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BEFORE THE SENATE FINANCE COMMITTEE
MAY 25, 2005

Chairman Grassley, Senator Baucus, Members of the Committee, thank you for the opportunity to discuss a report that my office is releasing today regarding the Internal Revenue Service's administration of certain employment tax laws.

The objective of our report was to determine whether the existing tax laws, tax regulations, and IRS policies and practices ensure fairness in the administration of self-employment tax laws for similarly situated taxpayers. We compared the employment tax liabilities of sole proprietors to the employment tax liabilities of single-shareholder S corporations. Our report found that employment tax inequities exist between sole proprietorships and single-shareholder S corporations.

These inequities have historical underpinnings. In 1958, Congress established Subchapter S of the Internal Revenue Code, which enabled small businesses, including sole proprietorships, to form corporations owned by 10 or fewer shareholders. Electing S corporation status exempts profits from corporate taxation and allows profits to "pass through" to the shareholders. Shareholders are then responsible for paying individual income taxes on the profits received. In addition, shareholders who actively operate the business are subject to employment taxes on the compensation received for their services.

The IRS developed its methodology for dealing with the employment taxes of S corporations in 1959. This methodology does not properly address how today's S corporations are structured because the 1959 methodology is based on the assumption that S corporations will have multiple shareholders or owners. In a multiple shareholder environment, a consensus of shareholders typically set the salary of the business operator at a level reflecting the market value of the operator's services.

However, in Tax Year 2000, 78.9 percent of all S corporations were either fully owned by a single shareholder, or more than 50 percent owned by a single shareholder. Therefore, in nearly 80 percent of S corporations, the individual who owns the business determines the amount of the salary paid to the shareholder operating the business.

The decision by the single shareholder of an S corporation of what amount to pay himself or herself in salary has tax consequences. A lower salary results in lower employment taxes and higher profits. In comparison, sole proprietorships are treated much differently for the purposes of employment taxes.

Employment taxes are authorized by the Federal Insurance Contributions Act, or FICA, and the Self-Employment Contributions Act, or SECA. FICA applies to S corporations, and SECA applies to sole proprietors. Under FICA, S corporations are required to withhold taxes from the wages of employees, with matching amounts paid by the employers. In comparison, under SECA, sole proprietors must pay taxes on profits from the operation of their businesses. The self-employment tax law treats all profits (except for an amount equal to the employer portion of FICA) as if they were wages. As a result, the sole proprietor pays the equivalent of both the employer and employee portions of FICA on business profits.

The different tax treatment has caused the S corporation form of ownership to become a multibillion dollar employment tax loophole for single-shareholder businesses. For example, as shown in this first chart, in Tax Year 2000, the owners of 36,000 single-shareholder S corporations received no salaries at all from their corporations, even though the operating profits of each of these corporations exceeded $100,000. This resulted in employment taxes not being paid on $13.2 billion in profits.

A 2001 tax court case provides a textbook example of the type of S corporation shareholder I am referring to. A veterinarian was the sole shareholder in his S corporation. His corporation produced over $400,000 in total profits over three years. Yet, during these three years, he declared no salary for himself, despite the fact that his corporation’s sole source of income was from his services. In court, the IRS prevailed. The tax court agreed that the corporation’s profits should be subject to employment taxes.

Determining what is reasonable compensation to pay a business officer is complex and subjective, and the IRS must sometimes engage in litigation. Since the IRS is forced to address the issue of reasonable officer compensation on a case-by-case basis, many owners of S corporations have apparently determined that saving employment taxes by minimizing salaries is worth the risk of an IRS examination. As shown in the next chart, single-shareholder S corporations vary widely in the amount of salary they give themselves. At the top of the chart, you can see that many are willing to set their salaries at $0 to maximize their employment tax savings.

