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Obama's Gift to the Rich: A Permanent Payroll Tax Holiday

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OBAMA'S GIFT TO THE RICH: A PERMANENT PAYROLL TAX HOLIDAY

Richard Winchester*

I. INTRODUCTION

In the wake of the second term victory by President Barack Obama, his opponent offered a widely publicized explanation for the election results.[1] Republican presidential candidate Mitt Romney asserted that the President used his position as the nation's chief executive to make "gifts" to key constituencies.[2] Mr. Romney specifically referred to things like the President's health care plan, his plan to forgive college loan interest, and a pledge to provide free contraceptives as reasons why racial minorities, young people, and women supported the President.[3] Although those groups may have voted in large numbers for the President, they were not the only ones.[4] Individuals with low incomes also voted in much greater numbers for the President than they did for Mr. Romney.[5] Moreover, there is at least one piece of tax legislation that was specifically designed to favor that cohort of individuals: the payroll tax cut that was in effect for 2011 and 2012.[6]

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1 *See generally* Ashley Parker, *Romney Attributes Obama Win to 'Gifts'*, N.Y. TIMES, Nov. 15, 2012, at A23, *available at* http://thecaucus.blogs.nytimes.com/2012/11/14/romney-blames-loss-on-obamas-gifts-to-minorities-and-young-voters/?_r=0 (providing Mitt Romney's explanation for losing the election); Joan Walsh, *Mitt Romney Is a Very Sore Loser; Offers Pathetic Excuses for Why He Lost*, ALTERNET (Nov. 15, 2012), http://www.alternet.org/election-2012/mitt-romney-very-sore-loser-offers-pathetic-excuses-why-he-lost (discussing Mitt Romney's excuses for losing the 2012 presidential election).

2 Parker, *supra* note 1.

3 *Id.*

4 *See President Exit Polls*, N.Y. TIMES, http://elections.nytimes.com/2012/results/president/exit-polls (last visited Sept. 18, 2013) (listing the 2012 presidential election results by demographics).

5 *See id.* (listing the results of the election by income categories). In the *New York Times*' 2012 poll, over 63% of voters earning under $30,000 voted for the President and 57% of voters earning over $30,000 but less than $50,000 also voted for him. *Id.* Mr. Romney outpolled the President among voters earning at least $50,000. *Id.*

6 *See infra* note 16 (describing how the benefits of the tax cut were concentrated on low- and middle-income working families).

There are a number of taxes that are taken out of a worker's paycheck. The tax that the President cut is commonly known as the Social Security tax because it funds the nation's Social Security program.[7] A worker ordinarily has to pay 6.2% of his wages (up to an annual limit) in Social Security tax.[8] However, under legislation signed by President Obama, that rate was reduced by two percentage points to 4.2% for 2011 and 2012.[9] Moreover, under that legislation, the worker continued to receive Social Security credit as if he continued to pay the full tax.[10] Thus, the tax cut has no effect on the amount of benefits that the worker will eventually receive.

The Social Security tax is a regressive tax. This means that it imposes a greater burden on a low-income person than it does on a high-income person.[11] It has this effect for two reasons. First, it is a flat tax. Admittedly, a pure flat tax requires each individual to pay the same portion of his income in tax.[12] However, the burden is heavier on low-income persons because each dollar they earn is more likely to be used to cover basic necessities. So, compared to persons with more resources, the poor feel greater pain with each dollar that they pay in tax.[13]

The Social Security tax is also regressive because it does not apply to earnings above a certain annual threshold.[14] Therefore, for someone whose earnings are too low to exceed the threshold, the tax applies to everything he makes. However, for anyone whose earnings are high enough to exceed the threshold, the tax only applies to a portion of what he earns—the portion below the threshold. Moreover, the tax never applies to the income someone might derive from investments like

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7 *See* 42 U.S.C. § 401(a)(3)–(4) (2006) (earmarking employment taxes to support the Federal Old Age and Survivors Insurance Trust Fund established by the Social Security Act).

8 I.R.C. §§ 3101(a), 3102(a) (2006).

9 Middle Class Tax Relief and Job Creation Act of 2012, Pub. L. No. 112-96, § 1001, 126 Stat. 156, 158–59 (extending the tax cut through the end of 2012); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 601(a)(2), (c), 124 Stat. 3296, 3309 (adopting the tax cut for calendar year 2011).

10 § 601(e)(2), 124 Stat. at 3309–10.

11 JOSEPH A. PECHMAN, FEDERAL TAX POLICY 220–21 (5th ed. 1987).

12 Jonathan R. Macey, *Government as Investor: Tax Policy and the State*, *in* TAXATION, ECONOMIC PROSPERITY, AND DISTRIBUTIVE JUSTICE 255, 263–64 (Ellen Frankel Paul et al. eds., 2006).

13 *See* LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE 24 (2002) (explaining why the rich can afford to pay more in taxes than the poor without an equivalent decrease in wealth).

14 I.R.C. § 3121(a)(1) (2006).

stocks and bonds.[15] The tax only applies to what an individual earns from working.

Because the Federal Insurance Contribution Act ("FICA") tax imposes a greater burden on low-income individuals than it does on persons in the higher income ranges, a cut in the tax necessarily provides greater relief to persons at the lower end of the income spectrum.[16] Thus, when the President signed legislation cutting the tax by a third for two years—without any reductions in the worker's future Social Security benefits—Mitt Romney might consider that to be a "gift" to one of the constituencies that helped re-elect the President.

However, that would be an incomplete picture of the payroll tax relief made possible by legislation signed into law by President Obama. Many high-income individuals enjoyed an even greater measure of payroll tax relief as a result of legislation that he signed. However, the relief was not granted directly under the terms of any specific tax law. Instead, as this Article will show, the relief was made possible because the provisions of tax legislation signed by the President made permanent what had been a temporary opportunity for individuals to avoid the payroll tax entirely when they work for a corporation that they also control.

An individual who owns and works for a corporation has at least two ways to access the earnings of the business. As a shareholder, he can access the earnings if the corporation pays a dividend on his stock.[17] Alternatively, he can withdraw earnings in the form of compensation, such as a salary or bonus, in exchange for his work. Until 2003, such an employee-shareholder almost always had an economic incentive to access the earnings as compensation, which triggered the FICA tax and

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15 *See id.* §§ 3101(a), 3121(a) (limiting the Social Security tax to wages and defining wages as remuneration for employment).

16 The magnitude of the benefits to individuals at the lower end of the income ladder can be quite stark. This was evident by an analysis performed in connection with an administration proposal to reduce the payroll tax even further by cutting in half the amount an employee would have to pay. *See* OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, A STATE-BY-STATE LOOK AT THE PRESIDENT'S PAYROLL TAX CUTS FOR MIDDLE-CLASS FAMILIES (2011), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/State-by-State-Look-at-the-Presidents-Payroll-Tax-Cuts-for-Middle-Class-Families-11-29-2011.pdf. In promoting this idea, the administration pointed out that it would provide tax relief that would be concentrated on low- and middle-income working families. *Id.* The Treasury's Office of Tax Policy quantified the magnitude of the relief and how it would be shared. *Id.* It determined that the proposed cut would reduce total federal taxes paid by families in the lowest quintile by 32.3%, while reducing those paid by families in the highest quintile by 5.1% and reducing those paid by families in the top 1% of the income distribution by only 0.9%. *Id.*

17 *See* I.R.C § 316(a) (defining a dividend as a distribution of corporate earnings to a shareholder).

other payroll taxes that would ordinarily come into play. However, starting in 2003, the tax that an individual pays on corporate dividends was drastically reduced.[18] That tax cut reversed the incentives for many employee-shareholders, who now have an incentive to substitute a dividend for any compensation they would have received, which allows them to avoid the full range of payroll taxes that would ordinarily apply.[19] Moreover, high-income individuals seem to be the principal beneficiaries of this indirect payroll tax holiday.[20]

To be fair, the legislation signed into law by the President did not create this payroll tax dodge for the rich. Instead, it was created as a result of the dividend tax cut signed into law by President George W. Bush.[21] That tax cut was supposed to be temporary, with its expiration due to occur in 2010.[22] However, it did not die. The tax cut was extended by two years as a result of legislation signed by President Obama in 2010.[23] The tax cut, in modified form, became permanent as a result of legislation signed by the President after winning re-election.[24]

Therefore, while it may be true that the President achieved a temporary payroll tax cut that primarily benefitted the poor, it also cannot be denied that he signed legislation that permanently allows the rich to help themselves to a payroll tax holiday when they work for a corporation that they also control. To the extent the rich take advantage of this opportunity to avoid the payroll tax, the tax system will fall short of achieving President Obama's objective: distributing the cost of government more fairly among taxpayers of various income levels.[25]

This Article will describe how the legislation signed into law by the President will operate within the context of the existing tax system to perpetuate what had been a temporary opportunity for high-income

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[18] *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 301(a)(1), (a)(2), (d), 302(a), 117 Stat. 752, 758, 760–61 (reducing the tax on long-term capital gains and subjecting most dividends to tax at the same rates).

[19] *See generally* Richard Winchester, *Working for Free: It Ought to be Against the (Tax) Law*, 76 MISS. L.J. 227 (2006).

[20] *See infra* Part IV.D (quantifying the tax savings produced by the payroll tax dodge); *see also* Winchester, *supra* note 19, at 271–77.

[21] *See* Winchester, *supra* note 19, at 295.

[22] The tax cut was originally scheduled to expire after 2008. § 303, 117 Stat. at 764. However, the tax cut was extended through the end of 2010. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 102, 120 Stat. 345, 346 (2006).

[23] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 102(a), 124 Stat. 3296, 3298.

[24] American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102(d)(2), 126 Stat. 2313, 2319 (2013).

[25] *See* Joseph J. Thorndike, *Tax History: Back to the Future of Tax Reform*, 138 TAX NOTES 777, 777 (2013) (arguing that President Obama seems to be attempting to redistribute the tax burden).

individuals to improperly avoid tax when they work for a corporation that they also own and control. The Article first examines the rules that determine how the earnings of a corporation are taxed when those earnings are received by an owner who also works for the business.[26] There are two sets of rules that must be examined. First, there are rules that tax an owner's share of the corporation's profits.[27] Second, there are rules that tax the amounts paid to the owner as compensation for services rendered to the corporation.[28]

Next, the Article shows how a shareholder who works for a solely owned corporation enjoys a significant opportunity to avoid tax that other employee-owners do not. Among other things, the discussion will demonstrate how the combination of rules that the President signed into law will perpetuate an incentive for an employee-shareholder to access corporate earnings by substituting a dividend for any compensation he would otherwise be entitled to receive. Moreover, the discussion will reveal how this outcome has a considerable class bias in two respects. First, high-income individuals are considerably more likely to be in a position to make this tax-saving substitution.[29] Second, when they do take advantage of this opportunity, these high-income employee-shareholders save far more tax dollars than their lower income counterparts would. The Article concludes by suggesting how the President ought to address this and other inequities that plague the nation's employment tax system, as he embarks on an effort to secure comprehensive tax reform.[30]

II. TAXATION OF CORPORATE PROFITS TO AN EMPLOYEE-SHAREHOLDER

When an individual works for a corporation that he also owns, several federal laws may apply to extract a tax on the earnings of the business. The total tax extracted will determine how much the employee-shareholder has left to spend on personal items unrelated to the business. There are two sets of tax rules to consider. First, there are income taxes that apply.[31] These taxes may be imposed on the employee-shareholder, the corporation, or both.[32] Second, there are federal employment taxes that may also come into play to the extent the earnings of the business are treated as the employee-shareholder's

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26 *See infra* Part II.
27 *See infra* Part II.A.
28 *See infra* Part II.B.
29 *See infra* Part IV.D; *infra* Tables 7–9.
30 *See infra* Part V.
31 *See infra* Part II.A.
32 *See infra* Parts II.A.1–2.

income from labor.[33] The following sections describe the pertinent aspects of each set of rules.

A. *Income Taxes on the Profits of a Corporation*

As a general proposition, there are two separate income taxes that apply to the profits of a corporation.[34] First, the corporation itself has to pay an income tax on what it earns.[35] Second, a shareholder is subject to tax on any after-tax profits that the corporation pays to him as a dividend.[36] This two-tiered tax structure is one of the hallmarks of the U.S. corporate tax scheme.

