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Tax Reform and Closely Held Business Entities

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Chairman Camp, Ranking Member Levin, and distinguished members of the Committee, thank you for inviting me to testify at this hearing.

The income taxation of closely-held business entities is clearly in need of reform. The principal closely-held business forms are corporations, partnerships, and limited liability companies.[1] Under current law, these enterprises may be taxed under one of three alternative regimes.

Most closely-held business entities are taxed as "pass-through" entities. As such, the income of the entity is taxed once, directly to the owners with each owner reporting his or her share of the entity's income. No further tax is generally imposed when the entity distributes its profits. Pass-through entity treatment is conferred by two alternative regimes ("Subchapter S" and "Subchapter K"). The Subchapter S regime is potentially available to all business forms, provided its eligibility requirements are satisfied. By contrast, only unincorporated enterprises can access the Subchapter K regime.

Other closely-held business entities are not taxed as pass-through entities. Rather, these entities are taxed like publicly-traded companies under the "Subchapter C" regime. As such, their income is subject to both an entity-level tax when it is earned and an owner-level tax when profits are distributed. Under current law, the Subchapter C regime generally imposes disproportionately high tax costs and is therefore not desired by closely-held entities. As explained below, most of the closely-held businesses that use this regime are either trapped in it or endeavoring to exploit its rate structure.

The existence of three alternative regimes, each with different tax effects, causes business owners to be unduly influenced by tax considerations when deciding how to organize and operate a business. This results in unfairness, inefficiency and complexity. I have previously written at length on how these effects might be ameliorated[2] and would like to focus on four recommendations today:

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[1] The majority of small businesses are sole proprietorships which are not business entities.
[2] Jeffrey L. Kwall, *"Taxing Private Enterprise in the New Millennium,"* 51 Tax Lawyer 229 (1998).

1. The manner in which closely-held business entities are taxed should depend on the complexity of the business arrangement, not the legal form of the business.

2. A single, *owner-level* tax should be imposed on the income of "simple" closely-held businesses under a pass-through system resembling current law's "S regime."

3. A single, *entity-level* tax should be imposed on the income of "complex" closely-held businesses to relieve the tax law of the burden of allocating the income of a "complex" entity among its owners. This entity-level tax would replace current law's "K regime."

4. Closely-held businesses should be excluded from current law's, double-tax "C regime."

Background

Historically, corporations and partnerships were the principal forms in which businesses, other than sole proprietorships, were conducted. Corporations have long been treated as separate legal entities under state law and as separate taxpaying entities under federal law. By contrast, partnerships were historically small, informal arrangements regarded as mere extensions of their owners, and accordingly, partnership income was taxed directly to the partners. Little overlap existed between the types of businesses that organized as corporations or partnerships. From a state law standpoint, however, a major factor distinguished corporations from partnerships. The liability of corporate shareholders was limited to their investment in the corporation. By contrast, partners had unlimited liability for claims against the partnership.[3]

Both large and small corporations were subject to the C regime through the first half of the twentieth century. The C regime has always been highly controversial because of its double taxation feature. Commentators have long called for the corporate tax and the shareholder tax to be integrated so that the C regime imposes the same tax burdens as the single individual tax imposed on pass-through entities.[4] Integration, however, has yet to be adopted, and it appears the C regime in its current form will continue to govern almost all publicly-traded entities.

During the 1950s, the pass-through alternatives to the C regime advanced dramatically. Prior to 1954, partnerships and partners had been taxed under rudimentary rules. As part of the 1954 Internal Revenue Code, a detailed pass-through system was enacted for partnerships in the

[3] Limited partnerships, however, conferred limited liability on all partners except for at least one partner with unlimited liability.