Furthermore, the owners of single-shareholder S corporations have been setting their salaries at a decreasing percentage of corporate profits in the past several years. As shown in this third chart, in Tax Year 1994, these shareholders paid themselves salaries subject to employment taxes equal to 47.1 percent of their profits. This percentage fell to 41.5 percent by Tax Year 2001. In comparison, sole proprietors pay employment taxes on all their operating profits.

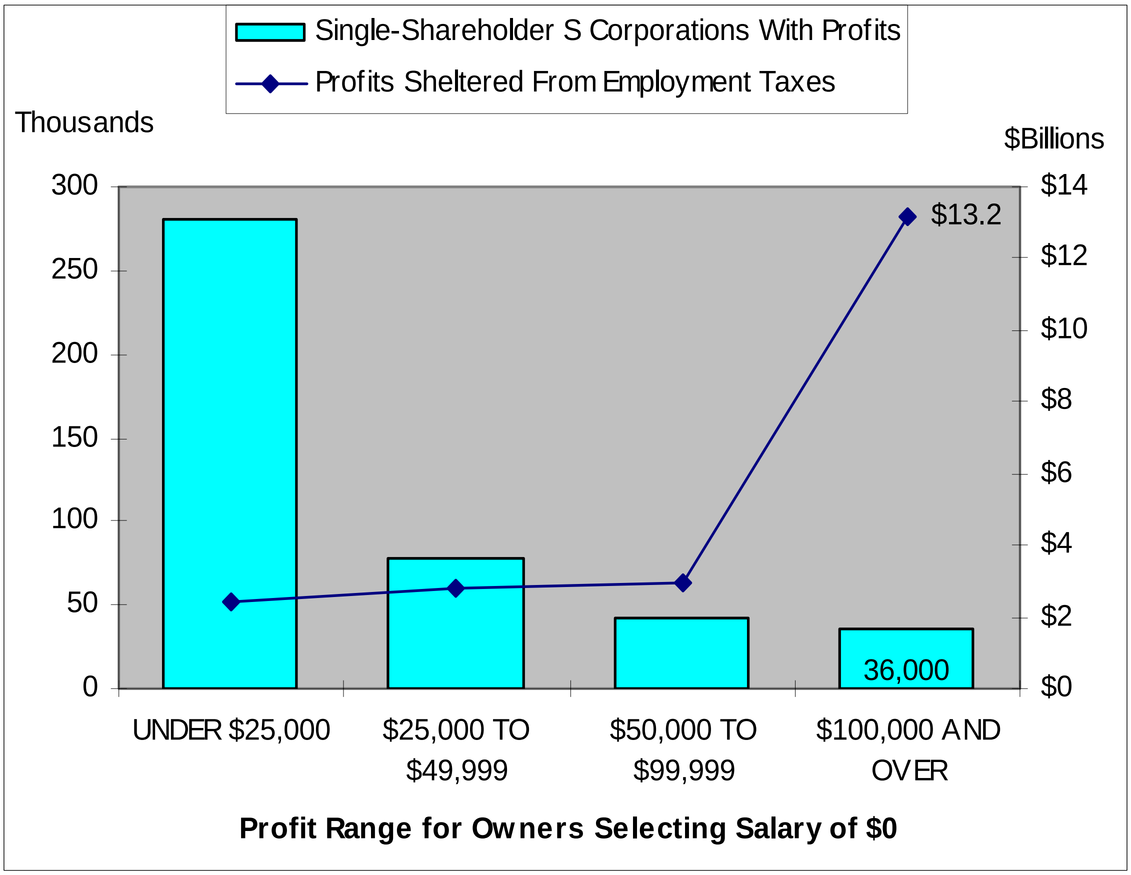
The employment tax consequences of these single-shareholder S corporations paying themselves little or no salaries are in the billions of dollars. My final chart compares the actual FICA taxation of single-owner S corporations to the theoretical SECA taxation that would have been paid if these profits were taxed as a sole proprietorship. In Tax Year 2000 alone, S corporations paid $5.7 billion less in employment taxes than would have been paid if the taxpayers were sole proprietors.

