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## TAXATION OF BUSINESS INCOME

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One of the most significant issues facing U.S. lawmakers is the fiscal deficit. There is no question that the U.S. government's expenditures are outpacing its revenues. To mitigate the growing deficit, lawmakers can reduce spending, increase revenues, or some combination of both.

Most Democrats and Republicans agree that spending should be cut and revenues increased—but that, however, is the only thing on which they agree. Holding all else equal, tax revenues can be raised either by increasing tax rates or by increasing the tax base (i.e., the income subject to taxes). Democrats tend to favor increasing tax rates whereas Republicans support broadening the tax base through growth and the curtailing of deductions (“loopholes”). Almost all of this debate centers on tax rates on individuals.

Interestingly, one aspect of tax policy on which both sides of the aisle seem to agree is the need to reduce the U.S. corporate tax rate. Currently, U.S. corporations face a top

statutory tax rate of 35%. This rate is quite high as compared to other OECD countries, which assess an average rate of 24%.<sup>1</sup> Proposals for corporate tax reform suggest that the corporate tax rate should be reduced to 28%. The arguments supporting this rate cut generally claim that this reduction is necessary to make the U.S. competitive with other jurisdictions for the location of new businesses and, hence, economic growth.<sup>2</sup>

Despite the ongoing debate on raising/lowering individual and corporate tax rates, there is little clarity on lawmakers' positions regarding business income, more generally. The issue is that many presume, wrongly, that all business income is taxed at corporate rates. However, this ignores businesses orga-

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nized as non-corporate organizations, such as sole proprietorships, partnerships, limited liability companies (LLCs), and S corporations: the bastions of small businesses and entrepreneurial capital.

In terms of employment, the Small Business Administration and Census Bureau report that over 50% of the U.S. workforce is employed by firms with 500 or fewer employees, with 30% employed by firms with no more than 100 employees. In terms of sheer numbers, sole proprietorships are the most common form of business organization in the U.S. Small businesses have been lobbying heavily for some sort of potential reprieve from the reversion of individual tax rates to pre-2003 levels, arguing that the rate increase will hurt their growth.<sup>3</sup> These groups maintain that the increase in personal tax rates will differentially affect small businesses relative to larger businesses.

On the other hand, opponents claim that reductions in tax rates on non-corporate business income will simply be a windfall to wealthy taxpayers.<sup>4</sup>

Both perspectives have merit. Non-corporate small businesses income will face a tax increase AND there are significant amounts of non-corporate business income reported on returns of wealthy taxpayers. But I believe that many (but by no means all) of the “wealthy” taxpayers that pundits argue would unfairly benefit from a reduction in tax rates on non-corporate business income only *appear* wealthy because of the non-corporate business income that they report on their business returns.

In this paper, I will discuss the most common structures of legal entities for U.S. businesses (corporate and non-corporate forms), their tax treatment, their contribution to U.S. tax revenues, and how the anticipated changes in tax policy could affect businesses tax obligations. By doing so, I hope to present readers with a deeper understanding of the issues affecting the tax burdens of non-corporate business entities and

the implications arising from the different ways in which corporate and non-corporate entities are taxed.

## **I. ORGANIZATIONAL STRUCTURES**

An entrepreneur who establishes a business has several legal options when selecting a structure for his/her enterprise. Although taxes most certainly play a significant role in the choice of entity, there are other legal and transactional cost considerations as well. For example, a small service provider (such as a landscaper) may not be interested in incurring the legal and accounting costs of setting up a business as a separate legal entity and so may choose simply to report business activity on his/her personal tax return. Each of the common organizational structures is discussed below: C corporations, sole proprietorships, S corporations, partnerships and LLCs. In addition to these four structures, the U.S. also has others for mutual funds (Regulated Investment Companies, or RICs) and real estate (Real Estate Investment Trusts, or REITs) that are only available to be used in specific industries and thus will not be discussed in this brief.

