Testimony

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C, K, or S: Exploring the Alphabet Soup of Small Business Choices in Advance of Tax Reform

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I. Introduction

Good morning. First, I thank the Committee for the opportunity to testify before you on the way businesses choose to organize, and the tax consequences that result from that choice. Second, I applaud the Committee for exploring this issue, as it is economically significant to many taxpayers, and the tax consequences often drive what business entities taxpayers use for their business operations. My comments largely will focus on smaller businesses and the tax issues surrounding their choice of business form. Smaller businesses commonly use business forms that are taxed under the Code's pass-through regimes.

One goal and objective of the tax system should be to create tax parity among the various business forms so that one taxpayer is not disadvantaged over another, from a tax perspective, simply because of its choice of business form. Because of the double tax imposed on regular corporate earnings, taxpayers that choose the regular corporation as their form of business are disadvantaged compared to the single-tax, pass-through regimes. I believe that tax reform efforts need to focus on eliminating this double tax, and its distortive effect on choice of entity. By adopting an acceptable corporate integration model under which income from regular corporations would be subject to a single level of tax, all business income generally would be subject to a single level of tax. Then, it should be possible to rationalize the various pass-through regimes with the adopted corporate integration model.

II. Some Background about the Popular Business Forms

Choice of business entity is first and foremost a business decision, but it is heavily influenced by the differing tax and liability consequences of using one business form rather than another. Factors affecting choice of entity are constantly in a state of flux. As new changes in federal and state laws are enacted, the pendulum swings back and forth in favor of one entity over another. For example, for many years, the regular corporate form was preferred by many businesses because of the limited liability offered to shareholders. However, when limited liability company (LLC) statutes were enacted by the 50 states, and the federal tax treatment of LLCs was clarified by the IRS, the LLC has become the preferred business form for many start-up businesses.

Regular corporations, partnerships, and sole proprietorships were the traditional business forms at the beginning of the 20th century. Regular corporations have long been subject to a double tax under the federal income tax laws--once on their corporate earnings and once on dividends paid to shareholders.[1] This compares with partnerships and sole proprietorships, whose earnings are taxed directly to the partners or the sole proprietor, respectively. General partnerships and sole proprietorships do not offer liability protection to their owners as does the regular corporation. This trade-off--the double tax on regular corporations while enjoying limited liability, and the single tax of the general partnership and the sole proprietorship but lacking liability protection--have made choice of business entity very difficult for small business owners over the years.

As one of its first steps to allow limited liability without a double tax, Congress enacted Subchapter S in 1958 for small businesses to use. This new subchapter allowed eligible corporations to elect to become "small business corporations,"[2] today more commonly referred to as "S corporations". As originally enacted, small business corporations were singly taxed, but were not true pass-through entities like partnerships. However, like regular corporations, they offered their shareholders limited liability protection.

By enacting Subchapter S, Congress sought to eliminate the impact of federal taxes on the choice of business entity, and to give small businesses a simpler form of taxation. Thus, the rationale at the time was to treat small business corporations similar to partnerships, i.e., subject to one level of tax at the shareholder level. Although Congress wanted to encourage eligible corporations to convert to small business corporations, a corporate-level toll charge was imposed on recognized capital gains for three years after the Subchapter S election went into effect.

For almost 25 years, Subchapter S remained a relative backwater in the Internal Revenue Code and largely went underutilized by many small business owners. To eliminate traps for the unwary, Congress enacted the Subchapter S Revision of 1982 (SSRA '82) and made Subchapter S a true

[1] Regular corporations currently are subject to a graduated corporate income tax schedule, beginning at a 15 percent tax rate on the first $50,000 of income and 25% on the next $25,000 of income. At higher levels of income, the benefit of these lower rates is taken away through higher marginal rates that reach 39 percent. For corporations with income exceeding $18.3 million, the applicable tax rate is 35 percent. If dividends are paid, the individual shareholders pay a maximum 15% tax on this income through 2010. Under present law, in 2011 and thereafter, dividends will be taxable at the applicable individual ordinary income tax rates in effect at that time.