Billions of dollars in Social Security and Medicare taxes are being avoided by single-shareholder and majority-owned S corporations. Trends indicate that the employment tax base is eroding. In fact, advising small businesses to save on employment taxes by forming S corporations has become a cottage industry. A search of the Internet yields many sites that advise entrepreneurs that they can save thousands of dollars a year in employment taxes simply by incorporating.

The Joint Committee on Taxation shares my concern about the employment tax treatment of pass-through entities – such as S corporations – and has recommended changes to their taxation. Additionally, the Joint Committee outlined five general principles for improving compliance and reducing the tax gap in testimony before this Committee last month. The employment tax treatment of owners of pass-through entities was included as one example of how compliance is hampered when tax outcomes are dependent on difficult factual determinations.

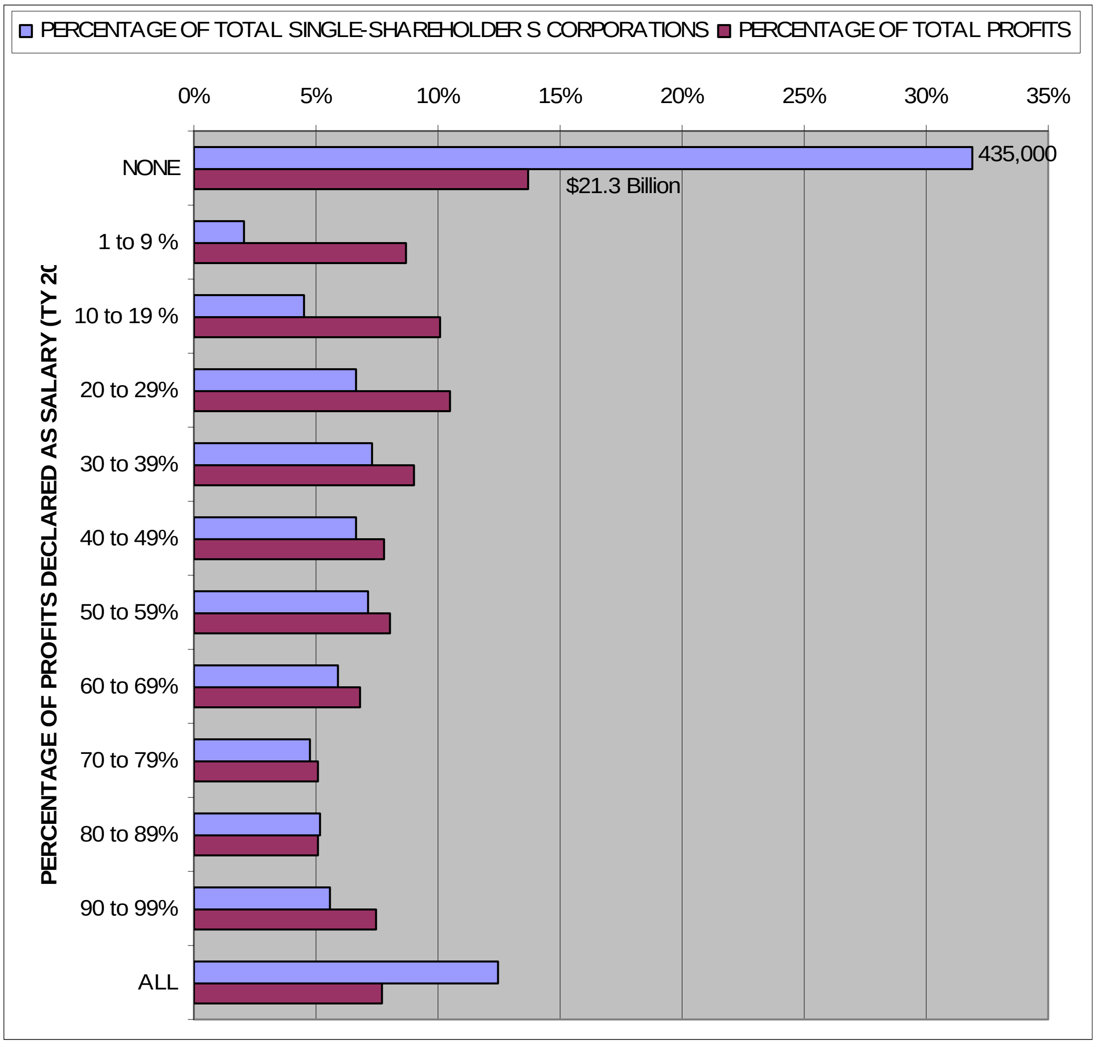
Mr. Chairman and members of the committee, I appreciate the opportunity to discuss this important issue. I look forward to working with the IRS to identify and recommend solutions to this problem. I will be happy to answer any questions you have at the appropriate time.