### **C CORPORATIONS**

A C corporation is the basic structure subject to corporate taxation. C corporations are separate entities for both legal and tax purposes. From a legal perspective, the benefit of the C corporation structure is that its owners have limited liability, meaning that if the corporation declares bankruptcy, the owners simply lose their investment in the corporation. They cannot be pursued by the firm’s creditors. From a tax perspective, the U.S. subjects C corporations to a double taxation or “classical” regime. Under a classical regime, the corporation files a tax return, pays corporate taxes and then any profits owners earn from their investment

in the corporation are taxed again. These investor profits can come directly from the C corporation in the form of either a share repurchase or a dividend. However, a corporation need not distribute its profits in order to trigger the second layer of tax. Secondary trading on the market results in the recognition of taxable capital gains, thus effectively subjecting the corporate profits to two layers of tax.<sup>5</sup>

For example, suppose a U.S. corporation earns \$100 of pre-tax income. Assuming that the corporation faces a 35% tax rate, the firm will pay \$35 in corporate taxes and there will be \$65 of retained earnings available to be distributed to shareholders. Under the current tax regime, individual shareholders face a maximum tax rate of 20% on dividends and up to a 39.6% tax rate on ordinary (i.e., non-investment) income. If the corporation distributes 10% of its after-tax profits, then the shareholders will receive a \$6.50 dividend on which they will owe \$1.30 in tax resulting in after-tax proceeds of \$5.20. So, the \$10 of pre-tax corporate profits represented by the dividend is effectively taxed at 48.0%. Note that the expiration of the 2003 tax rate reductions accompanied by the implementation of the 3.8% Medicare tax on investment income (due to the Affordable Care Act) will result in the \$10 of pre-tax corporate profits incurring a combined tax rate of 63.21%.

The mitigation of double taxation of corporate profits was a key driver of the 2003 reductions in the dividend and capital gains tax rates. Furthermore, avoiding the double taxation of corporate profits is one of the primary reasons for the popularity of conduit or pass-through organizational forms, which will be discussed below.<sup>6</sup>

Yet, despite the tax disadvantages described above, most large firms (e.g. General Electric, Dell, Boeing, Apple, Goldman Sachs, etc.) and a large fraction of medium-sized firms are organized as C Corporations. Furthermore, C corporations have not

<sup>1</sup> See <http://taxfoundation.org/article/oeed-corporate-income-tax-rates-1981-2012>.

<sup>2</sup> See Treasury Secretary Timothy Geithner’s February 2012 testimony before the House Ways and Means Committee on “The President’s FY2012 Budget Proposal.”

<sup>3</sup> See the National Federation of Independent Business’s perspective on the individual rate increases: <http://www.nfib.com/advocacy/taxes>.

[nfib.com/advocacy/taxes](http://www.nfib.com/advocacy/taxes).

<sup>4</sup> See the Center on Budget and Policy Priorities’ 2009 study titled “Very few small business owners would face increases under president’s budget” by Chye-Ching Huang, Jason Levits, and James Horney.

<sup>5</sup> Note that presumably the firm’s retention of its profits results in the appreciation of the equity.

<sup>6</sup> As an aside, many countries have an imputation or franking system to mitigate double taxation (e.g., Australia, U.K.). These systems eliminate the double taxation of corporate profits by effectively attaching some (or all) of the corporate tax payment to the dividend in the form of a tax credit thereby reducing the individual shareholder’s dividend-related tax obligation.

<sup>7</sup> For example, in the 1950s-1970s, C corporations faced tax rates around 48% whereas individuals’ top tax rates varied between 70 and 90%.

<sup>8</sup> There are some special taxes assessed on pass-throughs to prevent abusive behavior. The built-in-gain sting tax on S Corporations and the tax treatment of publicly-traded partnerships are examples.

always been tax-disfavored relative to other organizational forms.<sup>7</sup> Many organizations may have selected the C corporation form based on past tax regimes and, once an enterprise is a C corporation, it can be very difficult, if not impossible, for the enterprise to convert to a conduit.

### CONDUIT OR PASS-THROUGH STRUCTURES

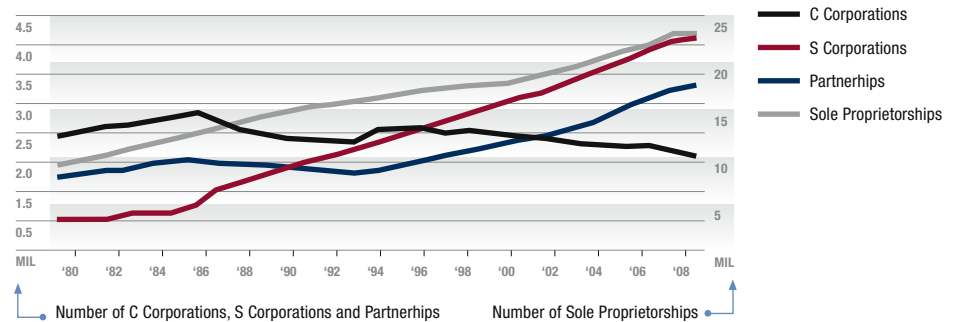
Conduit or pass-through entities are a category of organizational structures that are generally subject to only one layer of tax.<sup>8</sup> They are designated as “conduit” entities because their income passes through the entity and is taxed in the hands of its owners. Since conduits are not taxed separately, the income maintains its character as it flows through to the returns of its owners. So, unlike C corporations, where income is effectively converted to either dividends or capital gains, conduit entities typically result in their owners reporting ordinary income.<sup>9</sup>