[2] P.L. 86-866, Sec. 64, 85th Cong., 2d Sess. (1958), 1958-3 C.B. 254, 298-305. Section 64 of this Act added former Sections 1371 through 1377 as the original Subchapter S.

pass-through regime.[3] Although the Subchapter S regime is now pass-through like Subchapter K that applies to partnerships, the two subchapters have remained separate and distinct until present day. Most tax practitioners would agree that, although the two regimes are similar in that they provide pass-through taxation to their respective owners, the two subchapters are very different in how business income is allocated to the owners, and thus, how the income is ultimately taxed.

Importantly, Congress has continued over the years to modify and amend Subchapter S to make it more flexible and simpler to use in response to its concern regarding the taxation of smaller businesses.

In 1978, little noticed at the time, Wyoming enacted the first limited liability company statute offering LLC members protection from entity-level liabilities much like the liability protection of regular corporations. However, the tax status of LLCs remained uncertain until the IRS confirmed in Rev. Rul. 88-76[4] that under the old four-factor test for classifying business entities as partnerships, LLCs formed under the Wyoming statute could qualify for partnership tax status.

The IRS ruling was a watershed event because it motivated all the 50 states to enact LLC statutes so as not to be left behind their neighbors in attracting businesses to their state economies. Given the new-found popularity of the LLC, the move from regular corporate form to the LLC-partnership pass-through regime was off and running.

In 1997, prompted in large part by the enactment of the 50 state LLC statutes, the IRS issued its so-called "check-the-box" regulations, which offered another significant push towards using the partnership pass-through regime. Under these rules, an eligible entity, which would include partnerships and LLCs with more than one owner, defaults into partnership taxation without having to file a formal election. Furthermore, if the eligible entity has only one owner, then the entity generally is disregarded under the Internal Revenue Code, and is treated as part of its direct owner for federal income tax purposes. The simplicity of the check-the-box rules in entity tax classification has provided yet another incentive for taxpayers to use the

[3] P.L. 97-354, Sec. 2, 97th Cong., 2d Sess. (1982), 1982-2 C.B. 702. Section 2 replaced the former Suchapter S with existing Sections 1361 through 1379.

[4] 1988-2 C.B. 360, obsoleted by Rev. Rul. 98-37, 1998-2 C.B. 133 (the check-the-box regulations made classification rulings of this type obsolete because taxpayers either default or elect into the desired tax classification for their business entities).

non-corporate LLC and partnership business forms by providing easy access to the partnership pass-through tax regime.

III. Growth in the Use of Pass-Through Entities

As discussed in the previous section, changes in federal and state laws over the past two decades have favored the single-taxed, pass-through regime. Therefore, those business forms that fit into this regime--sole proprietorships, partnerships, limited liability companies, and S corporations--have as a group experienced remarkable growth. The percentage of businesses using pass-through regimes (including sole proprietorships) has increased from 85% in 1986 to 93% in 2005, and the percentage of business income earned through pass-through regimes has increased from 41% to 51% over the same period (see Table 1).[5]

These data show the growth in pass-through entities as well as well as the lower average income of businesses organized as pass-though entities.[6] Said differently, larger businesses tend to operate in regular corporate form, while smaller businesses tend to choose pass-through regimes when they can.

In 2003, among the largest corporations (those with business receipts of $50 million or greater), regular corporations were the most prevalent (constituting 52 percent of all businesses with business receipts of $50 million or greater), followed by S corporations (30 percent of all businesses with business receipts of $50 million or greater), partnerships (17 percent of all businesses with business receipts of $50 million or greater), and sole proprietorships (less than 1 percent of all businesses with business receipts of $50 million or greater).[7] Although there has been a distinct shift to the pass-through regime, larger businesses still are operated in regular corporate form, particularly those that require access to public capital markets.