Operating Profits of S Corporations That Paid No Salaries to the Sole Owners (Tax Year 2000)



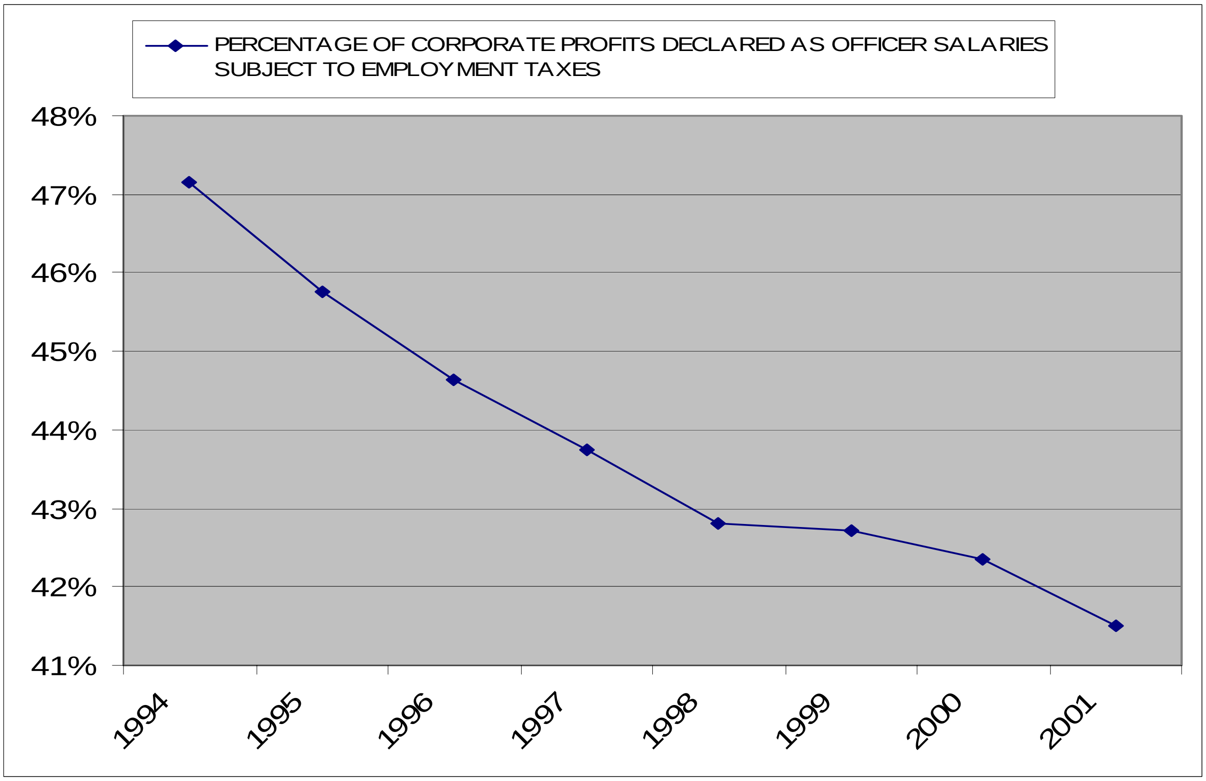
Source: TIGTA analysis of IRS Master File Data. These data reflect the impact of S corporation spousal ownership but not majority ownership.

