-2(h)(2). Congress acted in 1997 to prohibit the Internal Revenue Service from finalizing these regulations. Taxpayer Relief Act of 1997, P.L. 105-34, § 935.

<sup>102</sup> Revised Uniform Partnership Act § 303(a).

<sup>103</sup> The 1954 Conference Report includes the following language:

[Section 707(a) provides] for the use of the "entity" approach in the treatment of the transactions between a partner and a partnership . . . . No inference is intended, however, that a partnership is to be considered a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions.

H.R. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954).

<sup>104</sup> Rev. Rul. 69-184, 1969-1 C.B. 256.

<sup>105</sup> *Id.*

### **b. Member of a Multi-Member Limited Liability Company**

Because a multi-member limited liability company is treated as a partnership for federal income tax purposes (absent an election to be treated as a corporation), any member is treated as a partner in a partnership for purposes of the self-employment tax. However, applying the partnership rules to a limited liability company does not produce any clear answers.

A limited liability company has only one category of member, while the partners in a partnership can participate as either a general or a limited partner, depending on the level of liability protection the owner desires and the extent to which they intend to participate in the business of the partnership. In a limited liability company, each member enjoys the same level of protection from liability for the debts and obligations of the business; it is limited to the member's investment in the company.<sup>106</sup> In addition, a member does not jeopardize the limit on liability by participating in the business of the company.<sup>107</sup>

SECA applies a different set of rules depending on whether the individual is either a general or a limited partner in the partnership. However, a limited liability company draws no such distinction between its members. One could assert a reasoned basis for applying either rule. For example, it would seem appropriate to treat a member as equivalent to a general partner since all members are in a position to participate in the operations of the company.<sup>108</sup> On the other hand, one could argue that the limited partnership rules should apply on the grounds that that a member enjoys limited liability from the debts and obligations of the business, the hallmark of a limited partner's status as such.<sup>109</sup>

Understandably, the absence of a clear rule has been an invitation for some to take the position that a member must comply with the rules that apply to limited partners when doing so works to their advantage.<sup>110</sup> Taking that position minimizes the member's employment tax liability because the member's net earnings from self-employment would consist solely of amounts received from the company in exchange for services the member performed for the company; no part of the member's allocation of business profits would be included in the employment tax base.

### **c. Sole Proprietor**

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<sup>106</sup> Uniform Limited Liability Company Act [hereinafter "ULLCA"] (1996) §§ 303, 402(a).

<sup>107</sup> ULLCA (1996) § 303(a).

<sup>108</sup> ULLCA (1996) § 301(a), (c).

<sup>109</sup> See ULLCA (1996) § 303.

<sup>110</sup> See, e.g., Burgess J.W. Raby and William L. Raby, New Incentive for Avoiding SE and FICA Tax, Tax Notes Today, December 10, 1998, 98 TNT 237-58.

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If a single individual does not create or organize a formal entity through which to conduct a business, that individual is considered to be operating the business as a sole proprietor, a status that does not give rise to a separate legal entity. Thus, the assets of the business are considered to be owned by the individual sole proprietor. In addition, that individual is liable for the debts and obligations of the business.<sup>111</sup>

For purposes of the income tax, a sole proprietor is disregarded as a separate taxpaying entity.<sup>112</sup> Thus, the business, as such, does not pay income tax on the profits generated by its activities. Instead, any profits from the business are included in the gross income of the owner.<sup>113</sup> Thus, the owner pays tax on the business profits at the rates that apply to the owner.<sup>114</sup>

Aside from having to pay income tax on the business profits, a sole proprietor also will have to pay self-employment tax on those business profits.<sup>115</sup> Thus, as a general rule, any amounts that will be taxed to the owner for income tax purposes will also be taxed to the owner for employment tax purposes.

However, business losses are treated differently under the income and employment taxes. Under the income tax, the sole proprietor can utilize the loss to offset taxable income from other sources, both in the year of the loss and in other tax years.<sup>116</sup> Thus, for example, if the business loses \$10,000 in its first year of operation, and if the owner has income from other sources in that year, the loss will offset \$10,000 of income from those other sources, triggering a reduction in the owner's income tax liability. However, if the owner has no income from other sources or if the income from those other sources is less than what he lost from the business, the owner can utilize that loss to offset taxable income in other years. The loss is generally utilized in the prior two tax years and the succeeding twenty tax years.<sup>117</sup> A special rule permits the individual to waive the use of a loss to offset income in prior years.<sup>118</sup> By permitting the owner to utilize a loss to offset income in years other than the one in which the loss arose, the income tax rules essentially represent an exception to the general requirement that individuals must compute their income tax liability on the basis of the activities and events that occur within specific annual accounting period.

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<sup>111</sup> For a discussion of the sole proprietorship, see Larry E. Ribstein, *Unincorporated Business Entities* (3d ed.) chapter 2.01.

<sup>112</sup> Treas. Reg. § 301.7701-2(c)(2)(i). The mechanism for doing so is the Schedule C, which the owner must complete and include when filing her annual tax return.

<sup>113</sup> I.R.C. § 61(a)(3).

<sup>114</sup> Individuals are taxed under a graduated rate structure whose rates range from 10% to 35%. I.R.C. § 1(a) through (d); Rev. Proc. 2003-85. The 10% bracket will expire after 2008, leaving the lowest bracket of income to be taxed at 15%. The tax applies to amounts that exceed any exemptions, exclusions and deductions that are allowed to the individual. I.R.C. § 63.

<sup>115</sup> I.R.C. § 1402(a).

<sup>116</sup> I.R.C. § 172(a).

<sup>117</sup> I.R.C. § 172(b)(1)(A).

<sup>118</sup> I.R.C. § 172(b)(3).

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By contrast, the employment tax rules generally do not permit a business loss to reduce the amounts subject to employment tax. Thus, if a sole proprietor has wages from employment in a year that he also sustained a \$10,000 loss from the business, the business loss will not offset any portion of the wages, which will be subject to the FICA tax to the extent they do not exceed the contribution and benefit base. However, if an individual has several businesses that are each operated as a sole proprietorship, a loss sustained by one business will be taken into account to determine the individual's net earnings from self-employment for that year.<sup>119</sup> However, if the loss from one business exceeds the profits from all the other businesses, the net loss still is not available to offset taxable amounts in other years. In this way, the employment tax rules treat multiple businesses as one enterprise, while continuing to base the individual's employment tax liability solely on the activities and events that occur during a particular annual accounting period.

### C. Commentary on the Employment Tax Scheme

The existing federal employment tax statutory scheme is defective in several respects. First, it lacks a clear rule that applies to a member of any limited liability company that has not elected to be treated as a corporation for federal income tax purposes. The gap in the law gives rise to tax planning opportunities that can produce several undesirable outcomes. First, it increases the role that tax considerations play in the selection of an entity for conducting a business enterprise. Ideally, the choice of a business entity should not be influenced by tax considerations. Second, it creates the very real potential that individuals who may be identical situations will interpret the law differently, leading to different computations of their employment tax liability. In an ideal world, individuals in substantially similar situations should pay the same tax. Third, the government is likely to collect less than what it is due in tax, leading to underfunding of the Social Security and Medicare programs at a time when their long term financial solvency is in question. Fourth, the absence of clarity can increase how much it costs taxpayers to comply with the law. At one extreme, taxpayers who are willing and able to obtain competent tax advice will do so when such an expense can be avoided if the law merely enunciated a clear rule. Finally, the mere existence of a tax planning opportunity runs the risk of undermining respect for a tax system that relies on voluntary compliance, increasing the need for the government to fund enforcement activities.

Another defect in the existing statutory scheme is that the tax liability of a partner in a partnership depends on whether the partner owns a general or limited partnership interest. The use of two separate rules dates back to a time when there was a substantive difference between the two classes of partners.

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<sup>119</sup> Treas. Reg. § 1.1402(a)-2(c).

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The self-employment tax rules initially required all partners (whether limited or general) to be taxed on their distributive share of income.<sup>120</sup> At the time, a limited partner had to be a passive investor in the partnership, or risk losing the protection of limited liability. Congress later determined that it was inappropriate to treat as earnings from work amounts allocated to a limited partner who did not (and could not) play an active role in the business.<sup>121</sup> As a result, Congress changed the law so that the self employment tax of a limited partner would only be based on amounts the partner received in exchange for rendering services to the business.<sup>122</sup> Over the course of time, however, state law has evolved to permit individuals to play active roles in an unincorporated business without losing the protection of limited liability.<sup>123</sup> As a result, it no longer makes sense for the self-employment tax to be based on the mere designation of a partner as a general or limited one.

Continued use of an outdated rule can cause individuals who are in otherwise similar situations to pay a different tax. Taxpayers can lose respect for the tax system when it produces such inconsistent outcomes. In addition, the continued reliance on an immaterial factor in the computation of tax liability can represent an undesirable tax planning opportunity that, because of its very existence, can further undermine the respect taxpayers have for the system. When taxpayers lose respect for the system, compliance rates are likely to suffer and income is likely to go underreported with greater frequency, making it necessary to commit more government funds in enforcement activities to reverse the trend.