1. Taxes Imposed on the Corporation

The corporate tax applies only to the taxable income of a corporation.[37] Taxable income refers generally to revenues reduced by the firm's cost of goods sold and certain expenses allowed by law.[38] Among other things, a corporation can deduct amounts paid as compensation to any employee—including an employee-shareholder—for services rendered to the business.[39] The principal restriction is that the deduction is limited to amounts that are reasonable for the services performed.[40] Thus, a corporation's taxable income gets reduced to the extent it pays compensation to its employees, resulting in a lower corporate tax bill.

The corporate tax itself is determined under a system of marginal rates that applies to the firm's taxable income. The system effectively divides the firm's taxable income into several layers, each of which is

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33 *See infra* Part II.B.

34 As a general rule, any state law corporation is treated as a corporation for tax purposes. Treas. Reg. § 301.7701-2(b)(1) (2009). Such business entities are often referred to as C corporations because they are subject to the rules that appear in subchapter C of the Internal Revenue Code. However, under certain circumstances, a C corporation can elect to be subject to the rules that appear in subchapter S of the Internal Revenue Code. I.R.C. §§ 1362(a)(1), 1363(a) (2006). In such instances, the firm is referred to as an S corporation. Finally, any unincorporated business entity (such as a partnership or limited liability company) has the option to be treated as a C corporation for tax purposes. Treas. Reg. § 301.7701-3(a) (2012). When this Article uses the term corporation, it is referring to any business entity that is treated as a C corporation for federal income tax purposes.

35 I.R.C. § 11(a).

36 *Id*. § 61(a)(7).

37 *Id*. § 11(a).

38 *Id*. § 63(a).

39 *Id*. § 162(a)(1).

40 *Id*.

taxed at a different rate.[41] The first layer consists of all income up to $50,000, which is taxed at 15%.[42] The second layer consists of all income over $50,000 and up to $75,000, which is taxed at 25%.[43] Each successive layer covers a higher range of taxable income, starting where the preceding layer left off.[44] Additionally, the statute prescribes a different rate that applies to each of these layers. The marginal rates range from a low of 15% to a high of 39%.[45] The following table summarizes the range of taxable income covered by each layer and the tax rate that applies to each layer.[46]

Table 1
Corporate Income Tax Rates

Taxable Income		
Over	**Up to**	**Tax Rate**
$0	$50,000	15%
$50,000	$75,000	25%
$75,000	$100,000	34%
$100,000	$335,000	39%
$335,000	$10,000,000	34%
$10,000,000	$15,000,000	35%
$15,000,000	$18,333,333	38%
$18,333,333	unlimited	35%

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

2. Taxes Imposed on the Shareholder

Any profits that remain after the corporate tax has been extracted will be subject to tax again in the event those amounts are paid to the

41 *See id.* § 11(b)(1) (describing each layer of income and the marginal tax rate that applies to each individual layer).
42 *Id.* § 11(b)(1)(A).
43 *Id.* § 11(b)(1)(B).
44 *See id.* § 11(b)(1)(C)–(D); *infra* Table 1.
45 However, if a corporation qualifies as a personal services corporation, the law imposes a flat 35% tax on its taxable income. I.R.C. § 11(b)(2). Also, special tax rates and rules apply to certain financial institutions. *See id.* § 11(c).
46 *See id.* § 11(b)(1).

shareholder as a dividend.[47] When President Obama took office in 2008, dividends could be taxed in one of two ways, depending on how long the shareholder owned the stock in the dividend-paying corporation. If the shareholder owned the stock for less than sixty-one days, the dividend comprised part of the shareholder's ordinary income, making it subject to tax under the rates that apply to any other item of income.[48] The rate schedules in effect in 2008 through the end of 2012 contained the following six rates: 10%, 15%, 25%, 28%, 33%, and 35%.[49] However, in most cases where the shareholder owned the stock for at least sixty-one days, any dividend paid on the stock was classified as a "qualified dividend" and subject to tax at the same rate that applied to gains from the sale of stock and other capital assets held for over one year.[50] That rate varied depending on the top marginal tax rate that applied to the shareholder's ordinary income. If that marginal rate was 25% or higher, then the dividend was taxed at 15%.[51] If that marginal rate was below 25%, the dividend was taxed at 0%.[52]

This scheme for taxing dividends was supposed to expire at the end of 2010.[53] However, during his first term in office, President Obama signed legislation that extended this temporary measure for another two years, putting it on track to expire by the end of 2012.[54] Two years later, soon after winning re-election, the President signed another piece of legislation that made permanent this general scheme of taxing dividends with certain modifications.[55] Starting in 2013, dividends other than qualified dividends continued to be taxed at the same rates that apply to

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47 *See id*. § 61(a)(7) (declaring that dividends are included in a taxpayer's gross income).

48 *Cf. id*. § 1(h)(11)(B)(iii)(I) (identifying dividends that are not eligible to be treated as "qualified dividend income").

49 *See id*. §§ 1(a)–(e), (i)(1)(A), (i)(2).

50 *Id*. § 1(h)(11)(A), *as amended by* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302(a), 117 Stat. 752, 760; *id*. § 1(h)(3)(B), *as amended by* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302(e)(1), 117 Stat. at 763; § 303, 117 Stat. at 764 (listing the effective date of the rule changes).

51 I.R.C. § 1(h)(1)(C) (prior to the amendment made by the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102, 126 Stat. 2313, 2318 (2013)).

52 *Id*. § 1(h)(1)(B) (prior to the amendment made by the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102, 126 Stat. 2313, 2318–19 (2013)).

53 Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 102, 120 Stat. 345, 346. The tax cut was originally scheduled to expire at the end of 2008. *See* § 303, 117 Stat. at 764.

54 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 101(a), 124 Stat. 3296, 3298.

55 *See generally* 126 Stat. 2313 (modifying and permanently extending the 2001 and 2003 tax relief acts).

the shareholder's other income—aside from long-term capital gains.[56] However, the schedule of marginal tax rates now contains seven different rates—up from five—as follows: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%.[57] Alternatively, any dividends that meet the definition of a "qualified dividend" are now taxed at one of three different rates—up from two—depending on the shareholder's tax bracket. Qualified dividends are tax free if the shareholder is in either the 10% or 15% tax bracket.[58] Qualified dividends are taxed at 20% if the shareholder is in the 39.6% tax bracket.[59] In all other cases, qualified dividends are taxed at 15%.[60]

Ever since the end of 2012, corporate dividends, whether qualified or not, have also been subject to an additional Medicare tax in certain cases. Specifically, a 3.8% Medicare surtax is imposed on dividends received by married couples with incomes over $250,000 and unmarried individuals with incomes over $200,000.[61] Thus, the total tax on qualified dividends can now go as high as 23.8%, consisting of the 20% income tax and a 3.8% Medicare tax.[62] If the temporary tax cuts—both on dividends and other income—in place when President Obama took office were allowed to expire, any dividend received after 2012 would have been taxed as ordinary income under a schedule of five marginal tax rates, as follows: 15%, 28%, 31%, 36%, and 39.6%.[63]

Although the rules subject the profits of a business to tax at the corporate level and also at the shareholder level, there are many situations in which only one of the two taxes will apply. For instance, the shareholders will not have to pay tax on any profits that are not actually paid to them as dividends. In such a case only the corporation will be subject to tax on the earnings. Alternatively, only a shareholder will be subject to tax on amounts paid to him as reasonable compensation for services rendered to the firm. The corporation will pay

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56 *See supra* text accompanying notes 48–50 (discussing the distinction between qualified dividends and other dividends).

57 I.R.C. § 1(a)–(e), (i)(3).

58 *Id.* § 1(h)(1)(B).

59 *Id.* § 1(h)(1)(D).

60 *Id.* § 1(h)(1)(C).

61 I.R.C. § 1411(a)–(c) (2006 & 2011 Supp.) (added by Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1402(a), 124 Stat. 1029, 1060–62).

62 *See supra* text accompanying notes 59, 61.

63 I.R.C. § 1(a)–(e) (2006); *see* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 101(a)(1), 124 Stat. 3296, 3298 (modifying the expiration to occur after December 31, 2012); Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901(a), 115 Stat. 38, 150 (providing for tax rate changes to expire after 2010).

no tax on these amounts because they are a deductible item that reduces the corporation's taxable income dollar for dollar.[64]

When the ownership of a corporation is concentrated in the hands of a few individuals, it is not hard to imagine that the corporation and its controlling shareholders would want to take advantage of any opportunities for avoiding one of the layers of tax on corporate profits. For this reason the Internal Revenue Code contains a number of provisions that attempt to restrict the viability of these tax avoidance techniques. For instance, in cases where the corporation hopes to minimize its taxable profits by paying an employee-shareholder excessive compensation, the rules declare that the corporation cannot deduct any amount beyond what is "reasonable" for the services rendered to the business.[65] However, that ambiguous standard is exceedingly hard to enforce in practice since the taxpayer is expected to simply be honest when completing a tax return. All too frequently, taxpayers view the absence of a bright line rule as an invitation to exploit the law's ambiguity to their advantage, knowing that the chances of being caught or penalized are slim. Because unreasonable compensation is difficult to detect, many such overstated deductions go unchallenged.[66]

If a corporation elects to simply not pay dividends so that the shareholder level tax does not come into play, the rules do not appear to be any more effective at combating such a practice. A practice of not paying dividends to shareholders could trigger the accumulated earnings penalty tax. The Internal Revenue Service ("IRS") is authorized to assess this penalty when it determines that the corporation has accumulated profits beyond the reasonable needs of the business.[67] However, the law uses an extremely ambiguous standard to determine

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64 I.R.C. § 162(a)(1).

65 *Id.*; Treas. Reg. § 1.162-7(a)(3) (2010).

66 *See infra* text accompanying notes 178–79 (illustrating the low percentage of corporations that are selected for audit).

67 I.R.C. §§ 531, 532(a), 533(a). The tax is generally computed at a rate that corresponds to the top tax rate that a shareholder would have to pay on a dividend. Thus, it is currently set at 20%. *Id.* § 531, *amended by* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102(c)(1)(A), 126 Stat. 2313, 2319 (2013). A more targeted penalty tax operates to specifically discourage taxpayers from using corporations to hold and accumulate earnings from investment-type assets. Known as the personal holding company tax, this penalty must be paid by the corporation whenever two conditions are met. First, at least 60% of the corporation's gross income must come from certain passive sources, like interest and dividends. *Id.* § 542(a)(1). Second, fewer than six individuals must own over half of the corporation's stock in the last six months of the year. *Id.* § 542(a)(2). When the tax is triggered, the corporation must pay a 20% penalty on virtually all of its undistributed earnings. *Id.* §§ 541, 545, *amended by* American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 102(c)(1)(B), 126 Stat. 2313, 2319 (2013).

whether a violation has occurred, and it relies on the IRS to identify such cases and to devote resources to litigating them if the taxpayer objects. There is little evidence that the law represents a meaningful deterrent to abusive behavior.[68]

B. Federal Taxes on an Employee-Shareholder's Income from Labor

If corporate earnings are paid to an employee-shareholder in the form of compensation, the mix of rules described above will not apply to determine the federal tax that must be paid on those earnings. Rather, a different set of rules will come into play, starting with the federal income tax on individuals.[69] In addition, the payment will be subject to tax under FICA.[70] Finally, the tax imposed by the Federal Unemployment Tax Act ("FUTA") will also apply.[71] The following sections describe each of these taxes.

1. Federal Income Tax

The federal income tax on individuals is imposed under a schedule of marginal tax rates that is different from the rate schedule imposed under the corporate income tax. When President Obama took office in 2008, the rate schedule contained the following six rates: 10%, 15%, 25%, 28%, 33%, and 35%.[72] Those rates remained in effect through the end of 2012.[73] The schedule of marginal rates now contains the following seven rates: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%.[74] The individual income tax will apply to any wages that a C corporation pays to an employee-owner.[75] However, the tax that the individual must pay is only part of the income tax picture. The business will be able to deduct what it pays as compensation, reducing its taxable income dollar for dollar, resulting in a lower corporate tax on its earnings.

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68 *See, e.g.*, Richard Winchester, *Parity Lost: The Price of a Corporate Tax in a Progressive Tax World*, 9 NEV. L.J. 130, 173 & nn.344–45 (2008) (summarizing the five reported cases as of 1934).

69 *See infra* Part II.B.1.