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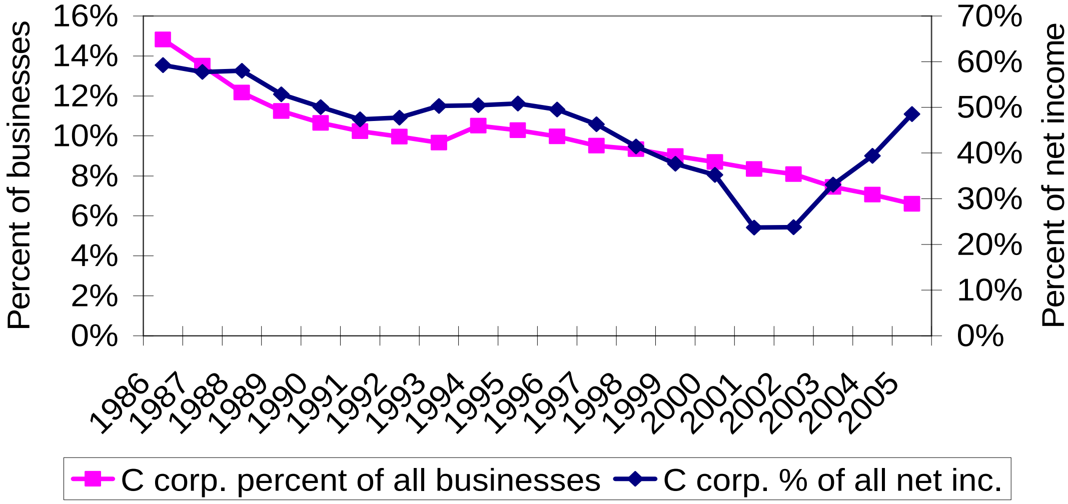
[5] See, Peter R. Merrill, "The Corporate Tax Conundrum", *Tax Notes*, (October 8, 2007) pp. 174-176.
[6] In 2003, IRS data show that the average amount of business income subject to tax reported by regular corporations was $339,000 as compared to $64,000 for S corporations, $127,000 for partnerships, and $11,000 for sole proprietorships.
[7] IRS Integrated Business Data at http://www.irs.gov/taxstats/bustaxstats/article/0,,id+152029,00.html.

Table I
C CORP. SHARE OF ALL BUSINESSES AND ALL NET INCOME (LESS DEFICIT)



Source: IRS Statistics of Income

What has caused this shift in favor of pass-through entities? Although not a comprehensive list, here are a few of the more significant changes over the past twenty years that have favored the pass-through regime: (1) the differential between the marginal tax rates imposed on corporations and individual taxpayers has been narrowed or eliminated; (2) the amount of double tax imposed on corporate dividends has remained high until relatively recently; (3) the enactment of LLC statutes in the 50 states; and (4) the adoption of the check-the-box regulations by the IRS which simplify entity classification for federal income tax purposes.

IV. Marginal Income Tax Rates Play an Important Role in Choice of Business Form

Marginal income tax rates imposed on corporate and non-corporate taxpayers play an important role in what business form business owners decide to use. The top existing federal marginal income tax rate imposed on regular corporations (35%), along with the double tax imposed on regular corporate earnings when dividends are paid to shareholders (15%), makes doing business in the regular corporate form significantly more expensive than operating in a pass-through regime with individual owners (who are taxed at individual rates no higher than 35%). This additional income tax burden puts the regular corporation at an unfair advantage.[8]

Now that over half of business income is earned through pass-through entities, changes in individual marginal tax rates directly affect incentives for investment and entrepreneurial activity. If a small business operates in the LLC form taxable as a partnership, the LLC's business earnings are reflected directly in the individual LLC members' taxable incomes. Small business persons can quickly find themselves at the current maximum 35% marginal income tax rate for individuals (e.g., $357,700 taxable income for married filing jointly in 2008) by including their business income on their personal income tax returns.

As marginal individual income tax rates change, small businesses react accordingly in their choice of business form. Significant shifts in marginal tax rates, and the relative differential between the corporate and individual tax rates, can likewise trigger significant shifts in choice of business form. If we had more tax parity in the Code, so that all entities were taxed relatively the same, changes in marginal rates would not have the consequential effects that they do today.