A third defect is that different rules apply to determine the employment tax base of an employee-owner of a business depending on the business entity that is used to conduct the enterprise. Under current law, the SECA rules apply to sole proprietors and to any individual with an interest in a partnership or other unincorporated business entity that has not elected to be treated as a corporation for federal income tax purposes. Under those rules, the employment tax base can consist of the employee-owner's entire share of the profits of the business, in addition to any compensation the individual receives for services rendered. By contrast, the FICA rules apply to any individual who owns an interest in any state law corporation or any unincorporated business entity that has elected to be treated as a corporation for federal income tax purposes. Under those rules, the tax base consists solely of amounts the employee-shareholder receives as compensation for services rendered. An individual's liability for employment tax should not depend on mere formalities.

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<sup>120</sup> I.R.C. § 1402(a) (1949).

<sup>121</sup> H.R. Rep. No. 702, Part I, 95<sup>th</sup> Cong., 1<sup>st</sup> Sess. 40-41 (1977).

<sup>122</sup> I.R.C. § 1402(a)(13).

<sup>123</sup> These developments include adoption of legislation recognizing the limited liability company, the limited liability partnership, and the limited liability limited partnership.

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Federal employment taxes are intended to apply to income from labor. When an individual works for a business he also owns and control, it is difficult, if not impossible, to determine the extent to which the profits of the business are the result of the employee-owner's labor or a return on any capital that may be invested in the business. Wherever the line may fall, it seems unlikely to depend on the legal formalities that matter under the current statutory scheme. Moreover, whatever standard is used to draw the distinction, it should apply to all individuals who work for a business they also own and control. It should not matter whether the business operates through a corporation, partnership, limited liability company, sole proprietorship or some other vehicle yet to be created.

### III. Recent Proposal for Reform

#### A. Proposal of the Staff of the Joint Committee on Taxation

The Staff of the Joint Committee on Taxation (the "JCT Staff") has advanced a proposal that goes a part of the way toward addressing these three defects.<sup>124</sup> The JCT Staff proposal would extend to any owner of a flow through business entity the current set of rules that apply to general partners under the self-employment tax. Thus, all such owners would generally have to pay self-employment tax on the profits of the business allocated to them, even if such income is not actually paid out to them. These owners would also be taxable on any compensation received for services rendered to the business. However, if the owner does not materially participate in the business, only the owner's reasonable compensation from the entity is treated as subject to SECA tax. This approach would apply to any owner in a business other than a sole proprietor and a shareholder in a taxable corporation.

The JCT Staff proposal retains the current limitation on the kinds of profits that are taxable to an owner under the self-employment tax. Thus, certain types of passive income like dividends and interest, certain gains, and other items that do not seem to qualify as income from labor would not be subject to tax. However, the proposal carves out an exception when the entity is in a service trade or business. In such situations, all of the profits allocated to an owner are treated as net earnings from self-employment.<sup>125</sup>

In his testimony at a May 5, 2005 Congressional hearing on Social Security, George K. Yin, Chief of Staff of the Joint Committee on Taxation explained the rationale for the rule.

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<sup>124</sup> Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures 99-104 (Jan. 27, 2005) JCS-02 05.

<sup>125</sup> A service business is defined to be one whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. This definition is similar to the one that appears in Code section 448(d)(2).

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“The conceptual premise of the proposal is that the base for FICA and SECA taxes is labor income. The proposal applies this notion more uniformly than does present law to individuals who perform services for or on behalf of a pass-through entity in which they own an interest (i.e., a partnership, limited liability company, or S corporation). The proposal treats such individuals similarly to sole proprietors, as well as similarly to each other. Not only does this more uniform treatment improve the fairness of the tax law and increase the internal consistency of the tax rules, it also tends to improve tax neutrality by reducing the importance of FICA and SECA tax differences in taxpayers’ choice of business entity.”<sup>126</sup>

The JCT Staff proposal appears to adequately address the three principal defects in federal employment tax law in the following ways. First, the proposal eliminates the uncertainty over how a member of a limited liability company should determine his employment tax liability. Second, it disregards a partner’s status as a general or limited partner as a factor in the computation of the partner’s employment tax liability, substituting a rule that considers the degree to which the partner participates in the business of the partnership. Third, the proposal enunciates a uniform procedure for computing the employment tax liability of any individual who owns an interest in any nontaxable business entity. Thus, under the proposal, the provisions of SECA would apply to determine the employment tax liability of anyone who owns an interest in an S corporation or any unincorporated entity that has not elected to be treated as a corporation for federal income tax purposes.

The JCT Staff proposal has been widely endorsed by the practicing bar for establishing a clear and uniform rule that applies to any employee-owner of a flow through entity.<sup>127</sup> In addition, although there are many different views on how best to distinguish an employee-owner’s labor income from any return on capital invested in business, the organizations and individuals who have voiced their reaction to the proposal seem to believe that it strikes an appropriate balance between the interest in basing the tax on a precise measure of labor income, and the interest in using a rule that taxpayers can understand and apply with relative ease.<sup>128</sup>

### **B. Commentary on the JCT Staff Proposal**

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<sup>126</sup> George K. Yin, Testimony at a Hearing of the Senate Committee on Finance on “Social Security: Achieving Sustainable Solvency,” May 25, 2005 (JCX-38-05).

<sup>127</sup> E.g., New York State Bar Association Tax Section, Comments on JCT Recommendation Relating to Employment and Self-Employment Taxes of Partners, LLC Members and S Corporation Shareholders (Sept. 23, 2005) reprinted in Tax Notes (Oct. 31, 2005) at 675.

<sup>128</sup> *Id.*

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The JCT Staff proposal does indeed represent an improvement over the current state of affairs. Among other things, by imposing the employment tax on amounts that a business makes for an employee-owner, not merely what the business pays to that person as compensation, the proposal severely reduces the opportunity for the understatement of labor income, and the underpayment of employment tax, by such individuals. However, because the rules do not apply to employee-shareholders of taxable corporations, the proposal falls short of establishing parity in the way federal employment tax rules apply to all individuals who conduct a business through a business entity.

The problems associated with this inconsistency are most apparent in the case of individual who plays a controlling role in the business that employs him. Such a business may generate profits that represent solely the product of the employee-owner's labor. However, under the JCT Staff proposal, if the business is conducted through a partnership, an employment tax would apply to the employee-partner's entire distributive share of the profits for the year, plus any salary. Meanwhile, if the business is conducted through a corporation, an employment tax would only apply to amounts actually paid to an employee-shareholder as compensation. That amount may be less than the individual's share of the business profits in any given year. In fact, it may be zero.

Indeed, in the setting of a corporation that is controlled by an employee-shareholder, that owner has an economic incentive to deal with the business in ways that minimize the total tax that both he and the corporation must pay. There is no reason this consideration would not play a role when the employee-shareholder wants to access the profits of the business and needs to decide how to do so. There could be many aspects to this decision, including whether the payout should take the form of compensation or a dividend, the amount of the payout and when it should occur.

Before the temporary dividend tax cut, the ability of a controlling employee-shareholder to exploit this flexibility had limited practical significance for employment tax purposes. In almost all cases, the combined tax liability of the corporation and the individual would be kept to a minimum if a payout were structured as compensation. Thus, there was almost no risk that a corporation would pay a dividend as a form of disguised compensation, potentially shortchanging the social security and Medicare trust funds. The primary advantage in the corporate setting was that a controlling employee-shareholder could decide whether to access the profits of the business at all. If he did not, none of the taxes associated with the transfer of money between him and the corporation would apply.

Ever since the temporary tax cut on dividends took effect, however, the math has changed. Now, if a controlling employee-shareholder wants to access the earnings of the corporation, that individual frequently has an incentive to do so by causing the corporation to pay him a dividend. To the extent the dividend is disguised compensation, the transaction avoids an employment tax that would

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otherwise apply to generate funds for social security and Medicare benefits at a time when the long term financial stability of those programs is at risk.

The following discussion illustrates the extent to which an incentive now exists for corporations to pay dividends as disguised compensation to controlling shareholders who work for the business. Among other things, the discussion shows that the dividend tax cut does not change the incentives in all cases involving closely held corporations. Rather, high income individuals who own and control low income corporations are the ones positioned to make the most of what appears to be an unintended tax saving opportunity created by the temporary dividend tax cut.

### IV. Financial Incentives to Minimize Federal Employment Tax

In order to illustrate the extent to which tax considerations can affect the form in which corporate profits are paid out to controlling employee shareholders, this analysis considers the simplified case of a corporation that has only one shareholder. That individual also works for the company and desires to access \$15,000 of the corporation's earnings. He faces the choice of structuring the payout as a year-end bonus or as a dividend.<sup>129</sup> For purpose of the analysis, it is assumed the employee-shareholder is a married individual who files a joint tax return with his spouse. In addition, the analysis assumes that the business made no less than \$50,000 (before paying any compensation to the employee-owner) in the year of the payout.<sup>130</sup> Finally, the analysis assumes that any bonus paid by the corporation will be the employee-shareholder's only source of income subject to employment tax.

The analysis does not take into account any alternative minimum tax liability that may apply to the employee-owner or to the corporation.<sup>131</sup> In addition, although the phase out of deductions can affect the marginal rate that applies to the income of an individual, such phase outs are not taken into account.<sup>132</sup>

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<sup>129</sup> A shareholder can also receive a distribution in the form of a loan. Because a loan must be repaid, it is materially different from both a dividend and compensation. As a result, this analysis does not consider the tax consequences of a loan.