[4] See, e.g., Michael J. Graetz & Alvin C. Warren, Jr., eds., INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS (1998).

form of the K regime. Access to the K regime was broadly granted provided the enterprise had at least two owners and was not incorporated. Implicitly, it appeared that unlimited liability for at least one owner was the price imposed to gain access to the K regime. Beyond that, however, the partnership regime accommodated virtually any business arrangement regardless of its level of complexity. For the tax reporting of partnership income and loss to be respected, it had to be consistent with the economic arrangement of the partners. Because most partnerships involved relatively simple arrangements at this time, the flexibility of the system did not pose major difficulties.

In 1958, the S regime was enacted as a pass-through alternative for closely-held corporations. Unlike the K regime, the S regime was extremely restrictive. Originally, a corporation could have no more than 10 shareholders to be eligible for the S regime.[5] More significantly, the S regime was only accessible to a corporation that issued a single class of stock, i.e., all shares of stock issued by the corporation were required to confer identical economic rights on the owner. This restriction dramatically simplified the operation of the S regime by necessitating a straightforward proportionate allocation of all corporate income and loss among the shareholders of the enterprise. Corporate shareholders who opted to use multiple classes of stock were relegated to the double taxation of the C regime.

The passage of time took a toll on this system. Until the latter part of the 20th century, limited pressures were imposed on the boundaries of the S and K regimes. During this period, the C regime, notwithstanding its double taxation, was the regime of choice. At this time, the corporate tax was a relatively low tax and the much higher shareholder tax was not imposed until dividends were paid. Hence, the second and more costly tax under the C regime could often be deferred or avoided. As a result, profitable closely-held enterprises normally aspired to the C regime. Thus, the S regime was not heavily utilized at this time.

Beginning in the 1960s, tax shelter activity took off and the K regime was utilized in a more aggressive fashion. The flexible loss allocation rules of the K regime were exploited by partners who disproportionately allocated deductions to investors desiring to shelter income from taxes. Although voluminous complex regulations governing income and loss allocations were promulgated to deter this conduct, it has proven extremely difficult to devise a system that ensures proper tax reporting when partners enter into complex allocation arrangements.

Even greater pressures were imposed on both the S and K regimes when, in the 1980s, individual tax rates were dramatically reduced. As a result of these individual rate reductions, corporate tax rates exceeded individual rates for the first time ever. This relationship created undue pressure to avoid and escape from the C regime. Closely-held corporations flocked to the S regime and the number of enterprises operating under that regime has exploded in the past few

[5] The shareholder limit has since been increased to 100 shareholders.

decades. In addition, the K regime that had been serving as the bastion of tax shelter activity was now besieged by profitable enterprises hoping to escape the higher corporate tax. Congress quickly prohibited publicly-traded enterprises from utilizing the K regime[6] but did nothing to staunch the exodus by profitable closely-held enterprises.

In a burst of activity during the late 20th century, state legislatures created a myriad of new business forms that conferred limited liability on all owners of the enterprise, most notably the limited liability company. Within a short period of time, all fifty states enacted limited liability company legislation. As a result, business owners no longer needed to incorporate to achieve limited liability. Hence, the historic connections between the C regime and limited liability, and the K regime and unlimited liability had disappeared. As such, regulations were promulgated in the late 1990's to allow eligible unincorporated enterprises to access the "C" and "S" regimes by electing such treatment. Efforts to permit incorporated enterprises to elect access to the "K" regime, however, have been rebuffed to date.[7]

As a result of all these developments, a hodge podge of tax alternatives for closely-held entities now exists. Consequently, tax considerations significantly influence the choice of business form decision. This leads to unfairness, inefficiency and complexity that could be mitigated with a series of incremental steps that are discussed below.

1. The manner in which closely-held business entities are taxed should depend on the complexity of the business arrangement, not the legal form of the business.