Tax reform should move in the direction of tax parity by integrating the corporate tax to eliminate as much as possible the distortions under the existing Code. Many economists and tax attorneys believe an integrated tax structure with a single level of taxation for all businesses would be preferable to the current double tax on C-corporation earnings.[9] In 1992, the U.S. Treasury Department issued a report on Integration of the Individual and Corporate Tax Systems.[10] The report concluded that integration of corporate earnings would make taxation of investment more uniform across sectors of the economy, create more parity in the tax treatment of debt and equity, minimize the distortion of deciding whether to retain or distribute

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[8] Prior to the Tax Reform Act of 1986, the 46 percent top corporate income tax rate was lower than the 50 percent top individual income tax rate. Following the Tax Reform Act of 1986, the 28 percent top individual income tax rate was lower than the 34 percent top corporate income tax rate, which increased the tax incentive to avoid use of regular corporations. As referenced above, the top individual and corporate income tax rates are both 35 percent and, since 2003, Congress has reduced the double taxation of corporate income distributed as dividends by lowering the top individual income tax rate on dividends to 15 percent.

[9] Gary Guenther, "Small Business Tax Benefits: Overview and Economic Rationales," CRS Report for Congress, Congressional Research Service, RL32254, March 3, 2008.

[10] U.S. Department of Treasury, "Integration of the Individual and Corporate Tax Systems," January 1992.

earnings, and create a tax system that taxes capital income once, i.e., eliminate the double tax.

V. Using Pass-Through Entities to Achieve Integration

The pass-through regimes effectively allow small business owners to integrate their business operations for federal income tax purposes through self-help elections and choice of appropriate business form.

Converting a regular corporation into a partnership or sole proprietorships generally is not very practical from a tax point of view. It certainly does not avoid the double tax. In fact, the conversion more than likely will accelerate the double tax under a constructive liquidation. More specifically, moving assets out of corporate solution triggers a double-tax on asset appreciation with gain recognition, but with no cash proceeds to pay the tax.

As matter of mechanics, current state conversion statutes make it easy to convert a regular corporation to another statutory form of doing business. However, business owners need to be careful not to trigger the double tax on what would be constructively treated as a liquidation of their corporations. Such conversions, assuming they would be unintended, could turn into a disaster to an unsuspecting small business owner in regular corporate form.

The only practical exit from the corporate double tax is for an eligible regular corporation to make an S corporation election to treat itself as pass-through for income tax purposes. In this regard, the S corporation serves much the same purpose today as it did in 1958 when it was first adopted--allowing corporations to move into the single tax regime to eliminate the distortive affect of the double tax on small businesses organized as corporations.

Converting to S corporation status is not without tax consequence. If assets held on conversion from regular corporate status to S corporation status are sold within the first 10 years after the conversion date, any built-in gain in those assets measured at the time of conversion is subject to a corporate level tax, and the gain is taxed again at the shareholder level. This built-in or gain tax acts as a substitute for collecting the double tax at conversion by allowing taxpayers the ability to pay the double tax when they have the wherewithal to pay, at the time the assets are sold for liquid proceeds.

To be clear, the S corporation election serves an important function under the current Code as a self-help mechanism for existing regular corporations to move from the double tax into a pass-through regime. Although S corporation earnings are passed through to the shareholders, the corporation's assets remain in corporate solution. This means if appreciated S corporation assets are distributed to the shareholders, a corporate level gain is triggered which flows up to the shareholders to be taxed one time at the shareholder level (and possibly twice if the distribution occurs during the built-in gains recognition period). This incidence of tax occurs not on a sale of the assets, but on distribution to the shareholders, and therefore, there are no proceeds available from the distribution transaction to pay the tax.

In this regard, the S corporation is not as favorable an option as either the partnership, or the LLC taxed as a partnership, because with these entities appreciated assets generally can be distributed to the partners under Subchapter K, without gain recognition at the partnership or partner level. The fact that S corporation assets are still in corporate solution inhibits conversions of S corporations into partnerships, and into LLCs taxed as partnerships.

VI. Structural Simplification of the Code--Now or Later?

The current Code supports several different pass-through, or single-tax regimes.[11] Subchapter K and Subchapter S are the pass-through regimes that apply to partnerships and S corporations, respectively. The character of income and deduction items incurred by these entities is preserved as these items flow up, and are taxed, to their owners. Although both Subchapter K and Subchapter S are pure pass-through provisions, the two regimes are quite different in their application. Recent changes to Subchapter S have made it more useful and available to a broader group of shareholders, but fundamentally, its rules are easier to comply with than the tax rules that apply to partnerships.