<sup>130</sup> As previously discussed, a corporation is taxed at 15 percent on taxable income up to \$50,000. See discussion accompanying note 21 et seq. As that discussion points out, the marginal rate could go as high as 39 percent when taxable income falls between \$100,000 and \$335,000. By not assuming any ceiling on the corporation's earnings, the analysis leaves open the possibility that the corporation would fall anywhere within the full range of marginal tax rates that applies to corporations.

<sup>131</sup> A corporation subject to the alternative minimum tax would generally be taxed at a flat 20 percent on an adjusted taxable income figure referred to as alternative minimum taxable income. An individual subject to the alternative minimum tax is taxed under a two tiered graduated rate structure with 26 and 28 percent as the rates. I.R.C. §§ 55 – 59.

<sup>132</sup> Robert J. Peroni, Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System, 91 Tax Notes 1415 (Special Supp. , May 28, 2001).

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### A. Compensation for Services

There are several tax effects produced by the payment of compensation by a corporation to an employee. First, the corporation can deduct amounts paid that are reasonable for the services rendered to it.<sup>133</sup> Any amounts received by the employee-owner as compensation count as gross income to him, triggering an income tax liability.<sup>134</sup> In addition, because the compensation qualifies as wages from employment, it also triggers an employment tax liability under FICA, with the employee and the corporation each being responsible for half the tax. The corporation is entitled to deduct its half of the tax paid.<sup>135</sup> That would reduce the income that is subject to the corporate tax, lowering the income tax liability of the business.<sup>136</sup> The following sections quantify the amount of tax owed or saved as a result of each of these effects.

#### 1. Employment Tax Effects

The corporation will have to pay an amount equal to 6.2% of the bonus to cover its half of the OASDI component of the FICA tax. Thus, it will owe \$930 on a \$15,000 bonus payment.<sup>137</sup> Meanwhile, the employee would also have to pay \$930 to cover his portion of the tax on that bonus. Because the bonus is well below the contribution and benefit base, there is no possibility that any portion of the bonus would be exempt from the OASDI component of the tax.

The corporation and the employee-shareholder will each have to pay a 1.45% tax on the bonus to cover the hospital insurance component of FICA. Thus, a \$15,000 bonus will cost the company \$218 in tax, and it will also cost the employee-shareholder \$218 in tax.<sup>138</sup>

#### 2. Corporate Income Tax Effects

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<sup>133</sup> I.R.C. § 162(a)(1).

<sup>134</sup> I.R.C. § 61(a)(1).

<sup>135</sup> I.R.C. § 162(a).

<sup>136</sup> The amount of compensation paid would have ancillary consequences. If the corporation pays for health insurance for the employee and his family, the deduction available to the corporation could depend on the amount paid to the employee. In addition, the amount that the owner employee can receive as deferred compensation depends in part on the amount of compensation the owner employee receives. These ancillary consequences are not taken into account in the analysis.

<sup>137</sup>  $\$15,000 \times 6.2\% = \$930$ .

<sup>138</sup>  $\$15,000 \times 1.45\% = \$218$ .

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The corporation will be entitled to deduct from gross income any compensation it pays to its employee-owner.<sup>139</sup> In addition, the corporation will be entitled to deduct its share of any employment tax on that compensation.<sup>140</sup> These deductions will translate into a lower corporate income tax liability. The actual tax savings will depend on the tax that would otherwise be due on income that is offset by the deductions.

Because the corporate tax is imposed under a system of graduated marginal rates, the tax savings will depend on the tax bracket into which the corporation falls in the year it makes the payments. As previously discussed, there are six marginal rates, ranging from a low of 15 percent to a high of 39 percent. At the low end of the spectrum, if the corporation is in the 15 percent bracket, \$15,000 in business profits (unreduced by any bonus payment) would cost the corporation \$2,250 in income tax.<sup>141</sup> Conversely, if the corporation uses that money to pay a deductible bonus, there is no income left to be taxed, resulting in no income tax liability for the corporation on that money. Thus, a \$15,000 bonus payment would translate into \$2,250 in tax savings for a corporation in the 15 percent tax bracket. Meanwhile, at the high end of the spectrum, the same \$15,000 bonus would translate into \$5,850 of tax savings to a corporation in the 39 percent tax bracket.<sup>142</sup>

The corporation would also be entitled to deduct any employment tax it must pay on any bonus paid to an employee. Like the deduction for the bonus itself, this deduction will also translate into tax savings that will vary with the corporation's marginal tax rate. There is a \$930 tax to cover the OASDI component of the FICA tax.<sup>143</sup> That translates into \$140 in tax savings if the corporation is in the 15 percent marginal tax bracket.<sup>144</sup> The savings top off at \$363 if the corporation is in the 39 percent marginal tax bracket.<sup>145</sup> For the health insurance component of the FICA tax, any \$15,000 of compensation would cost the corporation \$218 in tax that the corporation could deduct in computing its taxable income.<sup>146</sup> If the corporation is in the 15 percent tax bracket, that \$218 deduction corresponds to \$33 in income tax savings.<sup>147</sup> Meanwhile, if the corporation is in the 39 percent tax bracket, that \$218 deduction corresponds to \$85 in income tax savings.<sup>148</sup>

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<sup>139</sup> I.R.C. § 162(a)(1). If the corporation were publicly traded, the deduction for salaries paid to certain executives would be limited to \$1 million. I.R.C. § 162(m).

<sup>140</sup> I.R.C. § 162(a).

<sup>141</sup>  $\$15,000 \times 15\% = \$2,250$ .

<sup>142</sup>  $\$15,000 \times 39\% = \$5,850$ .

<sup>143</sup> *Supra* note 137.

<sup>144</sup>  $\$930 \times 15\% = \$140$ .

<sup>145</sup>  $\$930 \times 39\% = \$363$ .

<sup>146</sup> *Supra* note 138.

<sup>147</sup>  $\$218 \times 15\% = \$33$ .

<sup>148</sup>  $\$218 \times 39\% = \$85$ .

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### 3. Individual Income Tax Effects

Any bonus received by the employee-shareholder will be included in his gross income and subject to tax under the system of graduated marginal rates previously described.<sup>149</sup> For 2003 through 2010, the statute uses six marginal rates, ranging from a low of 10 percent to a high of 35 percent. After 2010, the pre-2001 marginal rate structure takes effect. It consisted of five marginal rates ranging from a low of 15 percent to a high of 39.6 percent. Thus, the income tax cost associated with the receipt of a bonus will depend on two things. First, it will depend on the year when the employee-shareholder receives the bonus. Second, it will depend on the employee-shareholder's marginal rate tax bracket in that year. Assuming the \$15,000 bonus is received in 2006, the individual will have to pay as little as \$1,500 in tax if he is in the 10 percent tax bracket.<sup>150</sup> However, that \$15,000 bonus will cost him as much as \$5,250 in income tax if he is in the 35 percent tax bracket.<sup>151</sup>

The following table summarizes the net savings and costs on a \$15,000 bonus paid by the corporation to the shareholder in 2003 through 2010. The net effect varies depending on two factors: the corporation's marginal tax rate and the shareholder's marginal tax rate.

**\$15,000 Bonus Paid by Corporation to Shareholder  
Combined Tax Savings (Cost)  
2003 through 2010**

| Corp. Rate | Shareholder Marginal Rate |           |           |           |           |           |
|------------|---------------------------|-----------|-----------|-----------|-----------|-----------|
|            | 10%                       | 15%       | 25%       | 28%       | 33%       | 35%       |
| 15%        | (\$1,373)                 | (\$2,123) | (\$3,623) | (\$4,073) | (\$4,823) | (\$5,123) |
| 25%        | \$242                     | (\$508)   | (\$2,008) | (\$2,458) | (\$3,208) | (\$3,508) |
| 34%        | \$1,695                   | \$945     | (\$555)   | (\$1,005) | (\$1,755) | (\$2,055) |
| 35%        | \$1,857                   | \$1,107   | (\$393)   | (\$843)   | (\$1,593) | (\$1,893) |
| 38%        | \$2,341                   | \$1,591   | \$91      | (\$359)   | (\$1,109) | (\$1,409) |
| 39%        | \$2,503                   | \$1,753   | \$253     | (\$197)   | (\$947)   | (\$1,247) |

Among other things, the table shows that there are situations in which the corporation and employee-shareholder collectively save more in taxes than they owe. The combined net savings is as high as \$2,503 when the corporation is in the 39 percent marginal tax bracket and the shareholder is in the 10 percent marginal tax bracket. As a practical matter, however, that particular pairing of tax brackets represents an anomalous situation.<sup>152</sup> Meanwhile, in the vast

<sup>149</sup> See discussion accompanying notes 26 through 31.

<sup>150</sup>  $\$15,000 \times 10\% = \$1,500$ .

<sup>151</sup>  $\$15,000 \times 35\% = \$5,250$ .

<sup>152</sup> The 10 percent tax bracket applies when an individual has taxable income that does not exceed \$15,100. That would mean that virtually all of the individual's other income was offset by exemptions, exclusions and deductions of one kind or another. The 39 percent tax

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majority of situations, the payment of compensation produces a net tax cost. The cost tops out at \$5,123 when the corporation is in the 15 percent marginal tax bracket and the shareholder is in the 35 percent marginal tax bracket.