70 *See infra* Part II.B.2.

71 *See infra* Part II.B.3.

72 I.R.C. § 1(a)–(e), (i)(1)(A), (i)(2) (modifying the tax rates after 2000). These rates refer to the rates in effect prior to amendment by the American Taxpayer Relief Act of 2012. § 101(b), 126 Stat. at 2316.

73 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 101(a), 124 Stat. 3296, 3298.

74 I.R.C. § 1(a)–(e), (i)(1)(A), (i)(2), (i)(3)(A).

75 *See id*. § 61(a)(1).

2. FICA

The tax imposed by FICA has two components. The first is the Old-Age, Survivors, and Disability Insurance component, often referred to as OASDI.[76] Ordinarily the OASDI component of the tax is a 12.4% levy on amounts that constitute "wages" from "employment."[77] One half of the tax is deducted from the employee's compensation.[78] The employer pays the other half.[79] However, for 2011 and 2012, the tax was temporarily reduced to 10.4%, with the employer paying 6.2% and the employee paying 4.2%.[80] The OASDI component of the FICA tax is earmarked to cover Social Security benefits. There is a limit on the amount of wages that can be taxed.[81] Referred to as the contribution and benefit base, this limit is $117,000 for 2014.[82] Thus, any wages from employment beyond that limit are exempt from the FICA-OASDI tax. The contribution and benefit base is adjusted each year to reflect increases in average wages of the U.S. economy.[83]

The second component of the FICA tax is the Hospital Insurance component, often referred to as HI.[84] The HI component of the tax is a 2.9% levy on an individual's wages from employment.[85] As with the OASDI component, one half of this tax is deducted from the employee's compensation, while the employer pays the other half.[86] In addition, effective after 2012, married couples with incomes over $250,000 and unmarried individuals with income over $200,000 must pay a 0.9% HI surtax on earned income above those respective thresholds.[87] For those taxpayers, the total employee portion of the HI tax is 2.35% on income above those thresholds. Unlike the OASDI component, there is no limit

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76 *Id.* § 3101(a).
77 *Id.* §§ 3101(a), 3111(a).
78 *Id.* § 3102(a).
79 *Id.* § 3111(a).
80 Middle Class Tax Relief and Job Creation Act of 2012, Pub. L. No. 112-96, § 1001(a), 126 Stat. 156, 158 (extending the tax cut through the end of 2012); Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 601(a), 124 Stat. 3296, 3309 (adopting a one year tax cut for 2011).
81 I.R.C. § 3121(a)(1).
82 *S.S.A. News Release*, Soc. Security Admin. (Oct. 30, 2013), http://www.ssa.gov/legislation/2014COLA.pdf.
83 42 U.S.C. § 430(a) (2006); *see* Joseph J. Thorndike, *Should the FICA Tax Earnings Cap Be Eliminated?*, 137 TAX NOTES 937, 938 (2012) (providing background and history for the benefit base).
84 I.R.C. § 3101(b) (2006 & 2011 Supp.).
85 *Id.* §§ 3101(b)(1), 3111(b)(6).
86 I.R.C. §§ 3102(a), 3111(b) (2006).
87 I.R.C. § 3101(b)(2) (2006 & 2011 Supp.).

on the amount of wages from employment that is subject to the HI tax.[88] Thus, the HI tax applies to all amounts that qualify as wages from employment, even amounts that exceed the OASDI contribution and benefit base. The HI component of the FICA tax is earmarked to cover Medicare benefits.

The FICA tax will apply to amounts that a corporation pays to its employee-shareholder as compensation or other remuneration for employment.[89] The individual's share of any other profits from the business generally is not subject to the FICA tax, even if it could be considered the product of the employee-shareholder's labor. As a result, earnings that the corporation retains are not subject to the FICA tax.[90] By defining the tax base in this way, FICA presents the opportunity for individuals to manage or control their employment tax liability when they own and control a business conducted through a corporation. In such cases, the individual can determine whether compensation is paid, when it gets paid, and how much is paid. By exercising this power, the individual necessarily controls whether he must pay the FICA tax, when he must pay the FICA tax, and how much tax he must pay.[91]

3. FUTA

Aside from the income and employment taxes described above, a federal unemployment insurance tax may apply to the compensation an employee-shareholder receives from a corporation. FUTA requires an employer to pay a 6% excise tax on up to $7000 of wages paid during the year to any employee.[92] Thus, the tax only comes into play when there is

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88 *Cf. supra* notes 81–82 and accompanying text.

89 I.R.C. § 3121(a) (2006).

90 However, when a corporation is an S corporation for tax purposes, it is the position of the IRS that any dividends paid by the corporation to a shareholder in lieu of reasonable compensation should be treated as wages subject to the FICA tax. Rev. Rul. 74-44, 1974-1 C.B. 287.

91 A limited liability company that is treated as a corporation for tax purposes enjoys additional tax planning opportunities. *See supra* note 34. Because shares in a state law corporation belong to designated classes, all owners of shares in a given class must share in any distribution paid to one class member; the corporation cannot single out an individual shareholder to receive a distribution. No such restriction applies to a limited liability company. Thus, the company is entirely free to single out one of its members for a distribution. Similarly, the company could make a distribution to several members and not be obligated to allocate the payment in any particular way. This flexibility presents the opportunity for an employee-member to receive a distribution as disguised compensation for services rendered to the company, potentially avoiding the member's employment tax liability.

92 I.R.C. §§ 3301(2), 3306(b)(1) (2006 & 2011 Supp.). If the employer contributes to a certified state unemployment insurance fund, those amounts are allowed as a credit toward the employer's FUTA tax liability. I.R.C. § 3302(a)(1) (2006).

an "employee" who receives "wages." The statute specifies that the term "employee" refers to the same individuals who are subject to the FICA tax.[93] Furthermore, the IRS made clear in an administrative ruling that amounts subject to the FUTA tax (i.e., the employee's wages) are identical to the amounts subject to the FICA tax.[94] In other words, the FUTA tax applies to amounts a corporation pays as compensation to an employee-shareholder. As in the case of FICA, the individual's share of any other profits of the business will not be subject to the FUTA tax even if those amounts could be considered the product of the employee-owner's labor.

III. AN ASSESSMENT

A corporation may generate profits that represent solely the product of the employee-shareholder's labor. However, payroll taxes only apply to amounts actually paid out to the employee-shareholder in the form of compensation.[95] That amount may be less than the individual's share of the business profits in any given year. In fact, it may be zero. Indeed, in the setting of a corporation that is controlled by an employee-shareholder, that owner has an economic incentive to deal with the business in ways that minimize the total tax that both he and the corporation must pay. There is no reason this consideration would not play a role when the employee-shareholder wants to access the profits of the business and needs to decide how to do so. There could be many aspects to this decision, including whether the payout should take the form of compensation or a dividend, the amount of the payout, and when it should occur.

In the absence of a relatively low rate of tax on dividends, the ability of a controlling employee-shareholder to exploit this flexibility has limited practical significance for payroll tax purposes. In almost all cases, the combined tax liability of the corporation and the individual would be kept to a minimum if a payout were structured as compensation, insulating the government from the risk that a corporation would pay a dividend as a form of disguised compensation.[96] The primary advantage in the corporate setting is that a

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93 I.R.C. § 3306(i) (2006).

94 Rev. Rul. 73-361, 1973-2 C.B. 331. Both FICA and FUTA generally define wages to be "all remuneration for employment." *See* I.R.C. §§ 3121(a), 3306(b) (defining the term "wages").

95 *See supra* Parts II.B.2–3.

96 *See* Winchester, *supra* note 19, at 276–77 (2006) (demonstrating that without the dividend tax cut there is no incentive for a corporation to use a disguised dividend to compensate an employee shareholder).

controlling employee-shareholder could decide whether to access the profits of the business at all. If he did decide to do so, he could control the timing of the payment and the amount of the payment. But if he simply allowed the profits to build up within the corporation while he worked for no compensation, none of the taxes associated with the transfer of money between him and the corporation would apply.

However, the Bush dividend tax cut changed the math. Ever since 2003, if a controlling employee-shareholder wants to access the earnings of the corporation that individual frequently has an incentive to do so by causing the corporation to pay him a dividend.[97] To the extent the dividend is disguised compensation, the transaction avoids any payroll taxes that would otherwise apply to generate funds for Social Security and Medicare benefits. Policymakers should be especially troubled by the prospect that someone could successfully avoid his obligation for these taxes now that the long-term financial stability of those programs is at risk.[98] The tax rules adopted under President Obama did not materially alter those incentives. To the contrary, the legislation President Obama signed made matters worse because such legislation gave perpetual life to a tax avoidance opportunity that was scheduled to die.

The following discussion illustrates how the rules signed into law by President Obama make permanent what had been a temporary incentive for corporations to pay dividends as disguised compensation to controlling shareholders who work for the business. Among other things, the discussion shows that the dividend tax cut does not change the incentives in all cases involving closely held corporations. Rather, high-income individuals who own and control low-income corporations are the ones positioned to make the most of this tax saving opportunity.[99]

IV. FINANCIAL INCENTIVES TO TAKE A PAYROLL TAX HOLIDAY

To illustrate the extent that tax considerations can affect the form in which corporate earnings are paid out to controlling employee-shareholders, this analysis considers the simplified case of a corporation

97 *Id*. at 271–76.

98 Under current assumptions, the OASDI trust fund is expected to grow until 2020. BD. OF TRS., FED. OLD AGE AND SURVIVORS INS. & FED. DISABILITY INS. TRUST FUNDS, THE 2013 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND FEDERAL DISABILITY INSURANCE TRUST FUNDS 11 (2013), *available at* http://www.socialsecurity.gov/oact/TR/2013/tr2013.pdf. However, beginning in 2021, the assets in the fund are expected to shrink as costs exceed income. *Id*. The reserves are expected to diminish until they are depleted in 2033. *Id*. After that, trust fund income will only be sufficient to cover a portion of benefits. *Id*.

99 *See infra* Part IV.C.

that has only one shareholder. That individual also works for the company and desires to access $15,000 of the corporation's earnings. He faces the choice of structuring the payout as a year-end bonus or as a dividend.[100] For purposes of the analysis, it is assumed that the employee-shareholder is a married individual who files a joint tax return with his spouse. In addition, the analysis assumes that the business made no less than $50,000—before paying any compensation to the employee-shareholder—in the year of the payout.[101] Finally, the analysis assumes that any bonus paid by the corporation will be the employee-shareholder's only source of income subject to employment tax.

The analysis considers the tax implications produced under the full range of tax rules signed into law by President Obama.[102] The analysis also illustrates how those consequences compare to those produced under the rules in effect when President Obama took office and the rules that would have applied had the Bush-era temporary tax cuts been allowed to expire.[103] The analysis does not take into account any alternative minimum tax liability that may apply to the employee-owner or to the corporation.[104] In addition, although the phase out of deductions can affect the marginal rate that applies to the income of an individual, such phase-outs are not taken into account.[105]

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

101 As previously discussed, a corporation is taxed at 15% on taxable income up to $50,000. *See supra* Part II.A.1. As that discussion points out, the marginal rate could go as high as 39% when taxable income falls between $100,000 and $335,000. By not assuming any ceiling on the corporation's earnings, the analysis leaves open the possibility that the corporation would fall anywhere within the full range of marginal tax rates that apply to corporations. The analysis also assumes that the corporation is not a "qualified personal service corporation." That would be the case if substantially all of the corporation's activities involved "the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting." I.R.C. § 448(d)(2) (2006). A qualified personal service corporation is subject to a flat 35% tax on its taxable income. *Id*. § 11(b)(2).

102 *See infra* Tables 7–9.

103 *See infra* Tables 10–11.

104 A corporation subject to the alternative minimum tax would generally be taxed at a flat 20% rate on an adjusted taxable income figure referred to as alternative minimum taxable income. I.R.C. § 55(b)(1)(B). An individual subject to the alternative minimum tax is taxed under a two-tiered graduated rate structure with 26% and 28% as the rates. *Id.* § 55(b)(1)(A)(i).

105 *See generally* Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 91 TAX NOTES 1415 (Special Supp. 2001) (discussing how phase-out provisions and deduction floors affect the individual income tax system).