Because Treasury exempts pass-throughs from two layers of tax, it places limitations on the attributes of the entities eligible to operate in such forms. For example, S corporations are only allowed to have 100 shareholders (and partnerships, corporations, and foreign individuals are ineligible shareholders) and one class of stock. Partnerships and LLCs, on the other hand, are precluded from accessing public equity unless their income is predominantly passive in nature (e.g., dividends, interest, capital gains, etc.).<sup>10</sup> There are no IRS-specific limitations on sole proprietorships, but these entities are somewhat disadvantaged as they provide no legal protection for their owners. In addition, sole proprietorships imply one owner, so there is no mechanism for a sole proprietorship to have additional investors. Although sole proprietorships, S corporations, partnerships, and LLCs each differ in form, the impact of taxes on these entities’ after-tax returns (or cash flows) is quite similar.

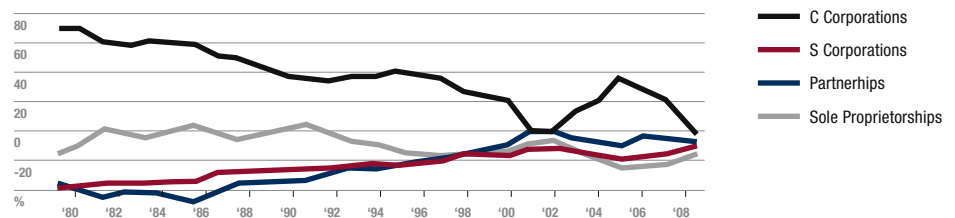
Figure 1A shows that sole proprietorships are the most common form of business organization. But in 2008, they reported less than 20% of aggregate U.S. business income (Figure 1B), implying that the average sole proprietorship is quite small. Overall, Fig-

the conduit does not create any incremental tax liability.<sup>11</sup> If the conduit distributes cash to its owners, suppose \$5.20 (i.e., the after-tax cash owners of the C corporation received), this amount would not create any incremental tax obligation. However, notice

**FIGURE 1A: THE NUMBER OF DIFFERENT ORGANIZATIONAL STRUCTURES FILING RETURNS FROM 1980 TO 2008**



**FIGURE 1B: PERCENT OF TAXABLE INCOME REPORTED BY DIFFERENT ORGANIZATIONAL STRUCTURES FROM 1980 TO 2008**



Data for this Figure was obtained from the Statistics of Income data found on the IRS website.

ures 1A and 1B demonstrate that conduits constitute a significant and growing portion of U.S. taxable income.

To compare the aggregate tax burden of the conduit to that of the C corporation, I rely on the same fact pattern outlined above in the C corporation example. If the conduit has \$100 of pre-tax income, all \$100 must pass through and be reported on its owners’ tax returns. Note that the income is reported by the owners on their returns regardless of whether the conduit entity distributes any cash. Assuming that owners face a 39.6% statutory tax rate, they will report the \$100 and owe taxes of \$39.60 to the U.S. tax authorities. Cash distributed by

that the owners have a net cash outflow of \$34.40 related to their investment in the conduit—the \$39.60 paid to the tax authorities less the \$5.20 received from the business. To prevent conduit-related tax obligations from negatively affecting owners’ cash flow, conduit entities often have tax sharing agreements that require the entity to distribute a percentage of its profits (usually pre-tax income times the top personal statutory tax rate) to its owners to cover their tax obligations.

With a tax sharing agreement in place, the conduit will distribute \$39.60 in cash to its owners for tax purposes in addition to the \$5.20 of cash described above. Under

<sup>9</sup> Each category of income or deduction that may have a special tax treatment (called separately stated items) in the hands of its owners maintains its character as it passes through to owners. For example, any dividends, capital gains, or tax credits are broken out in the conduit’s tax reporting as the owners may face beneficial tax rates (as is the case with dividends or capital gains) or particular

limitations (e.g., tax credits and Section 179 accelerated depreciation).