After 2010, the range of outcomes will change because the existing schedule of marginal income tax rates that applies to individuals will be replaced with the schedule that had been in effect prior to 2001. That schedule used five rates ranging from 15 percent to 39.6 percent. This change will alter the calculus by increasing what the shareholder must pay in tax on the bonus. That will increase the combined net tax cost, or eliminate any combined net tax savings, that would have otherwise occurred under the existing schedule of marginal rates. The following table summarizes the range of outcomes produced after 2010 on the assumption that the pre-2001 schedule of marginal rates takes effect.

**\$15,000 Bonus Paid by Corporation to Shareholder  
Combined Tax Savings (Cost)  
After 2010**

| <b>Corp. Rate</b> | <b>Shareholder Marginal Rate</b> |           |           |           |           |
|-------------------|----------------------------------|-----------|-----------|-----------|-----------|
|                   | 15%                              | 28%       | 31%       | 36%       | 39.6%     |
| 15%               | (\$2,123)                        | (\$4,073) | (\$4,523) | (\$5,273) | (\$5,813) |
| 25%               | (\$508)                          | (\$2,458) | (\$2,908) | (\$3,658) | (\$4,198) |
| 34%               | \$945                            | (\$1,005) | (\$1,455) | (\$2,205) | (\$2,745) |
| 35%               | \$1,107                          | (\$843)   | (\$1,293) | (\$2,043) | (\$2,583) |
| 38%               | \$1,591                          | (\$359)   | (\$809)   | (\$1,559) | (\$2,099) |
| 39%               | \$1,753                          | (\$197)   | (\$647)   | (\$1,397) | (\$1,937) |

The combined net tax effects associated with a bonus must be compared to the combined net tax effects associated with a dividend. The following section computes the combined tax cost incurred by a corporation and its shareholder on the payment of a dividend.

### B. Dividends

A payment of dividends triggers a different, and less complex, set of tax effects to the corporation and its employee-shareholder. Understandably, there are no employment tax effects to consider. In addition, because the corporation is not entitled to deduct any dividends paid to shareholders, there are no corporate income tax effects to consider. The only income tax effects will occur at the level of the employee-shareholder.

Dividends received by the employee-owner will count as gross income to him.<sup>153</sup> As such they will be subject to tax. As described above, the amount of

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bracket applies when a corporation has taxable income over \$100,000 and up to \$335,000. I.R.C. § 11(b).

<sup>153</sup> I.R.C. § 61(a)(7).

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tax will depend on two factors: the year of payment, and, where applicable, whether the dividend is a qualified dividend.<sup>154</sup> This analysis assumes that any dividend received by the employee-owner will be a qualified dividend whenever applicable. For 2003 through 2007, qualified dividends are taxable at one of two rates, depending on the marginal tax rate that applies to the recipient's ordinary income. If the recipient is in the 25 percent bracket or higher, a qualified dividend is taxed at 15 percent.<sup>155</sup> If the recipient is any other tax bracket, a qualified dividend is taxed at 5 percent.<sup>156</sup> In 2008, dividends are tax free to any recipient in a tax bracket below 25 percent, while the tax on dividends remains at 15 percent in all other cases.<sup>157</sup> The preferential rates that apply to qualified dividends are scheduled to expire after 2008.<sup>158</sup> Thus, the dividends would be subject to tax under the system of marginal rates that apply to all ordinary income.

This array of transitory rules makes it necessary to compute the combined net tax effects for many different periods of time. A \$15,000 dividend paid in 2003 through 2007 will have a net tax cost of \$2,250 if the recipient is in the 25 percent or higher marginal tax bracket. The net tax cost will be \$750 if the recipient is below the 25 percent tax bracket. The following table summarizes the full range of outcomes.

### \$15,000 Dividend Paid by Corporation to Shareholder Combined Tax Savings (Cost) 2003 through 2007

| <u>Corp. Rate</u> | <u>Shareholder Marginal Rate</u> |         |           |           |           |           |
|-------------------|----------------------------------|---------|-----------|-----------|-----------|-----------|
|                   | 10%                              | 15%     | 25%       | 28%       | 33%       | 35%       |
| All rates         | (\$750)                          | (\$750) | (\$2,250) | (\$2,250) | (\$2,250) | (\$2,250) |

A \$15,000 dividend paid in 2008 will continue to have a net tax cost of \$2,250 if the recipient is in the 25 percent or higher marginal tax bracket. However, there will be no tax cost if the recipient is below the 25 percent tax bracket. The following table summarizes the full range of outcomes.

### \$15,000 Dividend Paid by Corporation to Shareholder Combined Tax Savings (Cost) 2008

| <u>Corp. Rate</u> | <u>Shareholder Marginal Rate</u> |     |     |     |     |     |
|-------------------|----------------------------------|-----|-----|-----|-----|-----|
|                   | 10%                              | 15% | 25% | 28% | 33% | 35% |
|                   |                                  |     |     |     |     |     |

<sup>154</sup> See discussion accompanying notes 25 through 35.

<sup>155</sup> I.R.C. § 1(h)(1)(C).

<sup>156</sup> I.R.C. § 1(h)(1)(B).

<sup>157</sup> I.R.C. § 1(h)(1)(B).

<sup>158</sup> The Bush administration has proposed making permanent the preferential rates of tax that apply to qualified dividends.

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|           |     |     |           |           |           |           |
|-----------|-----|-----|-----------|-----------|-----------|-----------|
| All rates | \$0 | \$0 | (\$2,250) | (\$2,250) | (\$2,250) | (\$2,250) |
|-----------|-----|-----|-----------|-----------|-----------|-----------|

A \$15,000 dividend paid in 2009 and 2010 will have a net tax cost that will depend on the recipient's marginal tax bracket. The net tax cost will be as little as \$1,500 if the recipient is in the 10 percent tax bracket. The net tax cost will be as much as \$5,250 if the recipient is in the 35 percent tax bracket. The following table summarizes the full range of outcomes.

### \$15,000 Dividend Paid by Corporation to Shareholder Combined Tax Savings (Cost) 2009 and 2010

| Corp. Rate | Shareholder Marginal Rate |           |           |           |           |           |
|------------|---------------------------|-----------|-----------|-----------|-----------|-----------|
|            | 10%                       | 15%       | 25%       | 28%       | 33%       | 35%       |
| All rates  | (\$1,500)                 | (\$2,250) | (\$3,750) | (\$4,200) | (\$4,950) | (\$5,250) |

A \$15,000 dividend paid after 2011 will continue to have a net tax cost that depends on the recipient's marginal tax bracket. However, because the pre-2001 tax brackets will replace the ones now in effect, the range of outcomes will be different. At the low end of the spectrum, there will be a net tax cost of \$2,250 if the recipient is in the 15 percent tax bracket. The net tax cost will be as high as \$5,940 if the recipient is in the 39.6 percent tax bracket. The following chart summarizes the full range of outcomes.

### \$15,000 Dividend Paid by Corporation to Shareholder Combined Tax Savings (Cost) After 2010

| Corp. Rate | Shareholder Marginal Rate |           |           |           |           |
|------------|---------------------------|-----------|-----------|-----------|-----------|
|            | 15%                       | 28%       | 31%       | 36%       | 39.6%     |
| All rates  | (\$2,250)                 | (\$4,200) | (\$4,650) | (\$5,400) | (\$5,940) |

## C. Quantifying the Incentive

The difference between the combined net tax effects associated with each payout alternative will determine the extent to which there is a tax incentive for structuring a payout as one or the other. Because the combined net tax effects produced in any case varies depending on a number of transitory rules, any comparison between the two payout options is valid for only a discrete period of time. This analysis proceeds accordingly, starting with an analysis of the period covered by 2003 through 2007.

In 2003 through 2007, qualified dividends are taxed as long term capital gains, and ordinary income is subject to tax under a temporary schedule of marginal rates ranging from 10 percent to 35 percent. The following table shows

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the extent to which the corporation and the shareholder collectively save more, or pay more, in tax when a \$15,000 payout is structured as a bonus instead of a dividend.

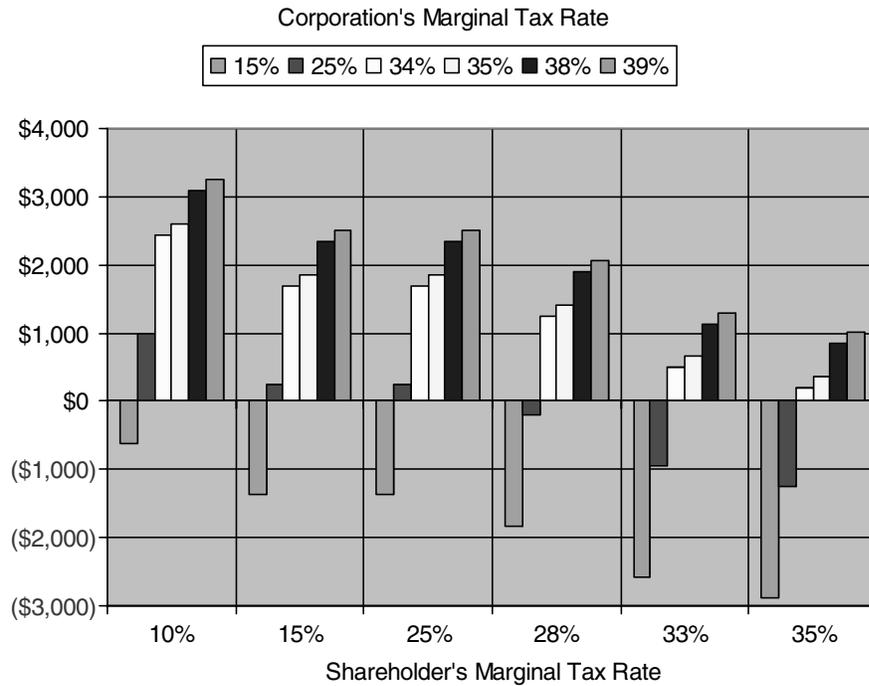
### Tax Advantage of Paying \$15,000 as a Bonus instead of Dividends 2003 through 2007