A. Compensation for Services

Several tax effects are produced when a corporation pays compensation to an employee. First, the corporation can deduct amounts paid that are reasonable for the services rendered to it.[106] Any amounts received by the employee-owner as compensation count as gross income to him, triggering an income tax liability.[107] In addition, because the compensation qualifies as wages from employment, it also triggers an employment tax liability under FICA, with the employee and the corporation each being responsible for half the tax.[108] The corporation would also have to pay the unemployment tax on the first $7000 of any compensation paid to an employee each year.[109] The corporation is entitled to deduct the amount it paid in both FICA and FUTA tax.[110] This deduction would reduce the income that is subject to the corporate tax, lowering the income tax liability of the business.[111] The following sections quantify the amount of tax owed or saved as a result of each of these effects.

1. Payroll Tax Effects

The corporation has to pay an amount equal to 6.2% of the bonus to cover its half of the OASDI component of the FICA tax.[112] Thus, it owes $930 on a $15,000 bonus payment.[113] Although the employee normally has to match the amount that the employer pays, he only had to pay a 4.2% tax of $630 in 2011 and 2012 to cover his liability.[114] After 2012, the employee has to pay the full $930. Furthermore, because the bonus is well below the contribution and benefit base, there is no possibility that any portion of the bonus would be exempt from the OASDI component of the tax.

106 I.R.C. § 162(a)(1).
107 *Id*. § 61(a)(1).
108 *Id*. §§ 3102(a), 3111(a).
109 *Id*. §§ 3301, 3306(b)(1).
110 *Id*. § 162(a).
111 The amount of compensation paid would have ancillary consequences. If the corporation pays for health insurance for the employee and his family, the deduction available to the corporation would depend on the amount paid to the employee. In addition, the amount that the employee-owner can receive as deferred compensation depends in part on the amount of compensation the employee-owner receives. These ancillary consequences are not taken into account in the analysis.
112 *See supra* text accompanying notes 77–80.
113 $15,000 × 6.2% = $930.
114 *See supra* text accompanying note 80. $15,000 × 4.2% = $630.

The corporation and the employee-shareholder will each have to pay a 1.45% tax on the bonus to cover the HI component of FICA.[115] Thus, a $15,000 bonus will cost the company approximately $218 in tax, and it will also cost the employee-shareholder approximately $218 in tax.[116] The corporation will also have to pay $420 to cover its unemployment tax obligation on the first $7000 of the bonus.[117]

The 0.9% HI surtax applies to the portion of a married couple's earned income that exceeds a $250,000 threshold.[118] Thus, if the employee-shareholder's spouse derives earned income of at least that amount, then the bonus paid by the corporation will be subject to that surtax. Otherwise, the surtax does not come into play. When the tax does apply, it will likely do so when a couple falls in the 33% tax bracket in 2013.[119] The illustrations presented below display the results under both scenarios.

2. Corporate Income Tax Effects

The corporation will be entitled to deduct from gross income any compensation it pays to its employee-shareholder.[120] In addition, the corporation will be entitled to deduct its share of any FICA tax and FUTA tax on that compensation.[121] These deductions will translate into a lower corporate income tax liability. The actual tax savings will depend on the tax that would otherwise be due on income that is offset by the deductions.

Because the corporate tax is imposed under a system of graduated marginal rates, the tax savings will depend on the tax bracket into which the corporation falls in the year it makes the payments. As previously discussed, there are six marginal rates, ranging from a low of 15% to a high of 39%.[122] At the low end of the spectrum, if the corporation is in the 15% bracket, $15,000 in business profits—unreduced by any bonus payment—would cost the corporation $2250 in corporate income tax.[123] Conversely, if the corporation uses that money to pay a deductible bonus, there is no income left to be taxed, resulting in no income tax

115 *See supra* text accompanying notes 84–85.
116 $15,000 × 1.45% = $217.50.
117 *See supra* note 92 and accompanying text. $7000 × 6.0% = $420.
118 *See supra* text accompanying notes 87–88.
119 *See* Rev. Proc. 2013-15, § 2.01, 2013-5 I.R.B. 444, 444–45 (indicating that couples will likely qualify for the HI surtax when their income reaches the 33% tax bracket).
120 I.R.C. § 162(a)(1) (2006). If the corporation were publicly traded, the deduction for salaries paid to certain executives would be limited to $1 million. *Id.* § 162(m).
121 *Id.* § 162(a).
122 *See supra* Part II.A.1.
123 $15,000 × 15% = $2250.

liability for the corporation on that money. Thus, a $15,000 bonus payment would translate into $2250 in tax savings for a corporation in the 15% tax bracket. Meanwhile, at the high end of the spectrum, the same $15,000 bonus would translate into $5850 of tax savings to a corporation in the 39% tax bracket.[124]

The corporation will also be entitled to deduct any FICA and FUTA tax it must pay on any bonus paid to an employee.[125] Like the deduction for the bonus itself, this deduction will also translate into tax savings that will vary with the corporation's marginal tax rate. There is a $930 tax to cover the OASDI component of the FICA tax.[126] That translates into approximately $140 in tax savings if the corporation is in the 15% marginal tax bracket.[127] The savings top off at approximately $363 if the corporation is in the 39% marginal tax bracket.[128] For the HI component of the FICA tax, any $15,000 of compensation will cost the corporation approximately $218 in tax that the corporation can then deduct in computing its taxable income.[129] If the corporation is in the 15% tax bracket, that $218 deduction corresponds to approximately $33 in income tax savings.[130] Meanwhile, if the corporation is in the 39% tax bracket, that $218 deduction corresponds to approximately $85 in income tax savings.[131] Finally, the $420 in FUTA tax will translate into $63 in tax savings to a corporation in the 15% tax bracket and as much as approximately $164 in tax savings to a corporation in the 39% tax bracket.[132]

3. Individual Income Tax Effects

Any bonus received by the employee-shareholder will be included in his gross income and subject to tax under the system of graduated marginal rates.[133] As previously described, the schedule of rates ranged from 10% to 35% when President Obama took office and remained unchanged through the end of 2012.[134] Now the rates range from 10% to 39.6%.[135] An individual must pay as little as $1500 in tax on $15,000 if he

124 $15,000 × 39% = $5850.
125 *See supra* Parts II.B.2–3.
126 *See supra* text accompanying notes 77–80. $15,000 × 6.2% = $930.
127 $930 × 15% = $139.50.
128 $930 × 39% = $362.70.
129 *See supra* text accompanying notes 85–86. $15,000 × 1.45% = $217.50.
130 $218 × 15% = $32.70.
131 $218 × 39% = $85.02.
132 $420 × 15% = $63; $420 × 39% = $163.80.
133 *See supra* text accompanying notes 72–75.
134 *See supra* text accompanying notes 72–73.
135 *See supra* text accompanying note 74.

is in the 10% tax bracket.[136] However, that $15,000 bonus will cost the individual as much as $5940 in income tax if he is in the 39.6% tax bracket.[137]

4. The Net Effect of All Taxes Triggered by a Bonus

The following table summarizes the net savings and costs on a $15,000 bonus paid by a corporation to an employee-shareholder in 2011 and 2012. The net effect varies depending on two factors: the corporation's marginal tax rate and the shareholder's marginal tax rate.

Table 2
Combined Tax Owed (Saved) When a Corporation Pays a $15,000 Bonus to its Employee-Owner in 2011 and 2012

Shareholder's Marginal Tax Bracket

Corp. Rate	10%	15%	25%	28%	33%	35%
15%	$1430	$2180	$3680	$4130	$4880	$5180
25%	($227)	$523	$2023	$2473	$3223	$3523
34%	($1718)	($968)	$532	$982	$1732	$2032
35%	($1884)	($1134)	$366	$816	$1566	$1866
38%	($2381)	($1631)	($131)	$319	$1069	$1369
39%	($2546)	($1796)	($296)	$154	$904	$1204

Among other things, the table shows that there are situations in which the corporation and the employee-shareholder collectively save more in taxes than they owe. The net tax savings is as high as $2546 when the corporation is in the 39% marginal tax bracket and the employee-shareholder is in the 10% marginal tax bracket. As a practical matter, however, that particular pairing of tax brackets represents an anomalous situation.[138] In the vast majority of situations, the payment of a bonus produces a net tax cost. In the most extreme case, a combined tax of $5180 is due when the corporation is in the 15% tax bracket and the employee-shareholder is in the 35% tax bracket.

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136 $15,000 × 10% = $1500.

137 $15,000 × 39.6% = $5940.

138 The 10% tax bracket applies when an individual has taxable income that does not exceed $15,100. That would mean that virtually all the individual's other income was offset by exemptions, exclusions, and deductions of one kind or another. The 39% tax bracket applies when a corporation has taxable income over $100,000 and up to $335,000. I.R.C. § 11(b)(1) (2006); *see supra* Table 1.

The following two tables summarize the net savings and costs on a $15,000 bonus paid by a corporation to an employee-shareholder after 2012. Table 3 assumes that the bonus is not subject to the 0.9% HI surtax. Table 4 assumes that the surtax does apply to the bonus.

Table 3
Combined Tax Owed (Saved) When a Corporation Pays a $15,000 Bonus to its Employee-Owner After 2012—No HI Surtax

	Shareholder's Marginal Tax Bracket			
Corp. Rate	10%	15%	25%	28%
15%	$1730	$2480	$3980	$4430
25%	$73	$823	$2323	$2773
34%	($1418)	($668)	$832	$1282
35%	($1584)	($834)	$666	$1116
38%	($2081)	($1331)	$169	$619
39%	($2246)	($1496)	$4	$454

	Shareholder's Marginal Tax Bracket			
Corp. Rate	33% low	33% high	35%	39.6%
15%	$5180	$5180	$5480	$6170
25%	$3523	$3523	$3823	$4513
34%	$2032	$2032	$2332	$3022
35%	$1866	$1866	$2166	$2856
38%	$1369	$1369	$1669	$2359
39%	$1204	$1204	$1504	$2194

Table 4
Combined Tax Owed (Saved) When a Corporation Pays a $15,000 Bonus to its Employee-Owner After 2012—Including HI Surtax

Shareholder's Marginal Tax Bracket

Corp. Rate	10%	15%	25%	28%
15%	$1730	$2480	$3980	$4430
25%	$73	$823	$2323	$2773
34%	($1418)	($668)	$832	$1282
35%	($1584)	($834)	$666	$1116
38%	($2081)	($1331)	$169	$619
39%	($2246)	($1496)	$4	$454

Shareholder's Marginal Tax Bracket

Corp. Rate	33% low	33% high	35%	39.6%
15%	$5180	$5315	$5615	$6305
25%	$3523	$3658	$3958	$4648
34%	$2032	$2167	$2467	$3157
35%	$1866	$2001	$2301	$2991
38%	$1369	$1504	$1804	$2494
39%	$1204	$1339	$1639	$2329

Among other things, Tables 3 and 4 show that the general pattern of outcomes after 2012 has not changed from those produced under the rules in place in 2011 and 2012. The highest combined tax cost occurs when the individual is in a high tax bracket and the corporation is in a low tax bracket. The combined tax tops out at $6305 when the corporation is in the 15% marginal tax bracket, the employee-shareholder is in the 39.6% marginal tax bracket, and the HI surtax applies. A net tax savings is produced in the anomalous cases when the corporation is in a high tax bracket and the employee-shareholder is in a low tax bracket.[139]

B. Dividends

A payment of dividends triggers a different and less complex set of tax effects to the corporation and its employee-shareholder. First, there

139 *See supra* note 138 and accompanying text.

are no payroll tax effects to consider.[140] In addition, because the corporation is not entitled to deduct any dividends paid to shareholders, there are no corporate income tax effects to consider.[141] The only income tax effects will occur at the level of the employee-shareholder.

Dividends received by the employee-owner will count as gross income to him, making them subject to tax.[142] As described above, the amount of tax will depend on two factors: the year of the payment and, where applicable, whether the dividend constitutes a qualified dividend.[143] This analysis assumes that any dividend received by the employee-shareholder is a qualified dividend, whenever applicable. In 2011 and 2012, such items were either tax free or subject to tax at 15%, depending on the recipient's tax bracket.[144] The following table summarizes the combined tax cost to the recipient and the corporation on the payment of a $15,000 dividend under legislation signed by President Obama during his first term.