Variations in Salaries Selected by Owners of Single-Shareholder S Corporations (Tax Year 2000)



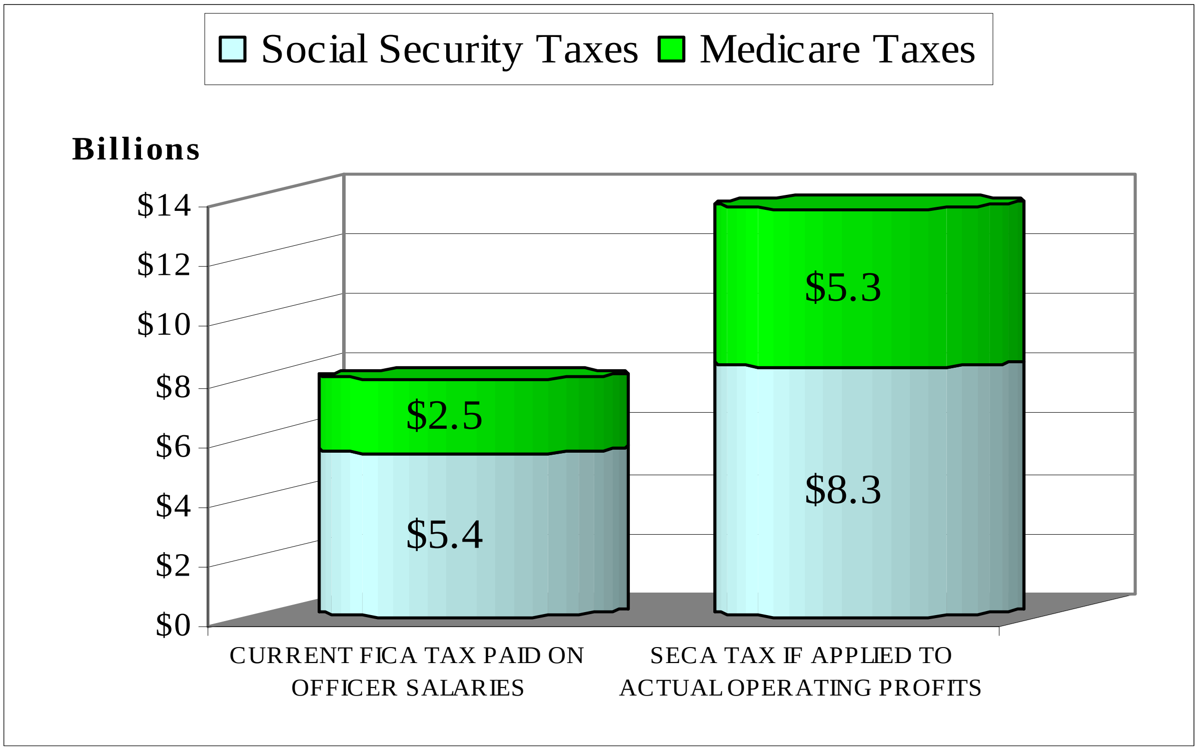
Source: TIGTA analysis of IRS Master File Data. These data reflect the impact of S corporation spousal ownership but not majority ownership.

Officer Salaries Declared by Single-Shareholder S Corporations As a Percentage of Operating Profits (Tax Years 1994 – 2001)



Source: IRS SOI function data.

Actual FICA Taxation vs. Theoretical SECA Taxation of S Corporations (Tax Year 2000)



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of IRS Master File data