<sup>10</sup> The publicly traded partnership (or PTP) rules effectively subject the partnership to corporate tax rules if the partnership is listed on an exchange – i.e. double taxation. However, if the PTP only participates in passive income activities, it may maintain its pass-through status (i.e.,

private equity).

<sup>11</sup> This assumes that the shareholder has basis in their shares that equals the amount of the distribution. Basis is roughly what the investor paid for his/her ownership interest plus (minus) the conduit’s profits (losses) minus any distributions to owners.

<sup>12</sup> Investors in conduit entities may only use losses to offset

other income if the investor is an active participant in the underlying business (i.e., the investment is not passive).

<sup>13</sup> Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce, and Richard Prisinzano, “Methodology to Identify Small Businesses and Their Owners,” Office of Tax Analysis, Technical Paper 4, August 2011. Using a sample of 2007 returns, the authors define non-

this scenario, the conduit will have \$55.20 of profits retained inside the conduit (less than the \$58.50 of “retained earnings” in the C corporation example). However, as the \$5.20 additional distribution does not create an incremental tax burden (i.e., it is not considered a dividend), the owners are able to retain the entire \$5.20. As a result, the effective tax rate on the profits of the conduit is 39.6%—only the shareholder level tax.

### III. TAXATION OF CONDUITS AND C CORPORATIONS: A COMPARISON

There is a conundrum created in the above example. Notice that although the aggregate tax rate on the distributed profits is less for the conduit (39.6% v. 48%), the conduit entity and its owners actually end up paying more tax than the C corporation and its shareholders (\$39.60 v. \$36.30). This incremental tax of \$3.30 is primarily attributable to the conduit income being taxed at the higher individual ordinary rates. The C corporation would have to increase its dividend to \$23.00 before the aggregate tax liability of the C corporation and its shareholders is as great as the burden on the conduit and its owners.

The relative tax advantage of the conduit hinges critically on the timing of the second layer of corporate tax. If a C corporate shareholder intends to hold an investment for his/her lifetime, as would often be the case in a family-run business, then the present value of the tax on the sale of the organization is very small. Similarly, reinvestment of profits in a corporation decreases current period payout (dividends or repurchases), also decreasing the present value of any investor-level tax.

Another important consideration in the choice between C corporations and pass-through structures is the treatment of losses. Just as a conduit entity passes through all

items of income, it also passes through losses.<sup>12</sup> Owners may then use these losses to offset other items of income on their tax returns. C corporations must retain all losses inside the corporation. These corporate losses, called net operating losses, are only available to offset future income of the C corporation. This asymmetric treatment of losses is one reason that the conduit entity is preferred over the C corporation for start-up businesses. Because conduit owners are able to use the losses from the conduit to shield other income (perhaps wage income from a spouse), then the losses can effectively provide another source of financing for the pass-through (as the owner now has more available capital to invest).

Although it is very costly for a profitable C corporation to convert to a conduit, it is relatively straightforward for a conduit to convert to a C corporation. Typically, once an enterprise requires access to external capital markets to raise funds for growth, it becomes a C corporation. C corporations provide the easiest mechanism to sell ownership to a diffuse investor base and are also afforded the opportunity to defer taxation on foreign earnings (an option not available to conduit entities). There are some publicly-traded partnerships (PTPs) that trade on major exchanges. However, the IRS limits the types of income that these entities can earn to qualifying passive income (i.e., rents, royalties, capital gains, dividends, interest etc.). If a PTP is found to have significant non-qualifying income, the PTP will be taxed as a C corporation.

### IV. WHAT TYPES AND SIZE OF BUSINESSES ARE REPRESENTED BY CONDUITS?

Debate about the effects of individual tax rate increases on pass-through entities centers on their potentially deleterious effects on the growth of small businesses and entre-

preneurial endeavors. But there is enormous variation in the types of businesses using the pass-through structure. Investment partnerships use the conduit form to hold portfolio assets, allowing the tax-efficient sharing of risk across partners. Law firms, medical practices, and accounting firms are but a few of the categories of professional service firms that rely on pass-through structures. Although sole proprietorships are the most common form of conduit, many of these filings represent taxpayers who are independent contractors (i.e., their pay is reported on a 1099-MISC instead of a W-2). For these taxpayers, the income from the sole proprietorship is almost identical to salary.

To evaluate entities whose tax returns often include business activities, a group from the Office of Tax Analysis (OTA) created a methodology to distinguish between business and non-business activity, and then between large and small businesses.<sup>13</sup> Ultimately, 55% of conduit entities are classified as businesses, 99% of which are “small” businesses. Business activity represents 93% of the net income reported on pass-through returns, whereas small business activity represents 25% of pass-throughs’ reported net income.