Table 5
Combined Tax Owed (Saved) When a Corporation Pays a $15,000 Dividend to its Employee-Owner in 2011 and 2012

	Shareholder's Marginal Tax Bracket					
Corp. Rate	10%	15%	25%	28%	33%	35%
All rates	$0	$0	$2250	$2250	$2250	$2250

The combined tax cost under that legislation was never more than $2250. By comparison, Table 2 previously showed that the combined tax was as much as $5180 when the payment was structured as a bonus in 2011 or 2012.

After 2012, qualified dividends are subject to tax at rates of 0%, 15%, or 20% depending on the recipient's tax bracket.[145] A 3.8% HI surtax also applies to dividends received by couples with incomes above a $250,000 threshold.[146] As already described, that threshold fell somewhere within

140 *Cf.* I.R.C. § 3101(a), (b) (imposing payroll taxes on wages).
141 *Cf. id.* § 162(a) (limiting deductions to amounts incurred in carrying on a business).
142 *Id.* § 61(a)(7).
143 *See supra* text accompanying notes 47–63.
144 *See supra* text accompanying notes 50–54.
145 *See supra* text accompanying notes 58–60.
146 *See supra* text accompanying note 61.

the 33% tax bracket in 2013.[147] The following table summarizes the combined tax cost to the recipient and the corporation on the payment of a $15,000 dividend under legislation signed by President Obama after winning his second term.

Table 6
Combined Tax Owed (Saved) When a Corporation Pays a $15,000 Dividend to its Employee-Owner After 2012

	Shareholder's Marginal Tax Bracket					
Corp. Rate	10% or 15%	25% or 28%	33% low	33% high	35%	39.6%
All rates	$0	$2250	$2250	$2820	$2820	$3570

The combined tax cost is never more than $3570. By comparison, Tables 3 and 4 previously showed that the combined tax will be as much as $6305 when the payment is structured as a bonus after 2012.

C. Quantifying the Incentive

The difference between the combined tax effects associated with each payout alternative will determine the extent to which there is a tax incentive to substitute a dividend for a bonus. The following tables show the extent to which the corporation and the employee-shareholder collectively realize tax savings or an additional tax cost when structuring a $15,000 payout as a dividend instead of as a bonus.[148] The table immediately below displays the range of possibilities under legislation signed by President Obama in his first term. The relevant provisions of those laws were in effect for 2011 and 2012.

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147 *See supra* text accompanying note 119.
148 *See infra* Tables 7–11.

Table 7
Tax Owed (Saved) When a Corporation Substitutes a $15,000 Dividend for a $15,000 Bonus in 2011 and 2012

	Shareholder's Marginal Tax Bracket					
Corp. Rate	10%	15%	25%	28%	33%	35%
15%	($1430)	($2180)	($1430)	($1880)	($2630)	($2930)
25%	$227	($523)	$227	($223)	($973)	($1273)
34%	$1718	$968	$1718	$1268	$518	$218
35%	$1884	$1134	$1884	$1434	$684	$384
38%	$2381	$1631	$2381	$1931	$1181	$881
39%	$2546	$1796	$2546	$2096	$1346	$1046

Among other things, the table shows a general pattern of net tax savings that grow larger as the corporation's marginal tax rate declines and the employee-shareholder's marginal tax rate increases. The tax savings from substituting a dividend for a bonus top off at $2930 when the corporation is in the 15% marginal tax bracket and the employee-shareholder is in the 35% marginal tax bracket. At the other extreme, there is an incentive to structure a payout as a bonus whenever the corporation is taxed above 25%.

The following two tables display the range of financial incentives under legislation President Obama signed after winning reelection. Table 8 shows the possibilities assuming any bonus is not subject to the HI surtax that is now in effect. Table 9 shows the possibilities on the assumption that the HI surtax does apply to any bonus.

Table 8
Tax Owed (Saved) When a Corporation Substitutes a $15,000 Dividend for a $15,000 Bonus After 2012—No HI Surtax

	Shareholder's Marginal Tax Bracket			
Corp. Rate	10%	15%	25%	28%
15%	($1730)	($2480)	($1730)	($2180)
25%	($73)	($823)	($73)	($523)
34%	$1418	$668	$1418	$968
35%	$1584	$834	$1584	$1134
38%	$2081	$1331	$2081	$1631
39%	$2246	$1496	$2246	$1796

Shareholder's Marginal Tax Bracket

Corp. Rate	33% low	33% high	35%	39.6%
15%	($2930)	($2360)	($2660)	($2600)
25%	($1273)	($703)	($1003)	($943)
34%	$218	$788	$488	$548
35%	$384	$954	$654	$714
38%	$881	$1451	$1151	$1211
39%	$1046	$1616	$1316	$1376

Table 9
Tax Owed (Saved) When a Corporation Substitutes a $15,000 Dividend for a $15,000 Bonus After 2012–Including HI Surtax

Shareholder's Marginal Tax Bracket

Corp. Rate	10%	15%	25%	28%
15%	($1730)	($2480)	($1730)	($2180)
25%	($73)	($823)	($73)	($523)
34%	$1418	$668	$1418	$968
35%	$1584	$834	$1584	$1134
38%	$2081	$1331	$2081	$1631
39%	$2246	$1496	$2246	$1796

Shareholder's Marginal Tax Bracket

Corp. Rate	33% low	33% high	35%	39.6%
15%	($2930)	($2495)	($2795)	($2735)
25%	($1273)	($838)	($1138)	($1078)
34%	$218	$653	$353	$413
35%	$384	$819	$519	$579
38%	$881	$1316	$1016	$1076
39%	$1046	$1481	$1181	$1241

The tables indicate that a dividend costs more in tax than does a bonus in the vast majority of situations. At one extreme, a $15,000 bonus enjoys a $2246 tax advantage over a $15,000 dividend when the corporation is in the 39% tax bracket and the employee-shareholder is in either the 10% or the 25% marginal tax bracket. In other words, in that situation, the corporation and shareholder end up with $2246 more after tax by structuring the payout as a bonus as opposed to a dividend. However, as explained earlier, it would be a rather anomalous situation for a low tax individual to own a high-tax corporation.[149]

The more relevant cases involve the corporations that are in the 15% and 25% marginal tax brackets. It is in those cases where a dividend enjoys a tax advantage over a bonus. In those situations, there is a financial incentive to substitute a dividend for a bonus to minimize the net tax cost to the shareholder and corporation. Further, the tax savings tend to be substantially larger when the employee-shareholder is in the higher tax brackets. At one extreme, the savings exceed $2500 in almost all cases when the corporation is taxed at 15% and the employee-shareholder is taxed at 33% or higher. The savings approach $2500 when both the corporation and the employee-shareholder are in the 15% tax bracket. However, the savings are substantially less when the employee-shareholder is taxed at a rate below 33%.

These results are not materially different from the results that were produced by the tax cuts initially adopted under President George W. Bush. The following table displays the full range of possibilities under the law in effect at the time President Obama took office. It shows how a bonus disguised as a dividend consistently produced greater savings for individuals in the higher income ranges when the corporation itself was in the two lowest tax brackets.

Table 10
Tax Owed (Saved) When Corporation Substitutes a $15,000 Dividend for a $15,000 Bonus in 2008–2010

	Shareholder's Marginal Tax Bracket					
Corp. Rate	10%	15%	25%	28%	33%	35%
15%	($1730)	($2480)	($1730)	($2180)	($2930)	($3230)
25%	($73)	($823)	($73)	($523)	($1273)	($1573)
34%	$1418	$668	$1418	$968	$218	($82)
35%	$1584	$834	$1584	$1134	$384	$84
38%	$2081	$1331	$2081	$1631	$881	$581
39%	$2246	$1496	$2246	$1796	$1046	$746

149 *See supra* note 138.

However, these results are drastically different from the results that would have occurred had the temporary tax cuts in place when President Obama took office simply expired. Under the law then scheduled to take effect, dividends would have been taxed at the same rates that apply to any other income.[150] In addition, individuals would have been taxed at one of five rates ranging from 15% to 39.6%.[151] The following table displays the full range of incentives under that set of assumptions.

Table 11
Tax Owed (Saved) When a Corporation Substitutes a $15,000 Dividend for a $15,000 Bonus if Bush-Era Tax Cuts Had Expired

	Shareholder's Marginal Tax Bracket				
Corp. Rate	15%	25%	31%	36%	39.6%
15%	$70	$70	$70	$70	$70
25%	$1727	$1727	$1727	$1727	$1727
34%	$3218	$3218	$3218	$3218	$3218
35%	$3384	$3384	$3384	$3384	$3384
38%	$3881	$3881	$3881	$3881	$3881
39%	$4046	$4046	$4046	$4046	$4046

Table 11 shows that there is no situation where there would have been a financial incentive to disguise a bonus as a dividend had the laws enacted under President Bush been allowed to expire. However, the legislation signed by President Obama prevented those laws from sunsetting as scheduled.[152] Instead, that legislation gave those laws perpetual life.[153]

D. *The Unequal Opportunity Payroll Tax Dodge*

It seems evident from the preceding analysis that the greatest tax savings are available when a low-income corporation substitutes a

[150] Winchester, *supra* note 19, at 234 (describing the law scheduled to take effect after 2010 before Congress passed legislation to extend the temporary rules through the end of 2012).
[151] *Id*. at 236 (describing the rates scheduled to take effect after 2010 before Congress adopted legislation to extend the expiration of the temporary rates through the end of 2012).
[152] *See supra* note 22 and accompanying text (describing the date the dividend tax cut was scheduled to expire).
[153] *See supra* text accompanying note 24.

dividend for a bonus to its employee-shareholder.[154] Further, the greatest tax savings occur when the employee-shareholder is in the highest tax brackets.[155] There is no evidence that concretely shows the extent to which high-income individuals own and control corporations that generate low incomes.[156] However, there is compelling evidence that the ownership of closely held corporations is severely concentrated in the hands of the most wealthy individuals. It also seems evident that all but a small minority of corporations have incomes low enough to place them in one of the two lowest tax brackets.[157]

The available evidence shows that the stock in closely held corporations is concentrated in the hands of very wealthy individuals. The IRS estimates that there were 2.3 million individuals in the United States with at least $2 million in gross assets in 2007, representing 1% of the total U.S. adult population.[158] Approximately 550,000 of this group of wealthy individuals—representing 24% of the total—owned stock in non-publicly traded corporations.[159] The total value of this stock was estimated to be nearly $1.5 trillion.[160] However, such stock ownership was concentrated in the hands of the very wealthy.

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154 *See supra* Part IV.C.

155 *See supra* Tables 8–9.

156 Indeed, researchers have noted how inherently difficult it is to link corporate firms with their individual owners. *See, e.g.*, MATTHEW KNITTEL ET AL., OFFICE OF TAX ANALYSIS, DEP'T OF THE TREASURY TECHNICAL PAPER NO. 4, METHODOLOGY TO IDENTIFY SMALL BUSINESSES AND THEIR OWNERS 15 (2011), *available at* http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf. By contrast, recently compiled databases have permitted researchers to link owners and firms other than taxable C corporations. *See id.* at 15–21 (discussing the use of the Compliance Data Warehouse to link owners and firms).

157 The ownership and income of corporations was previously analyzed by John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do,"* 78 TEX. L. REV. 885 (2000).

158 Brian Raub & Joseph Newcomb, *Personal Wealth, 2007*, I.R.S. STAT. INCOME BULL., Winter 2012, at 156, 156, *available at* http://www.irs.gov/pub/irs-soi/12pwwinbulwealth07.pdf. These estimates are based on the gross assets reported in federal estate tax returns, the only source of data from which to estimate the wealth holdings of the general population. *Id*. The term gross assets reflects the gross value of all assets owned by a decedent, including "the full face value of life insurance, reduced by the value of any policy loans." *Id.* at 157. The figure is not adjusted to reflect any other debts owed by the decedent. *Id*. The 2007 data is the most current information available. In an earlier study of personal wealth—covering 2001—the very wealthy accounted for a larger share of the total population and they also accounted for a smaller share of the closely held stock. *See* Barry W. Johnson & Brian G. Raub, *Personal Wealth, 2001*, I.R.S. STAT. INCOME BULL., Winter 2005–2006, at 120, 120, 122, *available at* http://www.irs.gov/pub/irs-soi/01pwart.pdf (reporting the top wealth holders in 2001).

159 Raub & Newcomb, *supra* note 158, at 169 tbl.1.

160 *Id*.