| Corp. Rate | Shareholder Marginal Rate |           |           |           |           |           |
|------------|---------------------------|-----------|-----------|-----------|-----------|-----------|
|            | 10%                       | 15%       | 25%       | 28%       | 33%       | 35%       |
| 15%        | (\$623)                   | (\$1,373) | (\$1,373) | (\$1,823) | (\$2,573) | (\$2,873) |
| 25%        | \$992                     | \$242     | \$242     | (\$208)   | (\$958)   | (\$1,258) |
| 34%        | \$2,445                   | \$1,695   | \$1,695   | \$1,245   | \$495     | \$195     |
| 35%        | \$2,607                   | \$1,857   | \$1,857   | \$1,407   | \$657     | \$357     |
| 38%        | \$3,091                   | \$2,341   | \$2,341   | \$1,891   | \$1,141   | \$841     |
| 39%        | \$3,253                   | \$2,503   | \$2,503   | \$2,053   | \$1,303   | \$1,003   |

The table indicates that a dividend costs more in tax than does a bonus in the vast majority of situations. For instance, a \$15,000 bonus enjoys a \$1,003 tax advantage over a \$15,000 dividend when the shareholder is in the 35 percent marginal tax bracket and the corporation is in the 39 percent marginal tax bracket. In other words, in that situation the corporation and shareholder end up with \$1,003 more after tax by structuring the payout as a bonus as opposed to a dividend. However, there is a range of situations when a dividend enjoys a tax advantage over a bonus. Specifically, that advantage exists whenever the corporation is in the 15 percent marginal tax bracket. It also exists when the corporation is in the 25 percent tax bracket and the shareholder is in one of the three highest income brackets. In those situations, there is a financial incentive to substitute a dividend for a bonus in order to minimize the net tax cost to the shareholder and corporation. The following chart depicts the range of outcomes graphically.

**Figure 1**  
**Tax Advantage to Paying \$15,000**  
**As a Bonus instead of Dividends**  
**2003 - 2007**

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The bars that rise above the zero dollar line represent the cases when a \$15,000 bonus costs less tax than a dividend of the same amount. Conversely, the bars that fall below the zero dollar line represent cases when a \$15,000 dividend costs less than a bonus of the same amount. Thus, a shareholder-employee in the 35 percent tax bracket will pay less in tax on a bonus, compared to a dividend, when the corporation is in any tax bracket above 25 percent. However, that same shareholder-employee will pay less in tax on a dividend, compared to a bonus, when the corporation is in any tax bracket below 34 percent. The length of the bar corresponds to the amount of tax dollars saved in any given case. Thus, if the shareholder is in the 35 percent tax bracket and the corporation is in the 15 percent tax bracket, a dividend will cost nearly \$3,000 less in tax compared to a bonus.

The graph makes it easier to appreciate the distribution of benefits that are available when a dividend is substituted for a bonus. Individuals in the three highest income brackets can save tax dollars by making the substitution in a wider range of situations. In addition, when they do so, they save far more in taxes than their lower income counterparts do. In effect, the can rich get richer when they work for free for a corporation they own and control.

The range of outcomes changes slightly in 2008 when qualified dividends are tax exempt to any recipient whose ordinary income is taxed below 25 percent. Because the change in the law reduces the cost associated with making a dividend, the incentive to substitute a dividend for a bonus operates in a

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greater number of cases affected by the tax cut. The following table quantifies the economic incentive to make the dividend-for-bonus substitution in 2008.

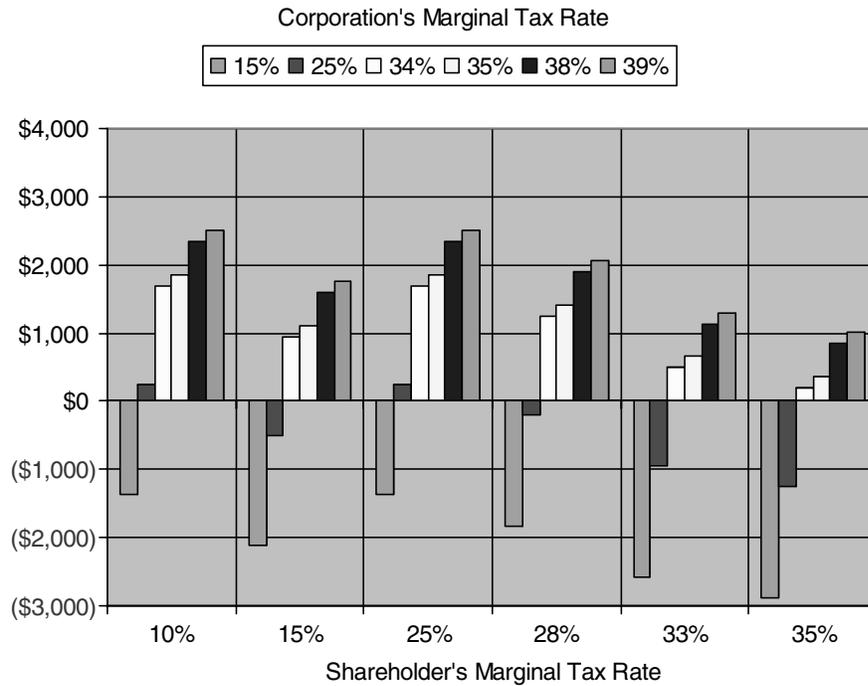
### Tax Advantage of Paying \$15,000 as a Bonus instead of Dividends in 2008

| Corp. Rate | Shareholder Marginal Rate |           |           |           |           |           |
|------------|---------------------------|-----------|-----------|-----------|-----------|-----------|
|            | 10%                       | 15%       | 25%       | 28%       | 33%       | 35%       |
| 15%        | (\$1,373)                 | (\$2,123) | (\$1,373) | (\$1,823) | (\$2,573) | (\$2,873) |
| 25%        | \$242                     | (\$508)   | \$242     | (\$208)   | (\$958)   | (\$1,258) |
| 34%        | \$1,695                   | \$945     | \$1,695   | \$1,245   | \$495     | \$195     |
| 35%        | \$1,857                   | \$1,107   | \$1,857   | \$1,407   | \$657     | \$357     |
| 38%        | \$2,341                   | \$1,591   | \$2,341   | \$1,891   | \$1,141   | \$841     |
| 39%        | \$2,503                   | \$1,753   | \$2,503   | \$2,053   | \$1,303   | \$1,003   |

The chart shows that if the employee-shareholder is in the 15 percent tax bracket, there will be an incentive to substitute a dividend for a bonus in cases where the corporation is in the 25 percent tax bracket. The following chart depicts the full range of outcomes graphically, permitting one to more easily appreciate the distribution of benefits available under a dividend-for-bonus substitution.

**Figure 2**  
**Tax Advantage to Paying \$15,000**  
**In Compensation instead of Dividends**  
**2008**

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Prior to 2008, the dividend-for-bonus substitution produced more tax savings more frequently as the employee-shareholder moved into higher income tax brackets. The temporary dividend tax exemption that applies to 2008 makes it possible for some lower income individuals to save more tax dollars in a greater number of cases than they would have otherwise. However, individuals in the highest income brackets continue to enjoy the lion's share of any tax savings by working for free.

If the temporary dividend tax cut expires after 2008, as scheduled, the incentive to substitute dividends for a bonus disappears. The following table shows the extent to which the corporation and the shareholder collectively save when a \$15,000 payout is structured as a bonus instead of a dividend after 2008.