Historically, access to the different tax regimes depended on the legal form of the business. Corporations utilized the "C" and "S" regimes and partnerships utilized the "K" regime. Limited liability was the original hallmark of this distinction. With the advent of the limited liability company, an unincorporated enterprise that bestows limited liability on all of its owners, it makes no sense to allow the legal form of the business to impact the tax regime that governs that business. The Treasury's decision to allow unincorporated business entities access to the "C" and "S" regimes recognizes this reality. However, incorporated enterprises remain legislatively blocked from accessing the "K" regime. That block cannot be justified, and if the status quo is maintained, it would be sensible for Congress to allow closely-held corporations elective access to the "K" regime.[8]

The different legal forms in which a business might be conducted no longer create a need for multiple tax regimes. It nevertheless remains unlikely that a single tax regime could be

[6] I.R.C. § 7704 (relegating most non-corporate publicly traded entities to the C regime).
[7] See, e.g., H.R. 4137, 108th Cong. (2004) (permitting certain non-publicly traded corporations to elect to be taxed as partnerships under Subchapter K).
[8] The need for this change would be eliminated if an entity-level tax is imposed on complex closely-held entities (recommendation 3, below), because in that event, the K regime will no longer exist.

designed to accommodate the endless variety of economic arrangements that the owners of closely-held entities might use. These arrangements range from a straightforward proportionate sharing of profits and losses to complicated special allocations of individual items of profits and losses. Rather, two tax regimes should be applied to closely-held business entities: one primary regime that governs the "simple" entity, and an alternative default regime that governs the "complex" entity.[9]

2. A single, owner-level tax should be imposed on the income of "simple" closely-held businesses under a pass-through system resembling current law's "S regime."

An equitable income tax imposes equal burdens on similarly situated individuals. Hence, an equitable income tax should cause the income of any business, regardless of legal form, to be taxed directly to the individual owners of the business with each owner reporting his or her share on the owner's personal tax return. This treatment would cause the income attributable to each owner to be taxed at the individual marginal tax rate of the owner. It would create a level playing field and minimize the influence of the tax law on the choice of the form in which to conduct a business.

Unfortunately, it is not practical to tax all business income to the owners of the enterprise. In the case of publicly traded enterprises where many different classes of stock might be issued and where stock is changing hands every second, it would be virtually impossible to allocate the income of the business directly to the owners of the enterprise. As will be explained in greater detail below, even in a non-publicly traded enterprise, where the owners enter into an economic arrangement that creates ownership interests with differing economic rights, the process of allocating the enterprise's income among the owners is extremely difficult. However, when an enterprise issues a single class of ownership interests and each share confers identical economic rights, the process of allocating the enterprise's income among the owners is relatively straightforward.[10]

Hence, a somewhat modified version of the S regime should serve as the normal regime for all closely-held business entities that issue a single class of ownership interests, regardless of whether the business is conducted by a corporation, partnership or limited liability company.[11]

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[9] Other commentators have advocated a similar dichotomy. See, e.g., George K. Yin, *"The Future of Private Business Firms,"* 4 Florida Tax Review 141 (1999); Lawrence Lokken, *"Taxation of Private Business Firms: Imagine a Future Without Subchapter K,"* 4 Florida Tax Review 249 (1999). For a recent compilation of the commentary on this subject, see Martin A. Sullivan, "Business Tax Reform from the Bottom Up," 133 TAX NOTES 263 (2011).

[10] Transfers of ownership interests during the year create some complexity but mechanisms exist to deal with these situations. See I.R.C. § 1377(a)(2).

[11] Owners of simple businesses should be permitted to elect out of the modified S regime and instead be subject to the entity-level tax imposed on complex businesses, discussed below. This election might be made if the business needs to reinvest all profits and cannot make cash distributions to owners who would not otherwise have the liquidity to pay an owner-level tax.

The S regime should be expanded beyond its current limits to the extent that doing so does not undermine the simplicity with which the regime can be administered or jeopardize tax collection.[12] The S regime is extremely popular[13] and works well.[14] It is desirable to build on that success by applying a modified S regime to all closely-held enterprises with simple ownership arrangements.