Individuals whose personal net worth exceeded $3.5 million accounted for 36.3% of wealthy individuals, but they owned 87.5% of the value of all stock in non-publicly traded corporations owned by wealthy individuals.[161] Individuals whose personal net worth exceeded $10 million accounted for approximately 8% of all wealthy individuals, but they owned 64.8% of all stock in non-publicly traded corporations.[162] The following table details the distribution of closely held stock among individuals by net worth based on 2007 data, the most recent figures available.[163]

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161 *Id.*

162 *Id.* This pattern of ownership is consistent with the findings of other studies. The Federal Reserve Board conducts a survey of consumer finances every three years. *See, e.g.*, Jesse Bricker et al., *Changes in U.S. Family Finances from 2007 to 2010: Evidence from the Survey of Consumer Finances*, FED. RES. BULL., June 2012, at 1, *available at* http://federalreserve.gov/pubs/bulletin/2012/pdf/scf12.pdf (surveying family finances from 2007 to 2010). The surveys consistently show that ownership of privately held business increases with family income. *See, e.g.*, *id.* at 43 tbl.9.A, 47 tbl.9.B (demonstrating that families with high incomes are more likely to have business equity than low-income families). The 2010 survey showed that 5.1% of families in the bottom quintile owned equity in a business. *Id.* at 47 tbl.9.B. That figure was 3.3% in 2007 and less than 4% in 2004. *Id.* at 43 tbl.9.A; Brian K. Bucks et al., *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, FED. RES. BULL., March 2006, at A22 tbl.8.B, *available at* http://federalreserve.gov/pubs/bulletin/2006/financesurvey.pdf. Meanwhile, of the families in the top tenth of the income scale, over 35% owned equity in a business in 2010. Bricker et al., *supra*, at 47 tbl.9.B. That figure was over 40% in 2007 and over 30% in the 2004 survey. *Id.* at 43 tbl.9.A; Bucks et al., *supra*, at A22 tbl.8.B. The survey considers equity in a business to include "sole proprietorships, limited partnerships, other types of partnerships, subchapter S corporations and other types of corporations that are not publicly traded, limited liability companies, and other types of private businesses." Bricker et al., *supra*, at 51 n.39; Bucks et al., *supra*, at A24 n.30. However, the category does not include self-employed individuals. Bricker et al., *supra*, at 51 n.39; Bucks et al., *supra*, at A24 n.31.

163 Raub & Newcomb, *supra* note 158, at 169 tbl.1. All figures are estimates based on samples. The data may not add to the total due to rounding.

Table 12
Ownership of Closely Held Stock
by Size of Owner's Net Worth
2007

Owner's Net Worth	**Cohort Size** Number (000)	**Cohort Size** % to Total	**Closely Held Stock** Value ($000,000)	**Closely Held Stock** % to Total
$20,000,000 or more	66	2.9%	818,667	51.9%
$10,000,000 under $20,000,000	116	5.1%	203,913	12.9%
$5,000,000 under $10,000,000	286	12.5%	242,341	15.4%
$3,500,000 under $5,000,000	364	15.9%	115,070	7.3%
$2,000,000 under $3,500,000	1008	44.0%	140,964	8.9%
Under $2,000,000	449	19.6%	56,760	3.6%
TOTAL	**2290**	**100%**	**1,577,715**	**100%**

Not only is the distribution of closely held corporation stock concentrated in the hands of wealthy individuals, there is strong evidence showing that the vast majority of corporations have low incomes. Statistics compiled by the IRS indicate that low-income corporations—other than S corporations—account for the overwhelming share of all active corporations.[164] The agency's annual survey of corporate incomes classifies a corporation by the size of its assets.[165] By this measure, non-S corporations are concentrated at the low end of the spectrum.[166] Moreover, these low asset corporations that dominate the universe also seem to have low incomes. According to data from the 2010 survey, over 60% of active non-S corporations with assets have no

164 The profits of an S corporation are not subject to the corporate tax. I.R.C. § 1363(a) (2006). An active corporation is one that reported either an item of income or an item of deduction or both on the federal income tax return. INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, 2010 STATISTICS OF INCOME: CORPORATION INCOME TAX RETURNS 296 (2010), *available at* http://www.irs.gov/pub/irs-soi/10coccr.pdf.

165 INTERNAL REVENUE SERV., *supra* note 164, at 300. The term "total assets" refers to amounts reported by a corporation in the end-of-year balance sheet. *Id*. The figure is a net amount that reflects reductions for "accumulated depreciation, accumulated amortization, accumulated depletion, and the [company's] reserve for bad debts." *Id.*

166 The figures do not reflect S corporations. However, the figures do include certain life insurance companies, property and casualty insurance companies, regulated investment companies (i.e. mutual funds), real estate investment trusts, and foreign corporations with business income from U.S. sources. *Id*. at 290.

more than $500,000 in total assets.[167] The average net income of that group of firms is just under $19,000.[168] Roughly 10% of non-S corporations have at least $500,000 in assets but not more than $1 million in assets.[169] The average net income for that group of firms is just under $55,600, which is only $5600 above the $50,000 upper limit for the lowest corporate income tax bracket: 15%.[170] The following table shows the average net income for all non-S corporations in each asset range for 2010.[171] Among other things, the table shows that low asset corporations dominate the landscape. The table also shows that a strong correlation exists between the size of a corporation's assets and the net income it generates.

167 *Infra* Table 13.
168 *Infra* Table 13.
169 *Infra* Table 13.
170 *Id.*; *see supra* Table 1 (providing tax rates for each layer of corporate income). It would be much more useful to know the number of corporations reporting income not in excess of each of the tax rate thresholds specified by statute. However, the data is not collected or reported in a way that permits that kind of analysis. Nevertheless, this less-than-perfect tabulation of the available data is sufficient to make a convincing case that low-income corporations account for the lion's share of the total universe of corporations. This conclusion is consistent with observations made by others. *See, e.g.*, Lee, *supra* note 157, at 906 (concluding that the majority of C corporations reported no income in 1993).
171 The table was derived using data appearing in two tables in the 2010 Corporation Source Book of Statistics of Income. INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, PUB. NO. 1053, 2010 CORPORATION SOURCE BOOK OF STATISTICS OF INCOME (2010), *available at* http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Source-Book:-U.S.-Total-and-Sectors-Listing. The publication includes a master table reflecting statistics for all corporations with net income, including S corporations ("Section 3"). *Id.* at 267. A separate table provides statistics solely for S corporations with net income ("Section 5"). *Id.* at 545. The table shows, among other things, the number of S corporations falling into each asset range category. *Id.*

Table 13
Active Non-S Corporations with Net Income
2010

Size of Total Assets	Number	% of Total	Net Income ($000,000)	Average Net Income
Zero Assets	101,945	12.5%	$40,545	$397,713
At least $1 and under $500,000	490,951	60.3%	$9183	$18,705
At least $500,000 and under $1,000,000	78,962	9.7%	$4388	$55,569
At least $1,000,000 and under $5,000,000	89,685	11.0%	$11,994	$133,735
At least $5,000,000 and under $10,000,000	16,478	2.0%	$6622	$401,857
At least $10,000,000 and under $25,000,000	11,659	1.4%	$10,083	$864,798
At least $25,000,000 and under $50,000,000	5601	0.7%	$11,617	$2,074,174
At least $50,000,000 and under $100,000,000	4386	0.5%	$16,352	$3,728,292
$100,000,000 or more	15,171	1.9%	$1,333,913	$87,925,179
TOTAL	814,838	100%	$1,444,697	

There is good reason to expect that controlling employee-shareholders of C corporations will exploit the opportunity to substitute dividends for a salary when doing so will save tax dollars.[172] Just consider how self-employed individuals have exploited the opportunity to take a payroll tax holiday when they operate a business as an S corporation.[173] As in the case of a C corporation, the full range of payroll

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172 There is evidence that dividend income increased following the Bush dividend tax cut. Qualified dividend income rose by 29.2% and the number of returns reporting that item increased by 9.2% in 2004, the first full year that the dividend tax cuts were in effect. Data Release, *Individual Income Tax Returns, Preliminary Data, 2004*, STAT. INCOME BULL., Winter 2005–2006, at 6, 7 fig.A. However, it is difficult to establish the extent to which any dividend income is a substitute for wages that a business would have otherwise paid an employee-owner.

173 An S corporation is a corporation that has elected to be subject to the rules that appear in subchapter S of the Internal Revenue Code. *See generally* I.R.C. §§ 1361–79 (2006 & Supp. 2011). While the profits of a C corporation are subject to tax at two potential points in time—when earned by the corporation and when paid out by the corporation to its

taxes are triggered when an S corporation pays an employee-shareholder a bonus or some other form of compensation for his work.[174] Moreover, an employee-owner has control over whether to receive any compensation for the work he performs.

In a study based on tax return data for the year 2000, owners of 36,000 single-shareholder S corporations received no salaries, even though the corporation in each case had over $100,000 in operating profits.[175] Moreover, the owners of single-shareholder S corporations have been setting their salaries at a decreasing percentage of corporate profits over time. In 1994, these shareholders received salaries equal to 47.1% of the corporation's profits; while in 2001, the salaries fell to 41.5% of the profits.[176] This situation has been described in a Treasury Department audit report as a "multibillion dollar employment tax shelter."[177]

It is not unusual to find the owners of single-shareholder S corporations taking a payroll tax holiday because taxpayers and their tax advisors know it is extremely unlikely that the government will detect and punish the practice. In 2004, the IRS examined a meager 0.19% of S corporation returns, down from an equally meager 0.43% in 2001.[178] Small corporations have been examined at a similarly low rate. The IRS examined 0.32% of small corporations in 2004, compared to 0.60% in

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shareholders as a dividend—the profits of an S corporation are only subject to tax once. Specifically, each shareholder pays tax on his share of the profits, whether or not they are paid out to him. *Id.* § 1366(a)–(b). The corporation itself pays no tax on its profits. *Id.* § 1363(a).

174 *See* I.R.C. § 3121(a) (2006) (triggering payroll taxes when an employee receives wages); *see also* Rev. Rul. 59-221, 1959-1 C.B. 225 (confirming that the self-employment tax base does not include an individual's pro-rata share of the earnings of an S corporation).

175 TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, DEP'T OF THE TREASURY, REF. NO. 2005-30-080, ACTIONS ARE NEEDED TO ELIMINATE INEQUITIES IN THE EMPLOYMENT TAX LIABILITIES OF SOLE PROPRIETORSHIPS AND SINGLE-SHAREHOLDER S CORPORATIONS 12 (2005), *available at* http://www.treasury.gov/tigta/auditreports/2005reports/200530080fr.pdf.

176 *Id.* at 5.

177 *Id.* The report determined that single owner S corporations would have owed $5.7 billion more in employment taxes in 2000 had those businesses operated as sole proprietorships, where all of the earnings would be subject to the self-employment tax. *Id.* at 6.

178 TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, DEP'T OF THE TREASURY, REF. NO. 2005-30-130, THE SMALL BUSINESS/SELF-EMPLOYED DIVISION IS BEGINNING TO ADDRESS CHALLENGES THAT AFFECT CORPORATE RETURN EXAMINATION COVERAGE 1 (2005), *available at* http://www.treasury.gov/tigta/auditreports/2005reports/200530130fr.pdf. In one reported case, the court recast dividends paid by the corporation to its sole shareholder as wages subject to FICA taxes. Nu-Look Design, Inc. v. Comm'r, 356 F.3d 290, 291 (3d Cir. 2004).

2001.[179] To make matters worse, even when an S corporation is selected for audit, the agent often fails to examine the issue of officer compensation. A 2002 study revealed that agents failed to consider the adequacy of officer compensation in 22% of audited S corporations that made a distribution to its shareholders.[180] A later report by the Government Accountability Office revealed a similar pattern in an analysis of S corporation examinations conducted between 2006 and 2008. The IRS examined 0.5% or fewer of the S corporation returns during that period and scrutinized shareholder compensation under a quarter of the time.[181]

Equally alarming is the fact that the S corporations examined in the 2002 study paid their officers an average of $5300 in wages compared to an average of $349,323 in non-wage distributions, strongly suggesting a practice of substituting non-wage distributions for salaries to avoid triggering the payroll taxes.[182] According to IRS data from a national research project for 2003 and 2004, "about 13% of S corporations paid inadequate wage compensation, resulting in just over $23.6 billion in net underpaid wage compensation to shareholders," which could result in billions of dollars in annual employment tax underpayments.[183]

Moreover the problem is concentrated among the S corporations with the fewest owners. According to the Government Accountability Office report, "single shareholder S corporations accounted for most of the net underpayments and those with one to three shareholders accounted for almost all of the net underpayment[s]."[184] Further, "[t]he median misreporting adjustment for underpaid shareholder compensation in all categories was $20,127."[185] There is already a cottage industry built around advising small businesses to save on employment taxes by forming S corporations.[186] That cottage industry may only

179 TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, *supra* note 178, at 1. Any corporation with less than $10 million in assets is classified as a small corporation. *Id*.