This OTA study also seeks to identify what portion of the businesses’ pass-through income is reported on high tax rate personal returns—i.e., those that would be affected by potential individual income tax rate increases. Of personal income tax returns reporting business income (as defined by the study), 12% represent taxpayers with adjusted gross income (AGI) of \$200,000 or more. These 12% of taxpayers report 79% of all business income. Consistent with small businesses reporting lower levels of income (which is by the study’s design), 11% of personal tax returns reporting small business income have AGIs of at least \$200,000 and they report 64% of the aggregate net income of the small business. Roughly half of all personal returns reporting large business

business entities to be those that either have \$5,000 or less of deductions or total income or deductions (the sum of total income and deductions) of \$10,000 (\$15,000) or less. Any business filing that has \$10 million or less of total income and total deductions are classified as small businesses.

<sup>14</sup> See Robert M. Solow Growth Theory: An Exposition.

New York: Oxford University Press, 1970. Neoclassical economic theory predicts that growth merely depends on the accumulation of capital (both physical—such as property, plant and equipment; and human—workforce). In the long-run, the level of taxes affects the optimal weighting between the two types of capital, but not the level of growth. Rather, growth is effectively pre-determined

based on the technological progress of the economy. So, when there is greater technological innovation, there will be greater economic growth irrespective of tax policy. However, changes in tax policy are predicted to create transitory growth as the economy reallocates between physical and human capital. For example, if new technology is discovered then firms may invest more in new

workers or in the education of its existing workers. Note that under the neoclassical theory, the transitory effects of a tax change can reverberate over decades.

<sup>15</sup> See Roger H. Gordon and Yong Lee, “Tax Structure and Economic Growth,” *Journal of Public Economics* 89 (5-6), 2005, p.1027-1043 and Robert E. Hall and Dale W. Jorgenson, “Tax Policy and Investment Behavior.”



FIGURE 2: IMPACT OF INDIVIDUAL TAX RATE INCREASES ON S CORPORATIONS

	2005	2006	2007	2008	2009
WORKING CAPITAL	469,051,572	521,828,993	580,441,465	573,861,462	552,099,718
NET INCOME	348,078,943	373,091,660	380,026,863	360,625,661	330,512,003
ESTIMATED SHAREHOLDER DISTRIBUTIONS	224,872,229	208,278,542	249,963,266	275,374,638	236,609,436
INCREMENTAL TAX DISTRIBUTION (5%)	17,403,947	18,654,583	19,001,343	18,031,283	11,044,458
CUMULATIVE INCREMENTAL TAX DISTRIBUTION	17,403,947	35,950,530	54,951,873	72,983,156	84,027,614
CUMULATIVE DISTRIBUTION AS A % OF WORKING CAPITAL	3.7%	6.9%	9.5%	12.7%	15.2%

**Working Capital** is current assets less current liabilities. **Net Income** is aggregate net income from profitable S corporations. **Estimated Shareholder Distributions** are computed by adding current year's aggregate net income to prior year's retained earnings and then subtracting current year's retained earnings. **Incremental Tax Distribution** is 5% (the difference between current tax rates and anticipated tax rates on ordinary income) of Net Income from profitable S corporations. **Cummulative Incremental Tax Distribution** is the accumulated incremental distribution from 2005. All amounts are aggregate dollars in thousands. All data were collected from *Statistics of Income*.

income face AGIs of \$200,000 or more and these taxpayers report 106% of the large business net income. Overall, it appears quite clear that a large share of conduit entities will be affected by the increase in personal tax rates.

## V. IMPACT OF THE PROPOSED RATE CHANGES

### CORPORATE RATE REDUCTION

Research generally suggests that lowering the tax rate on C corporations increases growth.<sup>14</sup> So, it seems likely that any reduction of the corporate tax rate will promote growth in the corporate sector.<sup>15,16</sup> To the extent these reductions are accompanied by increasing rates elsewhere, these beneficial effects may be partially offset.