3. A single, entity-level tax should be imposed on the income of "complex" closely-held businesses to relieve the tax law of the burden of allocating the income of a "complex" entity among its owners. This entity-level tax would replace current law's "K regime."

Ideally, all closely-held business entities would be subject to a single owner-level tax. Unfortunately, the history of the K regime has shown that devising a system to ensure that income and losses are properly allocated among owners who utilize multiple classes of ownership interests is extremely difficult, if not impossible. Some commentators believe that the K regime can be reformed to accomplish this goal.[15] Even if such a system could be devised, it would be extremely complex and undoubtedly difficult to administer.

The formidable nature of the problem is readily apparent. Clearly, the owners of an enterprise should be allowed to reach whatever economic arrangement they desire, regardless of how complex or convoluted the arrangement might be. Just as clearly, the income of such an enterprise must be taxed at the time it is earned just like the income of any other enterprise. Hence, if an owner-level tax is to be imposed, the tax law is burdened with the task of unraveling the economic arrangement to determine how much of the profit or loss is attributable to each of the owners. The law cannot wait until the profits are actually distributed and follow where they go because they frequently will not be distributed in the year they are earned.

The tax law should not be burdened with the task of unraveling complex economic arrangements. Even if it were capable of doing so, it is unlikely the resulting system would be administrable. This can be seen from the current operation of the "K" regime. Cautious taxpayers attempting to comply are faced with immense burdens. Aggressive taxpayers can utilize the complexity of these rules as an excuse for non-compliance.

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[12] For example, the issuance of preferred ownership interests that closely resemble debt should not bar an enterprise from access to the simple regime. On the other hand, a U.S. enterprise with foreign owners outside the U.S. taxing jurisdiction should be taxed at the entity level, rather than the owner level.

[13] In 2010, roughly 4.4 million enterprises reported under the S regime, 3.4 million reported under the K regime, and 2 million reported under the C regime. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME BULLETIN 365 Table 22 (Spring 2011).

[14] The current S regime is not without its flaws. For example, employee-owners of an S Corporation sometimes camouflage compensation for services as a distribution of previously taxed profits to avoid liability for Social Security and Medicare payroll taxes. Various proposals have been made to address this problem.

[15] See, e.g., Yin, *supra* note 9.

The best solution to the problems of imposing an owner-level tax on the "complex" closely-held enterprise is, instead, to impose a single, entity-level tax on the income of the enterprise.[16] When the entity-level tax applies, the owners would not be taxed directly on the income of the business. The entity-level tax would be a relatively simple way of ensuring that all income of the enterprise is taxed when it is earned. This system also allows the owners of the enterprise to use as complicated an economic arrangement as they like.

Not surprisingly, an entity-level tax like the one proposed will present a variety of operational issues. For example, the entity-level tax should probably be imposed at the maximum individual tax rate. Otherwise, the tax law would create an incentive for owners utilizing simple economic arrangements to gravitate to the entity-level tax regime and thereby avoid the higher individual tax rates imposed on a simple enterprise governed by the modified "S" regime. Imposing an entity level tax at the highest individual marginal rate might be seen as unfair to the owners of a complex entity who are not subject to the highest marginal tax rate. However, the entity-level tax is clearly a default regime – it applies when the owners choose a more complex economic arrangement.[17] As such, any additional tax burden resulting from an entity-level tax would represent a predictable cost imposed on those owners opting to utilize a complex economic arrangement.[18]

4. Closely-held businesses should be excluded from current law's, double-tax "C regime."

If Recommendations 2 and 3 are accepted, Recommendation 4 will automatically result. Pursuant to Recommendation 2, "simple" closely-held entities will be governed by a modified "S" regime. Pursuant to Recommendation 3, "complex" closely-held entities will be governed by the default regime which imposes a single, entity-level tax on the income of complex enterprises. As a result, no closely-held business would be governed by the C regime.