180 TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, DEP'T OF THE TREASURY, REF. NO. 2002-30-125, THE INTERNAL REVENUE SERVICE DOES NOT ALWAYS ADDRESS SUBCHAPTER S CORPORATION OFFICER COMPENSATION DURING EXAMINATIONS 3–4 (2002), *available at* http://www.treasury.gov/tigta/auditreports/2002reports/200230125fr.pdf.

181 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES 28 tbl.7 (2009), *available at* http://gao.gov/assets/300/299521.pdf.

182 *See* TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, *supra* note 180, at 3.

183 U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 181, at 25.

184 *Id*.

185 *Id*.

186 TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, *supra* note 175, at 13. There is no shortage of literature discussing ways to capitalize on this opportunity to minimize or eliminate employment taxes where such taxes would otherwise apply. *See, e.g.*, James L.

expand in scope now that the C corporation can be used to produce the same results with equally low rates of detection and punishment.[187]

Considering the track record of the S corporation, the C corporation form of ownership will likely operate as a similar payroll tax shelter to many high-income individuals as long as tax dollars can be saved by substituting dividends for a salary. In fact, one scholar recently illustrated the magnitude of the tax savings that could be enjoyed by a self-employed person who operated through a taxable corporation as compared to any other business form.[188] The analysis showed that when an individual in a high tax bracket owns a low-income business (i.e. $50,000 of earnings), the tax on the earnings will be the lowest when the firm operates as a C corporation that either structures a payout as compensation or makes no payout at all.[189] Another recent report by a team of government economists estimated that there were 1.56 million small business corporations in 2007.[190] Those firms accounted for 24% of all small business receipts for that year.[191] Thus, the taxable corporation represents a very sizeable segment of the small business universe, making it all the more important for policymakers to be concerned about the ways a C corporation can serve as a vehicle to shelter income and avoid tax.[192] Policymakers have expressed a growing interest in reducing the corporate tax as part of a tax reform agenda.[193] If that

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Wittenbach & Ken Milani, *FICA Factors for S Corporation Payments to Owner/Employees*, 75 PRAC. TAX STRATEGIES 338 (2005).

187 In fact there is already practitioner-oriented literature discussing situations in which the owner of a closely held corporation can save tax dollars by substituting dividends for a salary. *E.g.*, Susan L. Megaard & Michael M. Megaard, *Reducing Self-Employment Taxes on Owners of LLPs and LLCs After* Renkemeyer, 87 PRAC. TAX STRATEGIES 52, 61–62 (2011); Thomas Zupanc & Sabyasachi Basu, *Re-Evaluate the Various Ways to Tap Corporate Cash*, 74 PRAC. TAX STRATEGIES 332, 334–35 (2005).

188 *See generally* Martin A. Sullivan, *Economic Analysis: The Small Business Love-Hate Relationship with Corporate Tax*, 132 TAX NOTES 1321 (2011) (explaining why small business owners may prefer to file as a C corporation rather than as an S corporation).

189 *See id.* at 1323–25 (showing that small businesses that choose C corporation status over S corporation status in such circumstances enjoy annual tax savings of $3625).

190 KNITTEL ET AL., *supra* note 156, at 26 tbl. 4.

191 *Id.* Of an estimated $5.56 trillion in gross receipts—other than rent and investment income—generated by all small business firms, C corporations accounted for $1.34 trillion. *Id.*

192 In fact, there is a real possibility that C corporations will grow in popularity simply because the top individual tax rate of 39.6% exceeds the top statutory corporate tax rate of 35%. Tax advisors have already recognized that this situation creates a tax saving opportunity for individuals who currently own businesses as a sole proprietorship, a partnership, or an S corporation. *See, e.g.*, James G.S. Yang et al., *Tax Planning Strategies Under the American Taxpayer Relief Act of 2012*, 91 PRAC. TAX STRATEGIES 21, 31 (2013).

193 *See, e.g.*, H. COMM. ON WAYS & MEANS, 112TH CONG., DISCUSSION DRAFT ON TAX REFORM ACT OF 2011 (Comm. Print 2011) (proposing that the corporate tax rates be lowered); WHITE HOUSE & DEP'T OF THE TREASURY, THE PRESIDENT'S FRAMEWORK FOR

happens, the C corporation will likely become an even more appealing option for conducting a business, underscoring the need to address the tax avoidance opportunities that it offers.[194]

In short, the opportunity to save taxes by substituting dividends for compensation is not an abstract matter. Disguising compensation as a dividend is a very real option confronted by what appears to be a substantial number of individuals who own and control a corporation that employs them. Moreover, there is compelling evidence that the opportunity to save taxes is not shared uniformly within the universe of closely held business owners. The rich stand to gain more, and there appears to be very few other individuals who are in a position to exploit this opportunity. To compound the situation, there seems to be a very low risk that the government will detect and punish instances of individuals taking a payroll tax holiday.[195] In a very real sense, the combination of rules that President Obama signed into law will perpetuate a rich man's tax dodge that was supposed to die by the middle of his first term.

V. A RENEWED CALL TO ADOPT AN OLD PROPOSAL

There would be no economic incentive for a closely held corporation to substitute a dividend for a bonus to an employee-shareholder if the dividend tax cut did not exist. However, even in that situation, the corporate form offers payroll tax planning opportunities that should concern policymakers. Most important, a corporation can control when—if ever—the payroll taxes are triggered. There is no payroll tax liability as long as the corporation does not pay compensation to an employee-shareholder.[196] Indeed, there is no liability for any personal income tax if the corporation pays neither a bonus nor a dividend. In the event compensation is paid, the payroll tax liability will be based solely

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BUSINESS TAX REFORM 9 (2012), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf (proposing a reduction in the top corporate tax rate from 35% to 28%).

194 *See* Karen C. Burke, *Passthrough Entities: The Missing Element in Business Tax Reform*, 40 PEPP. L. REV. 1329, 1339 (2013) (indicating that a reduction in corporate tax rates would encourage more C corporations); *see also* Daniel Halperin, *Mitigating the Potential Inequality of Reducing Corporate Rates*, 126 TAX NOTES 641, 658 (2010) (concluding that a lower corporate tax rate will increase the options available to high-income taxpayers for sheltering income). *But see* Martin A. Sullivan, *Economic Analysis: Will Rate Changes Transform C Corps Into Tax Shelters?*, 134 TAX NOTES 1590, 1590, 1593 (2012) (questioning how attractive a C corporation will be following a cut in the tax rate).

195 *See supra* text accompanying notes 178–79 (discussing the government's track record auditing S corporations).

196 *See supra* Part II.B (discussing how payroll taxes apply to amounts received as wages).

on the amount paid, whether it accurately reflects an arm's length transaction or not. Moreover, because compensation in excess of the FICA contribution and benefit base is exempt from the OASDI component of the tax, payroll taxes could be saved by compressing into a single year the compensation derived over the course of several years. Thus, if the owner received $180,000 in compensation in 2014, only $117,000 would be subject to the 12.4% OASDI tax. The remaining amount would be exempt from that tax, even though it may relate to services performed during a year when the corporation did not pay the owner a salary.[197] Therefore, even when the employment tax is triggered, the tax liability can be managed and minimized by an individual who owns and controls the corporation that employs him.

Therefore, the source of the help-yourself payroll tax holiday is not the dividend tax cut itself. The tax cut has only magnified a more fundamental problem with the way the employment tax system operates when applied to an individual who works for a corporation that he also owns and controls. The rules simply give the employee-shareholder too much power to control how much employment tax he must pay on his share of the firm's earnings. The employment tax rules would be much more effective and fair if policymakers simply curtailed that power.

On a previous occasion, I suggested that policymakers could address this problem by expanding the scope of existing proposals aimed at correcting related defects in the nation's employment tax system.[198] There are several instances where the employment tax system produces undesirable outcomes as a result of rules that provide self-employed individuals with too much power to control their employment tax liability. These problems tend to occur when the self-employed individual engages in business through a business entity, rather than as a sole proprietor.

When someone works for himself as a sole proprietor, he must pay an employment tax on his entire earnings except for certain forms of passive income.[199] The tax itself is imposed under the Self-Employment

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197 Courts have determined that a corporation is entitled to deduct, in the year of payment, amounts that are intended to compensate an individual for services rendered in past years. *See, e.g.*, Aries Comm'ns, Inc. & Subsidiaries v. Comm'r, 105 T.C.M (CCH) 1585 (2013) (considering payments made to a chief financial officer who was also the corporation's sole shareholder).

198 *See* Winchester, *supra* note 19, at 285–88 (suggesting the SECA tax should apply to certain shareholders in closely held corporations).

199 The tax does not apply to rentals from real estate in certain cases, dividends and interest, and gains from the sale of a capital asset or from timber, certain minerals, or other property that is neither inventory nor property held primarily for sale to customers. I.R.C. § 1402(a)(1)–(3) (2006).

Contributions Act, or SECA, which is a corollary to the FICA tax that applies when someone works for a corporation.[200] There is nothing a sole proprietor can do to avoid this tax short of refusing to report his income. However, the tax base could be manipulated if that individual operated the business through a formal business entity.[201]

This Article has focused on the extent to which an individual can help himself to a payroll tax holiday when he works for a C corporation that he also controls. This Article has also described how individuals have been helping themselves to a payroll tax holiday when they work for an S corporation that they control.[202] However, a business structured as a partnership or limited liability company also offers opportunities for an employee-owner to control his employment tax liability.

The SECA tax will apply if a business is organized as a partnership.[203] However, the partner's tax base will depend on whether the partner is a general partner or a limited partner. If a partner is a general partner, the self-employment tax will apply to the partner's entire share of the firm's income.[204] The tax will also apply to any guaranteed payment the partner receives, whether for the use of capital or for the performance of services.[205] For a limited partner, the self-

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200 *Id*. §§ 1401–03.

201 This is not to suggest that the law accurately defines the employment tax base for a sole proprietor. There is evidence to suggest that the employment tax base for at least some sole proprietors is overstated because the tax applies to earnings that are more properly classified as income from capital, not labor. *See* Nicholas Bull & Paul Burnham, *Taxation of Capital and Labor: The Diverse Landscape by Entity Type*, 61 NAT'L TAX J. 397, 414 tbl.9, 415 (2008) (concluding that over 22% of the average sole proprietor's income that is subject to employment tax is actually income from capital). A more recent study of the SECA tax system generally concluded that the rules both substantially overstate and understate an individual's income from labor. CONG. BUDGET OFFICE, PUB. NO. 4168, THE TAXATION OF CAPITAL AND LABOR THROUGH THE SELF-EMPLOYMENT TAX, at v (2012). The study focused specifically on the HI component of the SECA tax base and found that labor income accounted for 58% of the tax base and income from capital accounted for the rest. *Id*. at v, vi fig.1.

202 *See* text accompanying notes 175–77.

203 I.R.C. § 1402(a).

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

205 Treas. Reg. § 1.1402(a)-1(b) (as amended in 1974). The regulation predates a 1977 amendment that redefined what counts as self-employment income to a partner. Social Security Amendments of 1977, Pub. L. No. 95-216, § 313(b), 91 Stat. 1509, 1536. The relevant provision of the statute was originally added as paragraph 12. *Id.* However, subsequent legislation redesignated paragraph 12 as paragraph 13. Social Security Amendments of 1983, Pub. L. No. 98-21, § 124(c)(2), 97 Stat. 65, 90. The change only

employment tax applies only to the guaranteed payments received for the performance of services; it does not apply to the partner's share of the firm's income.[206]

There are no provisions in the self-employment tax statute or regulations that specify what distinguishes a limited partner from a general partner for purposes of the statute.[207] Thus, under current law, a partner's exposure for the self-employment tax is purely a matter of the type of interest he owns in the partnership.[208] As a result, someone who is a general partner in a partnership can limit his employment tax exposure by holding the lion's share of his investment as a limited partnership interest. If a partner owns both a general partnership interest and a limited partnership interest, the self-employment tax applies only to that portion of the partner's distributive share associated with the general partnership interest.[209] Thus, a token interest as a general partner combined with a much larger interest as a limited partner will cause the employment tax to apply only to the token amount of partnership profits associated with the general interest. A sole proprietor enjoys no such flexibility.