### INDIVIDUAL INCOME TAX RATE INCREASE

Proposed changes in individual tax rates affect the ordinary income tax rates as well as the tax rates on dividends and capital gains. For purposes of the discussion of the effects of tax rate changes on business income, I am going to ignore the increases

in taxes on investment income and focus on the tax increase on business income.<sup>17</sup>

Upon any increase in individual tax rates, the income of conduit businesses is going to face higher taxes, as a significant portion of their income will be reported on the returns of individuals with high levels of AGI (see the Office of Tax Analysis study). Because the income is reported by the entity's owners, and owners will require the conduit to distribute greater amounts of cash to cover their tax liabilities, there will be less accumulation of assets inside the business. The rate change could be particularly harmful to small business conduits, as small businesses typically have a more difficult time obtaining external financing.

Consider the implications for S corporations. Using *Statistics of Income* balance sheet data, I infer the incremental distributions over the past five years (2005-2009) from S corporations that would have been required had the top personal statutory tax rate been 40%. Presuming that the S corporation's tax distribution agreement requires funds to be distributed at the top statutory tax rate, then all shareholders will receive tax distributions at this rate.<sup>18</sup>

Using the assumption that tax distribu-

tions will increase to 40% from 35%, Figure 2 illustrates that at the end of five years, S corporations would have had \$84 billion less in accumulated assets inside the business. This constitutes approximately 15% of S corporations' working capital.

It is difficult to estimate how much these incremental taxes will cost firms in terms of business growth. With the rate increase two things could happen. First, tax distributions could be increased as described above. Second, distributions could be held constant and owners could simply pay a greater proportion of their distributions towards taxes. Over the past five years, distributions have been between 55% and 76% of profits, suggesting that S corporation shareholders are receiving distributions in excess of what is required to cover tax burdens.<sup>19</sup> So, the incremental tax burden created by the rate increase could simply result in the owners using their non-tax distributions for taxes rather than fueling economic growth through saving, investment in other businesses, or consumption.

### TENSION BETWEEN CORPORATE AND INDIVIDUAL RATE CHANGES FOR BUSINESSES

American Economic Review 57, p. 391-414, June 1967.

<sup>16</sup> Note that there does appear to be some evidence that any positive response of publicly traded C corporations to the rate cut be attenuated by undesirable financial reporting consequences. Because accounting for income taxes can result in C corporations reporting future tax benefits as assets on their balance sheets, any rate

reduction effectively reduces these assets resulting in a reduction in both net income and total assets in the year of the rate reduction. I believe that only a few groups of firms face this unintended consequence – banks which typically have large deferred tax assets associated with their loan loss reserves and firms with large net operating losses. This effect is not trivial for financial institutions

as the asset write-down could hurt regulatory capital. I suspect that loss firms are less sensitive to the financial reporting outcome of their loss revaluation. See Michelle Hanlon's February 8, 2012 testimony before the United States House Ways and Means Committee.

<sup>17</sup> That is not to say that the increases on investment income do not have an impact on the allocation of capital

between investments (i.e., when dividend tax rates are high, holding all else equal, investors likely prefer holding investments that generate greater capital gains relative to dividends). But I am presuming that when choosing to enter into any investment, that the potential premium paid by future owners is taxed in the same manner regardless of whether the investment is a C corporation or a pass-

The primary issue is that businesses in pass-through form are going to effectively face a tax rate increase as compared to businesses organized as C corporations. So, is it inherently fair that a fast-food franchise owner organized as a conduit will now potentially face a 40% tax rate on his/her net business income whereas an owner organized as a C corporation will continue to 35% on his/her net business income? Probably not.

Some surmise that because personal taxes on dividends and capital gains are also increasing, there is little potential inequity, as both conduits and C corporations will be subject to higher tax burdens. While this is true, non-corporate business income will face a greater increase for two reasons. First, 100% of the conduit entity's income will be taxed at a 5% higher rate. By comparison only 65% of the C corporation's income will be subject to tax at the higher investment income tax rates (also increasing 5%; from 15% to 20%), resulting in only a 3.25% increase in taxes on the C corporation. Second, the second layer of tax on C corporations can be deferred to future periods (due to retaining earnings inside the enterprise), implying that the present value of the tax rate increase is much smaller than the 3.25%.

Many argue that very few pass-throughs will be affected by the individual rate increase because only the largest pass-throughs generate enough taxable income to qualify for the upper tax brackets, and then very few of these are "true" small businesses.<sup>20</sup> The Office of Tax Analysis study above, however, appears to debunk the myth that only low levels of conduit income (even small business income) will be subject to the individual income tax rate increase. But, from an economic (as opposed to a political) perspective, why does the "small" business designation even matter? From an economic efficiency perspective, business income should carry similar tax burdens regardless of the size of the enterprise or its organiza-

tional form.