While Subchapter S may be easier to comply with, most tax practitioners would assert that Subchapter K is far more flexible, and therefore, more attractive for the small business owner. However, with all its flexibility, the partnership form brings incremental complexity. Arguably, Subchapter K's complexity is elective on the part of its owners. For example, if the partners

[11] REITs and RICs are subject to a single-level of tax on their earnings through a distribution deduction at the entity level, as opposed to the pass-through of their earnings to their shareholders. These investment vehicles are uniquely focused in their purpose, and are not used by small businesses.

are satisfied with allocating their income and deduction items "straight-up" without any special allocations, their tax compliance generally will be much easier and akin to that of Subchapter S. On the other hand, no matter how simple the partnership's structure is, the Subchapter K rules bring to bear a great deal of complexity not present in Subchapter S. Many small business owners just are not ready to deal with that complexity on a day-to-day basis.[12]

Therefore, under the existing Code, it is important that taxpayers have the choice of using either the Subchapter S or the Subchapter K pass-through regimes. Giving small business owners this choice works to their advantage. When Congress is ready to fully integrate the Code, at that time it would be appropriate to rationalize the pass-through regimes with the adopted corporate integration model.

VII. Specific Recommendations for Congressional Consideration

A. Statutory Guidance is Needed for Classifying LLC Members as Either General or Limited Partners

The Code does not reflect any specific guidance regarding LLCs. This is appropriate as LLCs are state law entities that can be classified for tax purposes as partnerships, associations, or disregarded entities under the check-the-box regulations. With that said, there are a number of areas in the Code where the status of a general partner or limited partner is important in determining tax consequences. One area of significant importance is the treatment of general and limited partners under the self-employment (SE) tax rules.[13] General partners are subject to SE tax on their earnings, whereas limited partners are only subject to SE tax to the extent of guaranteed payments for services rendered.

We do not have authoritative guidance on whether LLC members are general or limited partners for SE tax purposes. The IRS has released proposed regulations that would treat any partner in an entity classified as a partnership (including an LLC) as a general partner if: (1) the individual has

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[12] Aside from special allocations on income and deduction items under Section 704(b), small business owners face complicated built-in gain property rules (Section 704(c)), disguised sale rules (Section 707(a)(2) (B)); partnership terminations (Section 708(b)); character recognition of gain or loss (Section 741) and hot assets (Section 751); and allocation of entity liabilities to partner basis (Section 752), to name a few.

[13] IRC Sections 1401 and 1402(a)(13). Other areas of concern where distinctions are made between general partners and limited partners are: Section 448 (cash method of accounting); Section 465 (at-risk); Section 469 (passive activity losses); and Section 736 (liquidating a partner's interest).

personal liability, (2) the individual has authority to contract on behalf of the partnership, or (3) the individual participates in the partnership's trade or business for more than 500 hours during the partnership's tax year.[14] This is proposed guidance, and thus, not definitive.

It would be helpful if Congress could address this issue as we are seeing an increasing number of LLCs classified as partnerships, and there is a lack of clarity around whether the LLC members should be subject to the SE tax, and, if so, to what extent.

B. Partnership Income Attributable to Capital Should Be Excluded from Self-Employment Tax

In the S corporation world, wages paid to shareholder-employees are subject to FICA taxes. An S corporation's distributive earnings are not subject to any employment taxes simply because the self-employment (SE) tax does not apply in a corporation-employee relationship.[15] If an S corporation shareholder-employee's wages are "too low", the IRS can challenge this compensation and re-characterize distributive earnings as wages. To avoid this concern, taxpayers are best advised to pay themselves a reasonable salary based on comparable wages for the services rendered in their locale. The portion of the S corporation earnings not paid out as wages remains outside the employment tax system, and is, in effect, earnings on return of capital.