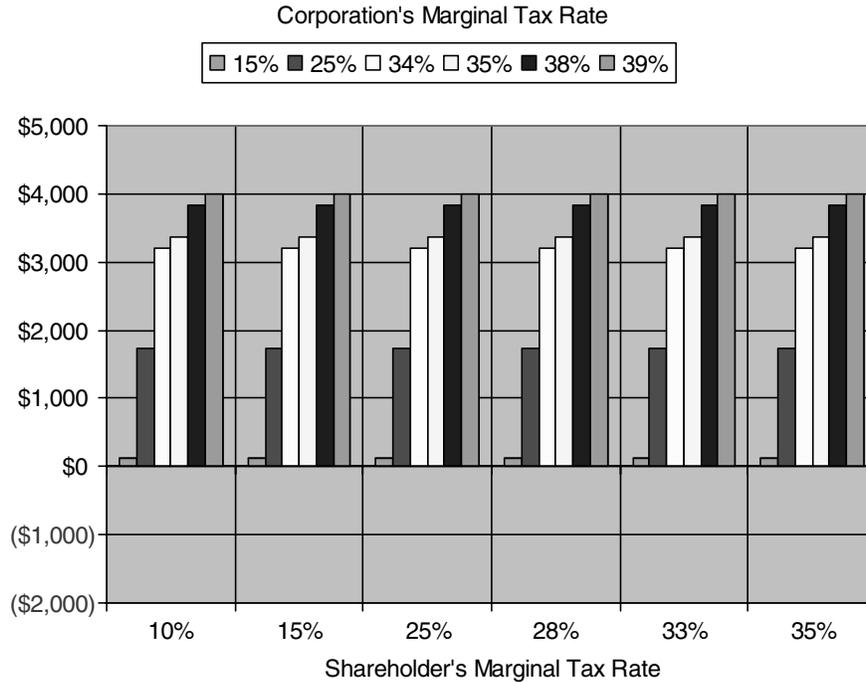
### Tax Advantage of Paying \$15,000 as a Bonus instead of Dividends 2009 and 2010

| Corp. Rate | Shareholder Marginal Rate |         |         |         |         |         |
|------------|---------------------------|---------|---------|---------|---------|---------|
|            | 10%                       | 15%     | 25%     | 28%     | 33%     | 35%     |
| 15%        | \$127                     | \$127   | \$127   | \$127   | \$127   | \$127   |
| 25%        | \$1,742                   | \$1,742 | \$1,742 | \$1,742 | \$1,742 | \$1,742 |
| 34%        | \$3,195                   | \$3,195 | \$3,195 | \$3,195 | \$3,195 | \$3,195 |
| 35%        | \$3,357                   | \$3,357 | \$3,357 | \$3,357 | \$3,357 | \$3,357 |
| 38%        | \$3,841                   | \$3,841 | \$3,841 | \$3,841 | \$3,841 | \$3,841 |
| 39%        | \$4,003                   | \$4,003 | \$4,003 | \$4,003 | \$4,003 | \$4,003 |

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The following chart depicts the outcomes graphically.

**Figure 3**  
**Tax Advantage to Paying \$15,000**  
**In Compensation instead of Dividends**  
**In 2009 and 2010**



The chart underscores the fact that once the dividend tax cuts expire, there is no tax related incentive to pay a dividend as disguised compensation. In effect the tradeoffs that had been in effect before the tax cuts were introduced will apply again. Furthermore the incentive to substitute a dividend for a bonus will not exist after 2010 either, when the marginal income tax schedule that had been in effect prior to 2001 will apply. The following table summarizes the extent to which a \$15,000 bonus has a tax advantage over a \$15,000 dividend after 2010.

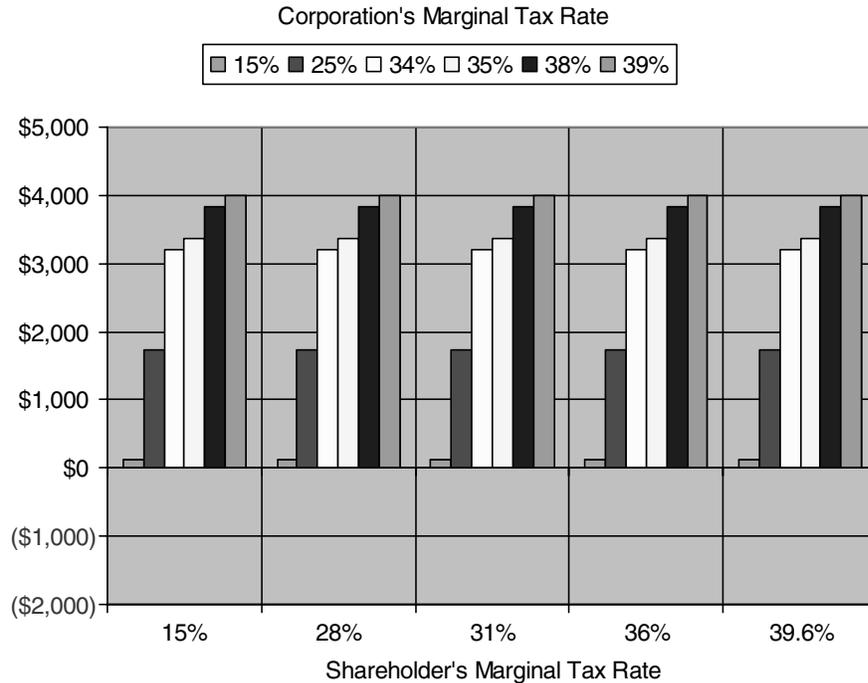
**Tax Advantage of Paying \$15,000**  
**as a Bonus instead of Dividends**  
**After 2010**

| Corp. Rate | Shareholder Marginal Rate |         |         |         |         |
|------------|---------------------------|---------|---------|---------|---------|
|            | 15%                       | 28%     | 31%     | 36%     | 39.6%   |
| 15%        | \$127                     | \$127   | \$127   | \$127   | \$127   |
| 25%        | \$1,742                   | \$1,742 | \$1,742 | \$1,742 | \$1,742 |
| 34%        | \$3,195                   | \$3,195 | \$3,195 | \$3,195 | \$3,195 |
| 35%        | \$3,357                   | \$3,357 | \$3,357 | \$3,357 | \$3,357 |
| 38%        | \$3,841                   | \$3,841 | \$3,841 | \$3,841 | \$3,841 |
| 39%        | \$4,003                   | \$4,003 | \$4,003 | \$4,003 | \$4,003 |

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The following chart depicts these outcomes graphically.

**Figure 4**  
**Tax Advantage to Paying \$15,000**  
**In a Bonus instead of Dividends**  
**After 2010**



### D. The Unequal Opportunity Tax Loophole

It seems clear that 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. There is no evidence that concretely shows the extent to which high income individuals own and control corporations that make low incomes. However there is compelling evidence that ownership of closely held corporations is severely concentrated in the hands of most wealthy individuals. It also seems clear that all but a small minority of corporations have incomes low enough to place them in one of the two lowest tax brackets.

The available evidence shows that the stock in closely held corporations is concentrated in the hands of very wealthy individuals. The Internal Revenue Service estimates that there were 6.5 million individuals in the U.S. with at least \$625,000 in gross assets in 1998, representing 3.4 percent of the total U.S. adult

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population.<sup>159</sup> Nearly 1.3 million of this group of wealthy individuals, representing nearly 20 percent of the total, owned stock in non-publicly traded corporations.<sup>160</sup> The total value of this stock was estimated to be over \$1.3 trillion. However, such stock ownership was concentrated in the hands of the very wealthy.

Individuals whose personal net worth exceeded \$2.5 million accounted for 10.5 percent of wealthy individuals, but they owned 73.5 percent of all stock in non publicly traded corporations. Individuals whose personal net worth exceeded \$5 million accounted for 3.8 percent of all wealthy individuals, but they owned 59.8 percent of all stock in non-publicly traded corporations. The following table details the distribution of non-publicly traded stock among individuals whose gross assets exceed \$625,000.

**Ownership of Non-Publicly Traded Stock  
by Owner's Size of Net Worth  
1998**

| <b>Size of Net Worth</b>        | <b>Number<br/>in<br/>Class<br/>(000)</b> | <b>% to<br/>Total</b> | <b>Total<br/>Value<br/>of Stock<br/>(000,000)</b> | <b>% to<br/>Total</b> |
|---------------------------------|--|-----------------------|---|-----------------------|
| \$20,000,000 or more            | 29                                       | 0.4%                  | 453,989   | 34.3%                 |
| \$10,000,000 under \$20,000,000 | 51                                       | 0.8%                  | 138,892   | 10.5%                 |
| \$5,000,000 under \$10,000,000  | 166                                      | 2.5%                  | 198,902   | 15.0%                 |
| \$2,500,000 under \$5,000,000   | 440                                      | 6.7%                  | 182,806   | 13.8%                 |
| \$1,000,000 under \$2,500,000   | 2,058                                    | 31.5%                 | 236,900   | 17.9%                 |
| \$600,000 under \$1,000,000     | 2,494                                    | 38.2%                 | 79,012  | 6.0%                  |
| Under \$600,000                 | 1,253                                    | 19.2%                 | 31,493  | 2.4%                  |
| Less than Zero                  | 39                                       | 0.6%                  | 3,087   | 0.2%                  |
| <b>TOTAL</b>                    | <b>6,530</b>                             |                       | <b>1,325,081</b>                                  |                       |

Not only are closely held corporations more frequently owned by the wealthy, the evidence suggest that the vast majority of corporations have low incomes.

Statistics compiled by the Internal Revenue Service show that small corporations (measured by size of assets) account for the overwhelming share of all active corporations. Active corporations with less than \$5 million in assets accounted for over 97 percent of all corporations in 2002. Moreover, it appears to be unusual when the income generated by these corporations is high enough to

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<sup>159</sup> Barry W. Johnson and Lisa M. Schreiber, *Personal Wealth*, 1998, *Statistics of Income Bulletin* (Winter 1998) at 87.

<sup>160</sup> *Id.* At 103, tbl. 1.