Conduit entities do have the option to convert to C corporations to take advantage of the lower corporate tax rate. This course of action has some drawbacks, however. First, if the business's income is highly volatile (i.e., net losses can sometimes be expected), then being a C corporation will prevent the owner from being able to use any losses to offset other income. Economic

**From an economic efficiency perspective, business income should carry similar tax burdens regardless of the size of the enterprise or its organizational form.**

theory argues that the ability of owners to utilize these losses to reduce their tax burdens encourages entrepreneurial risk taking (i.e., the government is providing a subsidy equal to the taxes saved).<sup>21</sup>

Second, conduit entities offer more flexibility for tax-efficient acquisition structures. Many entrepreneurial enterprises require external capital to expand the business. This capital is either infused by some third-party (e.g., private equity) or through the acquisition of the business by another business (e.g., Instagram's acquisition by Facebook). In either case, being in pass-through form allows any acquisition premium to be allocated to the business's assets, which provides future tax savings through incremental depreciation (called the tax basis "step-up"). If the business to be acquired is a C corporation, gaining the incremental depreciation would be prohibitively expensive. I suspect that Dell, Apple, Google and Facebook were all initially organized as conduit entities that took advantage of venture capital investment made more affordable by the "step-up."

Finally, the benefits of being a C corporation result because the owners intend to hold the business for an indefinite period and reinvest the earnings into the enterprise. Recall that any benefits of the C corporation structure increase in the owners' holding period of the business but decrease as the business distributes dividends.

Congress does have the option to create some special tax treatment for business income in pass-through form, to offset the rate increase. Examples include House Majority Leader Eric Cantor's proposed 20% tax deduction for businesses with fewer than 500 employees and the provision of deductions or credits for a percentage of each employee's wages.<sup>22</sup> Critics of these proposals argue that the majority of benefits will inure to professional service firms (i.e., lawyers, doctors, accountants etc.) rather than the real "job creating" conduit businesses.<sup>23</sup>

Though the distinction between which industries create jobs is unsubstantiated and somewhat arbitrary, there is precedent that service firms take advantage of organizational forms to garner tax benefits.<sup>24</sup> Hence, the ability of service providers to qualify for lower tax rates on their net income is potentially problematic. Consider that salary income is subject to ordinary tax rates. There is little a highly compensated salaried employee can do to avoid high tax rates. However, professional service firms' owners and employees are often the same group of individuals. If the net income of conduit entities bears a lower tax rate than salary income (as would be the case under the Cantor proposal), the owners of the conduit will be incentivized to reclassify their wage income as business income. This is because the wages that they pay themselves are treated as salary income and will face the highest statutory tax rates, whereas the income from the business will effectively be subject to a lower rate. Assuming that the top personal statutory tax rate is 40%

through. Said another way, the disparity in tax treatment between conduits and C corporations is on the accumulated profits of the enterprise, not the premium created by future investors' anticipated growth in the enterprise.

<sup>18</sup> S corporations are not allowed to make different rates of distributions to different shareholders as doing so is deemed to create a second class of stock thereby mak-

ing the entity ineligible to be an S corporation.

<sup>19</sup> I roll-forward retained earnings using the Statistics of Income for aggregate S corporation tax filings. To estimate distributions, I add current year's earnings to prior year's retained earnings and then subtract the current year's retained earnings.

<sup>20</sup> See Matthew Yglesias "House Republicans Exploit

Americans' Misunderstanding of Marginal Tax Rates to Sow Fear About Obama's Proposed Tax Hikes," [www.slate.com](http://www.slate.com), July 11, 2012.

<sup>21</sup> See Julie B. Cullen and Roger H. Gordon "Taxes and Entrepreneurial Risk-Taking: Theory and Evidence for the U.S." *Journal of Public Economics*, Vol. 91, 2007, 0.1479-1505 and William M. Gentry and Glenn R. Hub-

bard, "Success Taxes, Entrepreneurial Entry, and Innovation," NBER Working Paper, vol. 1055, 2004.

<sup>22</sup> Martin A. Sullivan's March 7, 2012 testimony before the United States House Ways and Means Committee.