On the other hand, in the partnership world, a general partner's distributive share of earnings generally is entirely subject to the SE tax. Congress should consider excluding a general partner's share of partnership income from the SE tax to the extent the earnings are attributable to capital. Therefore, the amount that would be in excess of what would constitute reasonable compensation for services rendered by the partner for the partnership would not be subject to the SE tax. Such a proposal, if enacted, would generally put general partners on par with shareholder-employees of S corporations.[16]

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[14] Prop. Reg. Section 1.1402(a)-2(h).

[15] Rev. Rul. 59-221, 1959-1 C.B. 225. Also see, e.g., Radtke, 895 F 2d 1196 (7th Cir. 1990), Spicer Accounting, 918 F 2d 90 (9th Cir. 1990).

[16] See H. R. 4137, 108th Cong. 2d Sess., Section 3 (introduced by Mr. Houghton). A similar proposal was recommended by the ABA Section of Taxation, "Tax Rules Governing Self-Employment Income of Limited Liability Companies and Partnerships," May 29, 2002.

C. Partners as Employees of Their Own Partnerships

With the growth of partnerships and LLCs treated as partnerships, owners want to treat themselves as employees of their own business entities. The motivation frequently has nothing to do with employment taxes, and all to do with tax compliance issues. Many partners simply prefer the income tax withholding system on their earnings, versus time-intensive quarterly estimated tax payments.

Congress could help clarify the situation and permit certain partners also to be employees of their partnerships. Perhaps it would be appropriate to allow non-manager partners (those without the authority to bind the partnership) to also be employees of their partnership. This dual status would permit income tax withholding on their wages for services rendered. The distributive share of their partnership income would be subject to quarterly estimated tax payments, but the risk of underpayments of tax will have been reduced.

This proposal couples nicely with the above proposal to exclude partnership income attributable to capital from the SE tax. To the extent a partner is an employee compensated reasonably for services rendered, the empoyer-employee FICA taxes will be paid. Excess earnings would be attributable to capital, and exempt from SE tax, but subject to quarterly estimated income taxes with less risk for underpayment penalties.

D. S Corporation Reforms

As mentioned earlier, Congress has been quite attentive to Subchapter S over the years. A number of improvements and refinements have been enacted making the S corporation easier to use and available to a broader base of taxpayers. In addition, the IRS has been very responsive to S corporation needs, and has interpreted the S corporation rules reasonably and fairly. Personally, I commend the IRS for its efforts to provide guidance to the S corporation community. For the most part, they have done an outstanding job.

One area of legislative concern that could be considered is the one-class of stock restriction imposed on S corporations. This restriction is intended to keep Subchapter S simple. However, it limits S corporation access to capital. Congress could consider modifying the one-class-of stock rule by permitting S corporations to issue a preferred stock. In general, such stock would be stock that is not convertible, and would not participate in corporate growth to any significant extent. Payments on the preferred stock would be treated as interest. In essence, the preferred stock would be similar to a straight debt instrument, and therefore, would be treated as such under this proposal.[17] Allowing for a preferred stock restricted in this manner would give the S corporation small business owner one more option in seeking capital to fund business operations.

VIII. Conclusion

Over the last two decades, more small businesses have chosen to organize under one of the Code's pass-through regimes. As noted earlier, a number of factors have contributed to this migration from the regular corporate form of doing business. The most significant factors are the increase in the relative tax disadvantage from operating as a regular corporation as well as the ability to obtain limited liability protection through entities subject to pass-through taxation. To reduce existing distortions in the Code affecting choice of entity, Congress should consider undertaking true corporate integration to eliminate the double tax. Once this regime is agreed and relative parity is achieved, it would be appropriate to look to the pass-through regimes, and rationalize them with the adopted corporate integration model.

Until the distortions created by the double tax can be resolved, the current pass-through regimes provide a valid self-help integration function which allows for a more efficient tax system (at least to the segment of the economy that can use these pass-through tax regimes). Subchapters K and S should continue to co-exist under the existing Code awaiting corporate integration.

Thank you for the opportunity to join you in today's hearing.

[17] The Senate Finance Committee has considered this proposal in the past. See, Joint Committee on Taxation, *Present Law and Proposals Relating to Subchapter S and Home Office Deductions* (JCS-16-95), May 24, 1995, at page 29.