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put place them outside the 15 percent tax bracket, which applies to income up to \$50,000. The average income for corporations with less than \$500,000 in assets was \$10,909. The average income for corporations with assets falling between \$500,000 and \$1 million was \$20,407. The average income for corporations with assets falling between \$1 million and \$5 million was \$48,154. The following table shows the full distribution of corporations for 2002.<sup>161</sup>

| <b>Active Corporations with Assets<br/>2002</b> |                  |                       |                             |                               |
|---|------------------|-----------------------|-----------------------------|-------------------------------|
| <b>Asset Size</b>                               | <b>Number</b>    | <b>% to<br/>Total</b> | <b>Net Income<br/>(000)</b> | <b>Average<br/>Net Income</b> |
| \$1 under \$500,000                             | 3,825,530        | 81.8%                 | 41,734,405                  | 10,909                        |
| \$500,000 under \$1,000,000                     | 344,464          | 7.4%                  | 7,029,441                   | 20,407                        |
| \$1,000,000 under \$5,000,000                   | 369,682          | 7.9%                  | 17,801,498                  | 48,154                        |
| \$5,000,000 under \$10,000,000                  | 57,408           | 1.2%                  | 8,429,533                   | 146,836                       |
| \$10,000,000 under \$25,000,000                 | 36,819           | 0.8%                  | 4,805,044                   | 130,504                       |
| \$25,000,000 under \$50,000,000                 | 13,904           | 0.3%                  | 5,527,357                   | 397,537                       |
| \$50,000,000 under \$100,000,000                | 9,344            | 0.2%                  | 5,781,520                   | 618,741                       |
| \$100,000,000 under \$250,000,000               | 8,595            | 0.2%                  | 10,110,897                  | 1,176,370                     |
| \$250,000,000 under \$500,000,000               | 4,226            | 0.1%                  | 16,452,094                  | 3,893,065                     |
| \$500,000,000 under \$2,500,000,000             | 4,958            | 0.1%                  | 83,007,982                  | 16,742,231                    |
| \$2,500,000,000 or more                         | 1,909            | 0.0%                  | 377,525,169                 | 197,760,696                   |
| <b>TOTAL</b>                                    | <b>4,676,839</b> |                       | <b>578,204,940</b>          |                               |

Thus, the opportunity to save taxes by substituting dividends for compensation is not an abstract matter. Working for free is a very real option confronted by what appears to be a substantial number of individuals who own and control a corporation that employs them. What's more, there is compelling evidence that the opportunity to save tax taxes is not shared uniformly within the universe of owners of closely held businesses. The rich stand more to gain, and there appear to be very few other individuals who are in a position to exploit this opportunity. In a very real sense, the dividend tax cut has inadvertently created a rich man's tax loophole that reduces employment tax

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<sup>161</sup> See IRS, Statistics of Income Bulletin, Summer 2005, tbl. 1 at 75. The statistics include data for both S corporations and C corporations. S corporations account for approximately 60 percent of all active corporations. They also accounted for 32.6 percent of the net income generated by all corporations in 2002. See Kelly Lutrell, S Corporation Returns, 2002, Statistics of Income Bulletin (Spring 2005) 59, figure D at 63, and Heather Duffy, Corporation Income Tax Returns, 2002, Statistics of Income Bulletin (Summer 2005) 67, table 1, at 75. It is not possible to adjust the data to reflect solely the distribution and activity of C corporations. However, even under the most conservative of assumptions, the evidence shows that all but a small minority of C corporations have income high enough to be taxed above the 15 percent and the 25 percent tax brackets.

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receipts at precisely the time when the social security and Medicare trust funds need the money more than ever.

### V. Exposing and Reforming Employment Tax Defects

There is no economic incentive to substitute a dividend for a bonus after the dividend tax cut expires. However, even in that situation, the corporate form offers employment tax advantages that other forms of doing business do not. Most important, a corporation can control when (if ever) the employment tax is triggered. There is no employment tax liability as long as the corporation does not pay compensation to an employee-owner. In the event compensation is paid, the employment tax liability will be based on the amount paid. Moreover, because compensation in excess of the FICA contribution and benefit base is exempt from the OASDI component of the tax, employment taxes could be saved by compressing multiple years worth of compensation into a single year. Thus, if the owner received \$180,000 in compensation in 2006, only \$94,200 would be subject to the 12.4 percent OASDI tax. The rest would be exempt from that tax, even though it may relate to services performed during a year when the corporation did not pay the owner a salary. Therefore, even when the employment tax is triggered, the tax liability can be managed and minimized by an individual who owns and controls the corporation that employs him.

The JCT Staff proposal virtually eliminates any opportunity for understating employment tax liability when an individual owns and works for a business conducted through a flow through entity. That individual is subject to employment tax on any amounts paid as compensation and on the individual's share of the profits of the business. However, the JCT Staff proposal leaves in place the opportunities to understate employment tax liability when an individual owns and works for a business conducted through a corporation. Such an individual is only subject to employment tax on amounts actually paid as compensation. Allowing this rule to remain in effect ignores the full range of opportunities to control and minimize employment tax liability when a self employed individual operates through a corporation.

It makes little sense to have the employment tax liability of an individual depend on the business form through which the business is conducted. However, that is exactly what happens now, and it will continue to happen (with less frequency) in the event the JCT Staff proposal is adopted. Formal distinctions appear to matter least in the case of a closely held business, where the interests of the business and a controlling employee-owner are not adverse. Transactions between the two parties are unlikely to occur at arms length. The JCT Staff proposal prevents the employment tax from being a victim of self-dealing when a flow-through entity is used to conduct a business. However, the employment tax falls victim to self dealing when an individual operates his business through a corporation. Not only does this represent an undesirable tax

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planning opportunity, it can cause taxpayers who are in economically similar situations to be treated differently, solely because the rules operate by reference to irrelevant legal formalities.

Federal employment tax rules would produce more sensible and uniform outcomes if economic realities, not legal formalities, played a greater role in determining how the rules apply. There are real and compelling ways for individuals to understate their employment tax liability when they own a corporation that employs them. These opportunities are more likely to be exploited when the individual is in a position to influence decisions by the corporation. Thus, any approach to address this situation should consider the extent to which such opportunities to exercise and exploit control exist. As a general proposition, such opportunities occur in the closely-held corporation.

The JCT Staff proposal could be improved if its rules were made to apply to individuals who own and work for closely held corporations. There are several ways to define a closely held corporation. However, there are already a number of instances in which a corporation is considered to be closely held for income tax purposes if the corporation satisfies the stock ownership test contained in the personal holding company rules.<sup>162</sup> Under that test, a corporation would be considered closely held if five or fewer individuals own more than 50 percent of the stock of the corporation during the last six months of the taxable year.<sup>163</sup>

Whenever a corporation qualifies as a closely held corporation, then the rules of SECA should apply to determine the employment tax liability of any owner, as follows. First, the tax should apply to the investor's share of the corporation's earnings for any given year and to any amounts paid to the owner as compensation for services rendered. A corporation is already required to compute its earnings and profits.<sup>164</sup> The earnings and profits generated in any given year would be used to determine an employee-shareholder's share. That share would be a function of the shareholder's interest in the corporation as measured by stock owned. Thus, if the employee-shareholder owned 40 percent of the stock in a year that the corporation generated \$160,000 in earnings and profits, \$64,000 of that amount would represent that individual's share of the corporation's earnings.<sup>165</sup> In addition, the self-employment tax would apply to any amounts actually paid to that individual as compensation. However, if the shareholder does not materially participate in the business, only amounts actually paid to him as reasonable compensation would be subject to the SECA tax. This approach would establish near complete parity in the way the rules

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<sup>162</sup> The personal holding company stock ownership test is incorporated in the at risk rules. I.R.C. § 465. The test is also incorporated in the passive activity loss limitation rules. I.R.C. § 469A.

<sup>163</sup> See I.R.C. § 542(a)(2).

<sup>164</sup> I.R.C. § 312.

<sup>165</sup>  $\$160,000 \times 40\% = \$64,000$ .

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operate, regardless of the legal entity through which an individual conducts a business.

The JCT Staff proposal applies two sets of rules to determine the extent to which the profits of the business are subject to employment tax. For all businesses other than a service business, the employment tax applies only to the investor's share of earnings other than certain passive income items that are already excluded from the definition of net earnings from self-employment. However, if the business is in a service business, no such adjustment is made.<sup>166</sup> The distinction between service and non-service business should apply with equal force when the business is conducted through a corporation.

The suggestions just proposed offer a number of advantages. First, they would reduce the opportunities for undesirable tax planning that can shortchange the federal government in one way or another. Second, they would promote greater consistency in the way taxpayers are treated, resulting in more sensible outcomes. Finally, they would extend an element of economic reality to the way closely held businesses are addressed by federal tax law.

There are a number of instances in which special rules already apply to prevent taxpayers from exploiting opportunities to utilize corporations to avoid or evade tax. This is accomplished in a number of ways. In some cases the approach is not to treat the corporation as a separate and distinct taxpaying unit. In other cases, the approach is simply to penalize or eliminate any advantage that may be gained by using a corporation as an element in a particular arrangement. In all instances, however, there is an element of economic reality that informs the approach.

### A. Use of Multiple Corporations

As a general rule, a corporation is considered to be a separate tax paying unit. However, a corporation's independent tax status may be disregarded if that corporation and one or more others are under common control. It is more likely that the higher marginal tax rates would kick in when income is consolidated in one corporation. Using multiple corporations to generate the same income could effectively fracture that income. If structured properly, such an arrangement could prevent the higher tax rates from coming into play if the amount of income generated by each commonly controlled corporation did not exceed the \$50,000 threshold that applies to the 15 percent marginal tax bracket. To guard against this hazard, all corporations under common control are treated as one for purposes of computing the income tax on their total income.<sup>167</sup>

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<sup>166</sup> The JCT Staff proposal employs an existing definition of a service business. Under that definition, a service business is one in which substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. I.R.C. § 448(d)(2)(A).