Even if Recommendations 2 and 3 are not accepted, the C regime should no longer be offered as an option to any closely-held entity. Most new businesses will routinely avoid the C regime in light of the current corporate and individual rate structure, and the fact that corporate capital gains are not taxed at a lower rate than other corporate income. Utilizing the C regime effectively locks in a 34% or 35% corporate tax on the sale of a successful business, in addition to a 15% shareholder capital gains tax. By contrast, the sale of a similarly situated pass-through

[16] See, e.g., Lokken, *supra* note 9 (favoring an entity level tax on complex enterprises); but see Yin, *supra* note 9 (favoring an owner level tax on these businesses).
[17] The entity-tax regime would also apply if a simple entity elected such treatment. See *supra*, fn 11.
[18] Additional rules would be needed to ensure that a U.S. tax could be collected from U.S. owned, foreign enterprises.

entity generally results in a single, 15% capital gains tax. Thus, new business owners anticipating great success will not normally choose the C regime.

The closely-held businesses that currently utilize the C regime fall primarily into one of two categories. First, some closely-held corporations are not eligible for S regime status. Moreover, they cannot access the K regime because of their status as corporations. If they disincorporated, the same high tax costs resulting from a sale of the business would occur; namely, a 34% or 35% corporate tax and a 15% shareholder tax. Hence, these businesses are trapped in the C regime.

Other closely-held businesses use the C regime to exploit the lower marginal tax rates that apply to the first $75,000 of corporate income. Specifically, the first $50,000 of corporate income is taxed at a 15% rate and the next $25,000 of corporate income is taxed at a 25% rate. By contrast, business owners are taxed at a maximum individual rate of 35% in 2012. Thus, owners expecting their business to generate a low level of income might be induced to incorporate the business to reduce the immediate tax otherwise imposed on that income. This practice would cease if closely-held enterprises were denied access to the C regime.[19]

Eliminating the C regime as an option for closely-held businesses would help level the playing field and thereby advance fairness and efficiency. It would also allow for significant simplification.[20]

Conclusion

The impact of the three alternative tax regimes that apply to closely-held business entities is largely the result of random historical developments. As such, the current system often distorts business decisions and creates needless complexity.

Quite clearly, a pass-through regime for all closely-held enterprises would be the ideal. In light of recent developments, the time is ripe for establishing this result where such a system can be effectively administered. Specifically, the income of any closely-held enterprise, regardless of its form, should be taxed directly to the owners of the enterprise when the economic relationship among the owners accommodates this result. As such, all "simple" enterprises, enterprises where all ownership interests confer identical economic rights, should be taxed under a pass-through system. A single owner-level tax would be assessed against the income at the time it is earned, and each owner's share would be taxed at his or her own marginal rate.

[19] The practice could also be stopped by simply taxing all corporate income at a flat, single rate. See Jeffrey L. Kwall, *"The Repeal of Corporate Graduated Tax Rates,"* 131 TAX NOTES 1395 (2011).

[20] For example, if closely-held entities could not operate under the "C" regime, the corporate penalty taxes could be repealed. See I.R.C. §§531-537, 541-547. Also, the redemption rules could be simplified. See I.R.C. § 302.

With regard to those closely-held enterprises with multiple-classes of ownership interests, the pass-through entity approach should be abandoned. Instead of forcing the tax law to sort out the economic relations among the owners, a single, entity-level tax should be imposed. No further tax would normally be imposed at the owner level when distributions are made. Although the entity-level tax might be imposed at a higher rate than some owners would pay if they were taxed directly on the entity's income, the difference constitutes a predictable cost of a complex economic arrangement.

Replacing the current system of three elective alternative regimes with a general system for simple enterprises and a default system for complex enterprises would advance tax fairness, efficiency and simplicity.[21] Now is an ideal time for Congress to improve the system.

Thank you for inviting me to participate in this hearing. I welcome your questions.

[21] Transition issues must be addressed, but they do not seem insurmountable.