<sup>23</sup> See Chuck Marr's Center on Budget and Policy Priorities study "Cantor Proposal for 20 Percent Business Tax Deduction Would Provide Windfall for Wealthy, Not Create

and that the top tax rate on business income would be 32% (assuming 20% deduction of net income), for each dollar an owner-employee reduces his/her salary (which increases the net income of the conduit) and then increases cash distributions from the business, he/she saves \$0.08. Ignoring any payroll taxes, for a \$100,000 salary reduction and accompanying increase in distribution, this strategy yields the owner-employee an additional \$8,000.<sup>25</sup>

Any proposal intended to alleviate the potential tax rate increase on conduit businesses needs to be carefully crafted and narrowly targeted so as to benefit the appropriate constituency. Although such an endeavor is worthy, any proposal is likely going to have to be extremely unwieldy in order to prevent abuse. The complexity of such legislation will be confounded by the lack of clear definition as to what constitutes a “small business.” As many factions will have their proverbial fingers in the pot, I worry that any resulting business tax relief legislation will be so complex that “true” small businesses will be unwilling to invest the time to take advantage of the tax benefits and so the legislation will be for naught.<sup>26</sup>

### BASE BROADENING VERSUS RATE INCREASES

Although both parties agree that revenues need to be raised, they are in complete disagreement as to how to accomplish this feat. Democrats insist on rate increases; Republicans insist on eliminating deductions. Although both proposals will raise revenues, I conjecture that the elimination of deductions, rather than the imposition of rate increases, will have a slightly more congruous effect across businesses in different organizational forms. Clearly, the Democrats’ proposal (inadvertently?) taxes conduit businesses more heavily than C corporation businesses. Reducing individual deductions systematically applies to all business owners regardless of their organizational structures.

For example, both C corporation and conduit owners will face the same limits on the deductibility of home mortgage interest.

But conduit businesses may still face a bigger tax hike for at least two reasons. First, the proposed limitation of deductions phases in when taxpayers report \$200,000 or more of adjusted gross income. Because conduit owners report all of the income on their personal returns, they will likely hit the deduction limitation thresholds more frequently than C corporation owners (recall that C corporation owners only report dividends and capital gains on their personal returns).

Second, some of the proposed limitations of deductions stem from expenses generated from their businesses. For example, charitable contributions are treated as flowing through the conduit entity onto the returns of the owners. So, if their business makes charitable contributions, then these deductions will be subject to limitation under the more stringent individual rules rather than the less stringent C corporation rules.

State and local income taxes are another example of where deductions will be more limited for conduits than C corporations. Unfortunately, the Republicans have been rather sparse on the details of their deduction limitation proposal. Though it may be slightly preferable to conduit businesses as compared to across-the-board individual rate increases, I worry that once the incremental compliance burden is considered that the Republican proposal will be scrapped.

## V. SUMMARY

Pass-through businesses represent a substantial portion of aggregate taxable income from businesses. The conduit organizational form is in place to reduce the effects of double taxation on business profits, particularly on organizations that have less opportunity to raise affordable external

capital. However, recently proposed tax legislation reduces taxation on C corporation businesses while raising them on the conduit sector. Although C corporation tax reform is needed, it seems unfair to pay for such overhaul by increasing the taxes on the income of conduit businesses. Although there are no precise estimates of the effect of the individual income tax rates on conduit businesses’ growth and productivity, there is much anecdotal evidence that small conduit businesses could reduce hiring and/or capital investment.<sup>27</sup>

Perhaps the disparate tax increase on conduits could be partially mitigated by the establishment of a threshold for assessing the higher tax rates on individuals before non-corporate business income. This would at least limit the conduit income subject to the higher tax rates to individuals who have substantial amounts of income from non-business sources. However, there will have to be some provision to limit conduit business owners from re-characterizing their salary income as conduit income to avoid higher taxes on their salaries. Overall, the goal of any reform should be to tax similar types of income at similar rates.

Jobs,” May 22, 2012.

<sup>24</sup> Professional Service Corporations (or PSCs) are C corporations that have a substantial portion of their profits derived from professional services (i.e., law, medicine, architecture etc.). Their profits are taxed at the highest corporate statutory tax rate. PSCs originated because professional service providers realized that they could

incorporate and have their customers pay a variety of different corporations for their services thereby taking advantage of the progressive corporate tax rate.

<sup>25</sup> If the owner-employee received the incremental \$100,000 he/she would have \$60,000 after taxes. By reducing salary, the employee increases the income of the conduit by \$100,000 which will only create an incremental \$32,000

in taxes.

<sup>26</sup> See the Domestic Manufacturing Deduction from the American Jobs Creation Act of 2004 as an example of unwieldy legislation.

<sup>27</sup> See Emily Maltby and Angus Loten “Cliff Fix Hits Small Businesses,” The Wall Street Journal, January 3, 2013.

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