<sup>167</sup> I.R.C. § 1561(a).

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The rule essentially denies the benefit associated with the use of a corporation to engage in a business. In addition the rule acknowledges the economic realities behind the use of multiple corporations by a common owner. In a similar fashion, the proposal advanced above acknowledges the need to disregard the separate existence of the corporation when it is owned and controlled by someone who works for it. In addition, the proposal takes an approach that prevents someone from using a corporation to minimize or eliminate a tax liability that would otherwise apply.

### **B. Personal Services Corporation**

As a general rule, a corporation and its owner are two separate and distinct taxpaying units. However, if the principal activity of the corporation is to perform personal services that are actually performed by a 10 percent owner, the Internal Revenue Service can reallocate items between the corporation and its owner, provided the arrangement was used to avoid tax.<sup>168</sup> Any allocation made by the government must be necessary to prevent avoidance or evasion of federal income tax or to clearly reflect the income of the corporation or its employee-owner.<sup>169</sup> The statute effectively acknowledges that transactions between a corporation and someone who controls it may not occur on an arm's length basis. To address this possibility, the statute enables the Internal Revenue Service to disregard the actual form of a transaction and to make reallocations that reflect the economic realities.

The proposal advanced in this article operates in a similar way. It manifestly acknowledges that transactions between corporations and the owners who control them should not be taken at face value. Thus, a payment that takes the form of a dividend should not be treated as such if it in fact constitutes disguised compensation for services rendered. Moreover, even if a payment is made in the form of compensation, the amount paid may bear little or no resemblance to the economic realities. Those economic realities may be difficult to determine in any situation where an individual is both an owner and an employee of a business. Because the earnings of the business may represent both a return on the individual's capital investment and a product of the individual's labor, distinguishing one from the other may be arbitrary. But any method used

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<sup>168</sup> I.R.C. § 269A(b). This rule does not authorize the Secretary to make a reallocation in the case under review. First, because the statute limits the Secretary's reallocation powers to cases involving the possible avoidance or evasion of federal income tax, the Secretary has no power to make a reallocation where the employment tax may be avoided or evaded. Second, even if the power were available to address possible evasion or avoidance of the employment tax, the power could only be exercised when the corporation performs services for one other corporation, partnership or other entity. As a result, the power cannot be applied to address the employee owner of a corporation that performs services for more than one corporation, partnership or other entity.

<sup>169</sup> I.R.C. § 269A (a) (flush language).

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to make the distinction should be applied to in all cases. The JCT Staff proposal uses an approach that appears to enjoy widespread appeal. However, that proposal only applies its approach in the context of flow-through business entities. The proposal described above merely extends that approach to closely held corporations, resulting in uniform standard.

### C. Qualified Personal Service Corporations

As a general rule, the income of a corporation is taxed under a system of graduated marginal rates. Under this system, the taxable income of a corporation falls into several layers, each one being subject to a (generally) higher rate that applied to the one below it. In many cases, this system will cause at least a portion of the corporation's income to be taxed at a rate as low as 15 percent, even if the corporation may have enough income to put it in a higher rate bracket. However, all of a corporation's income is taxed at a flat 35 percent if the corporation is a "qualified personal service corporation."<sup>170</sup> A corporation acquires that status if substantially all of its activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.<sup>171</sup> The rule effectively prevents a corporation from enjoying the tax savings it would otherwise enjoy of the graduated rates were allowed to apply.

In the absence of the rule, an individual in a high income bracket could divert a portion of his income to a corporation, where a lower tax might be imposed under the system of graduated marginal rates. A flat 35 percent tax on all the income of the corporation reduces or eliminates any savings that might otherwise be gained by an individual using a corporation to operate a service business. In a similar way, the modifications suggested to the JCT Staff proposal eliminate any employment tax savings that might otherwise be gained in situations where an individual operates a business through a corporation.

### D. Personal Holding Company Tax

The personal holding company tax represents an instance in which the law imposes a penalty when a corporation is used in a way to minimize or avoid a tax that would otherwise apply. As explained above, the hallmark of the corporate tax system is the fact that profits are taxed first when earned by the corporation and again when distributed to shareholders. However, the shareholder level tax will not come into play if the earnings are not distributed. The personal holding company tax operates to penalize a corporation in certain

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<sup>170</sup> I.R.C. § 11(b)(2).

<sup>171</sup> I.R.C. § 448(d)(2)(A).

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situations when profits are not distributed. The amount of the penalty is equal to what the shareholders would have paid.<sup>172</sup>

The penalty tax can only apply if ownership of the corporation is concentrated. Specifically, more than half of the value of the corporation's stock must be owned by five or fewer individuals (and certain related parties) at any time during the last half of the tax year.<sup>173</sup> If the stock ownership test is met, the second question is whether the corporation meets an income test, which requires that at least 60 percent of the corporation's gross income (after certain adjustments) be passive type items, like dividends, interest, certain rents and royalties.<sup>174</sup>

Because the personal holding company tax provisions consider whether stock in the corporation is concentrated, they acknowledge the potential for closely held corporations to operate in undesirable ways that widely held corporations do not. In this case, the provisions address the risk that (primarily) high income individuals would attempt to reduce their tax bill by transferring to a corporation income producing assets. In the absence of the transfer, the income from such assets would be subject to tax at the high marginal rates that apply to the owner. However, the tax bill could be much less if the income was taxable to a corporation where lower marginal tax rates would apply. Furthermore, if the corporation never distributed the earnings, the shareholder tax that applies to dividends would never come into play.

The personal holding company tax provisions essentially make it very unattractive to use a corporation as a vehicle to separate an individual from income that ought to be taxable to him. Under the current set of rules, and under the proposal made by the JCT Staff, a corporation can operate as a vehicle that separates an individual from income that ought to be subject to employment tax as labor income. The suggestions made in this article prevent that from happening. However, they do so without operating as a penalty. Instead, the suggestions merely require all individuals in economically similar situations to be subject to the same set of rules.

### **E. Accumulated Earnings Tax**

Even in situations where a corporation is not subject to the personal holding company tax, it may nevertheless face a penalty for failing to pay dividends to shareholders so as to prevent the shareholder level tax from

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<sup>172</sup> I.R.C. § 541. The penalty tax is not a substitute for the tax imposed on an actual dividend received by a shareholder from the corporation. It is an additional levy. Thus, even when a corporation pays the personal holding company tax, any later dividends paid by the corporation will be taxed to the shareholder as usual.

<sup>173</sup> I.R.C. § 542(a)(2). Attribution rules operate to cause a shareholder to constructively own shares actually owned by certain related parties. I.R.C. § 544(a).

<sup>174</sup> I.R.C. §§ 542(a)(1); 543.

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applying to its earnings.<sup>175</sup> Specifically, the Internal Revenue Service can assess an accumulated earnings penalty tax on any corporation that accumulates earnings beyond the reasonable needs of the business.<sup>176</sup> This power can be exercised only in cases where there is evidence that the corporation was utilized to avoid or evade the tax that shareholders would have to pay on dividends.<sup>177</sup>

The accumulated earnings tax represents one way to restrain the ability of a corporation to control when the shareholder level tax comes into play. The measure proposed by this article constitutes a different kind of mechanism directed at a similar activity. Under current law and under the JCT Staff proposal, the employment tax liability of a corporation's owner-employee could be controlled in undesirable ways. That power is eliminated under the measure proposed in this paper, resulting in more uniform treatment of all employee - owners whose economic situations are substantially the same.

## VI. Conclusion

Employment taxes account for a substantial portion of federal tax receipts. Yet the tax is assessed and collected under an outdated set of rules that is in desperate need of reform. Not only are there gaps in the law, the rules themselves offer a number of opportunities for taxpayers to arrange their affairs so as to prevent the tax from coming into play when it otherwise would.

Prior to the enactment of the temporary tax cut on dividends, the defects in the employment tax scheme were severe enough. However, after those tax cuts took effect, the defects have taken on greater significance because they appear to jeopardize the government's ability to collect the employment tax from a substantial number of people. Specifically, high income individuals who own and control corporations that employ them stand to save substantial amounts by substituting dividends for compensation they would have otherwise received from the business.

As it stands, there does not appear to be much tangible evidence that the situation will change. The JCT Staff has advanced a sensible proposal that serves as a very helpful framework for addressing the problem. However, there does not seem to be much interest in adopting it or any other measure directed at addressing any of the well understood defects in the employment tax laws. The last legislative measure was introduced during the Clinton administration. By contrast, there have been repeated attempts by the Bush administration and others to make permanent the dividend tax cuts, which create new and hard-to-resist opportunities for the rich to underpay employment tax by exploiting

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<sup>175</sup> The tax does not apply if the following penalty taxes come into play: the personal holding company tax imposed in section 542, the foreign personal holding company tax imposed by section 552, the passive foreign investment company tax imposed by section 1297.

<sup>176</sup> See I.R.C. § 537 describing how to measure the reasonable needs of the business.

<sup>177</sup> See I.R.C. § 533.

## **Working for Free**

defects in the law. Those defects are already long overdue for correction. A very bad situation will only be made much, much worse if the dividend tax cuts are made permanent in the absence of legislation that eliminates the opportunity to substitute a dividend for compensation. It doesn't seem right that the rich should be able to get richer at the government's expense by working for free.