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affected what counts as self-employment income to a limited partner. *Id*. The legislative history does not elaborate on the intended scope of the change. *See* H.R. REP. NO. 95-702, at 84 (1977), *reprinted in* 1977 U.S.C.C.A.N. 4155, 4241. Thus, it appears that general partners remain subject to employment tax on guaranteed payments received both for services performed and for the use of capital.

206 I.R.C. § 1402(a)(13).

207 However, there are proposed regulations which would consider the degree to which a limited partner participates in the operations of the partnership. Prop. Treas. Reg. § 1.1402(a)-2(h)(2), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997). Congress acted in 1997 to prohibit the IRS from finalizing these regulations and imposed a one year moratorium on the agency's authority to issue regulations addressing this question. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788, 882. By contrast, under the Uniform Limited Partnership Act, a limited partner is a partner who is not liable for the debts and obligations of the partnership, even if the limited partner participates in the management and control of the partnership. UNIF. LTD. P'SHIP ACT § 303 (2001).

208 One might expect that amounts received by a partner in exchange for the performance of services would count as wages from employment for FICA purposes. However, the legislative history indicates that Congress determined it would not be appropriate to treat the partnership as a separate taxpaying unit (as opposed to an extension of the partner) in certain situations. *See* H.R. REP. NO. 2543, at 59 (1954) (Conf. Rep.) ("No inference is intended . . . that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions."). In addition, the IRS long ago concluded that it is inappropriate to treat a partnership as an employer of one of its members. Rev. Rul. 69-184, 1969-1 C.B. 256. As a result, payments that are considered to be made by the partnership to a partner, who is not acting in his capacity as a partner, will not count as wages that are subject to the FICA tax. *Id*. Instead, the amounts are treated as self-employment income to the partner. *Id*.

209 Prop. Treas. Reg. § 1.1402(a)-2(g), 62 Fed. Reg. 1702, 1704 (Jan. 13, 1997).

A limited liability company can offer an employee-owner even more flexibility if the company has more than one owner.[210] A multi-member limited liability company is generally classified as a partnership for federal tax purposes.[211] As a result, any member of the company will be viewed as a partner for tax purposes.[212] To determine a partner's SECA tax bill, one must know whether the partner is a limited partner or a general partner in the firm. However, limited liability company statutes do not draw distinctions between members in any way that corresponds to the classifications employed by SECA.[213]

One could assert a reasoned basis for treating a limited liability company member as equivalent to either a general partner or a limited partner for employment tax purposes. For example, it would seem appropriate to treat a member as equivalent to a general partner since all members are in a position to participate in the operations of the company.[214] On the other hand, one could argue that the limited partnership rules should apply on the grounds that a member enjoys

210 If a limited liability company has only one member, the firm will be disregarded for tax purposes and the owner will be treated the same as if he were a sole proprietor. Treas. Reg. § 301.7701-2(a) (2013). However, a single member limited liability company can elect to be classified as a C corporation for tax purposes. *Id.* § 301.7701-3(a). A single member limited liability company can also make an additional election to be treated as an S corporation, assuming it is eligible to do so. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 137035-07 (May 2, 2008) (allowing a limited liability company to make both elections even though the deadline for doing so had expired). The regulations also permit an S election to take effect even when a limited liability company does not also separately elect to be treated as a C corporation. Treas. Reg. § 301.7701-3(c)(1)(v)(C).

211 Treas. Reg. § 301.7701-3(b)(1)(i). However, the company has the option to elect to be classified as a C corporation. *Id.* § 301.7701-3(a). Moreover, the firm can also elect to be classified as an S corporation, assuming it is eligible to do so. *See supra* note 210 (explaining the options available to a single member limited liability company that would ordinarily be disregarded for tax purposes).

212 *See* I.R.C. § 7701(a)(2) (2006) (defining the terms "partnership" and "partner").

213 *See supra* text accompanying notes 203–06 (describing the differences in the tax base of a limited partner and the tax base of a general partner).

214 UNIF. LTD. LIAB. CO. ACT § 301(a)(1), (c) (1996). The employment tax was drafted to apply different rules to general and limited partners because at the time this distinction was drawn, a limited partner ran the risk of losing his limited liability if the partner participated in the management of the partnership's business. State laws have since evolved to where they now permit limited partners to participate in management without jeopardizing their limited liability for the debts and obligations of the business. *See* STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, 277–87 (Comm. Print 2001) (advocating updated references to general and limited partners throughout the Internal Revenue Code in light of the growth of limited liability companies that are treated as partnerships for federal tax purposes).

limited liability from the debts and obligations of the business, the hallmark of a limited partner's status as such.[215]

Understandably, the absence of a clear rule has been an invitation for some to contend that a member must comply with the rules that apply to limited partners since doing so works to their advantage.[216] This position minimizes the member's employment tax liability because the member is taxed solely on amounts received from the company in exchange for services the member performed for the company; no part of the member's allocation of business profits would be included in the employment tax base. A sole proprietor enjoys no such freedom to limit his employment tax bill.

Policymakers and scholars have long decried both (1) the defective ways the employment tax rules apply in the context of an S corporation, partnership, or limited liability company, and (2) the wide variation in the way the rules operate across the entire spectrum of business entities.[217] Moreover, tax advisors have long known that by strategically selecting and using a business entity, a self-employed individual can reduce or otherwise control his employment tax liability.[218]

There exists no shortage of ideas for reforming the nation's employment tax system.[219] The most commonly cited proposals for addressing the defects have correctly focused on eliminating the inconsistencies and ambiguities in the rules.[220] Indeed, it would be a huge step in the right direction if the system used a uniform rule to define the employment tax base of a self-employed person, regardless of the way the business might be classified for tax purposes.

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215 *See* UNIF. LTD. LIAB. CO. ACT § 303 (1996) (generally limiting the liability of a member for debts, obligations, or other liabilities of a limited liability company).

216 *See, e.g.*, Burgess J.W. Raby & William L. Raby, *New Incentive for Avoiding SE and FICA Tax*, 81 TAX NOTES 1389, 1389–90 (1998) (discussing how active members in a limited liability company can claim to be exempt from the self-employment tax).

217 *See* STAFF OF JOINT COMM. ON TAXATION, 107TH CONG., TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY 57–59 (Comm. Print 2008) (discussing proposals that alter the way federal employment tax rules apply to owners of S corporations, C corporations, and partnerships); Willard B. Taylor, *Payroll Taxes–Why Should We Care? What Should Be Done?*, 137 TAX NOTES 983, 986–88 (2012) (explaining that payroll taxes affect a business differently depending on the firm's tax classification).

218 *See supra* notes 186–87 and accompanying text (discussing the techniques used by tax advisors in the S corporation context).

219 *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 217, at 57–59 (describing proposals from 2005 and 2006); Taylor, *supra* note 217, at 993–94 (summarizing the recent legislative measures).

220 *See* Richard Winchester, *The Gap in the Employment Tax Gap*, 20 STAN. L. & POL'Y REV. 127, 147–48 (2009).

One of the more widely cited ideas was first proposed in 2005 by the staff of the Joint Committee on Taxation, a team of economists and lawyers who support the work of the tax writing committees in the Senate and the House of Representatives.[221] Under this proposal ("JCT Staff Proposal"), any partner in a partnership and any shareholder in an S corporation would generally have to pay self-employment tax on his share of the firm's profits that are earmarked for him.[222] These individuals would also have to pay self-employment tax on any compensation they receive for services rendered to the business.[223] However, a special rule would apply if the individual does not "materially participate" in the business.[224] In such a case, the tax would only apply to the "reasonable compensation" that the individual receives.[225]

The material participation standard is already used to determine whether an activity constitutes a "passive activity" with respect to a

221 STAFF OF JOINT COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 99–104 (2005).

222 *Id*. at 99–100.

223 *Id*.

224 *Id*.

225 *Id*. The material participation standard has been endorsed elsewhere as a way to determine whether a partner should be treated as a general partner for employment tax purposes. *See, e.g.*, THE PRESIDENT'S ECON. RECOVERY ADVISORY BD., THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE AND CORPORATE TAXATION 62 (2010); KIMBERLY S. BLANCHARD & ANDREW KREISBERG, N. Y. STATE BAR ASS'N TAX SECTION, COMMENTS ON JCT RECOMMENDATION RELATING TO EMPLOYMENT AND SELF-EMPLOYMENT TAXES OF PARTNERS, LLC MEMBERS AND S CORPORATION SHAREHOLDERS 4 (2005). This approach also seems to be consistent with, but not identical to, the approach that the U.S. Tax Court took in a recent case. In *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), the court held that the interests of partners in a law firm structured as a limited liability partnership were not limited partnership interests exempt from the self-employment tax. 136 T.C. 137, 150 (2011). In reaching this conclusion, the court focused on the partners' actual participation in the business operations of the firm, observing that all but a nominal amount of the firm's income was generated by that activity. *Id*. However, the decision left unanswered many other questions that only Congress can address. *See* Sheldon I. Banoff, Renkemeyer *Compounds the Confusion in Characterizing Limited and General Partners–Part 2*, 116 J. TAX'N 300, 302–15 (2012) (indicating that *Renkemeyer* creates confusion about how employment tax rules apply to unincorporated entities). Interestingly, Congress also adopted the material participation standard to determine when the new 3.8% HI surtax will apply to certain forms of passive income. *See* I.R.C. § 1411(a)(1) (Supp. 2011). The tax base includes items of income derived from a trade or business that is a passive activity within the meaning of Section 469. *Id*. § 1411(c)(2)(A). A business activity is passive if the individual does not materially participate in the activity. I.R.C. § 469(c)(1)(B) (2006). Thus, if an individual is a partner in a partnership, his interest is generally considered to be a passive investment if the partner does not materially participate in the business, and the new 3.8% HI surtax would apply to the partner's share of the firm's income.

taxpayer.[226] In addition, the standard's contours are well developed in a set of regulations.[227] As a result, it is well understood by taxpayers and their advisors. By employing the material participation standard in its employment tax proposal, the JCT Staff Proposal is invoking the mechanical tests in those regulations.

Under the JCT Staff Proposal, certain kinds of income are exempt from the employment tax.[228] These items are identical to the items of passive income that are not subject to the tax when derived by a sole proprietor.[229] However, one exception exists: no income is excluded from the employment tax base if the activities of the business involve "the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting."[230]

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226 I.R.C. § 469(c)(1)(B) (2006). When an individual is engaged in a passive activity that individual is subject to certain restrictions on his ability to deduct the losses generated by that activity. *Id.* § 469(a)(1).

227 An individual materially participates in an activity if either (1) he participates in the activity for more than 500 hours during the year, (2) his participation constitutes substantially all of the participation in such activity of all individuals during the year, (3) his participation involves more than 100 hours during the year and is not less than the participation of any other individual, or (4) his aggregate participation in significant participation activities exceeds 500 hours for the year. Treas. Reg. § 1.469-5T(a)(1)–(4), (c) (2013). In addition, there are two situations in which material participation in prior years constitutes material participation in the current year. One such situation arises when the individual met the material participation test in five of the past ten years. *Id.* § 1.469-5T(a)(5). The second situation arises when the activity consists of providing a personal service and the individual satisfied the material participation test in any three prior years. *Id.* § 1.469-5T(a)(6). Only three of these six tests are used to determine whether a limited partner satisfies the material participation standard. *See id.* § 1.469-5T(e)(1), (2). Under current rules, an individual is considered to be a limited partner if (1) his interest in the partnership is designated as such; or (2) if his liability for the obligations of the partnership is limited. *Id.* § 1.469-5T(e)(3). In 2011, the Treasury Department proposed certain amendments that redefined the term limited partner for purposes of applying the material participation standard. *See* Prop. Treas. Reg. § 1.469-5, 76 Fed. Reg. 72875, 72877 (Nov. 28. 2011). Under the proposed rules, an individual is treated as a limited partner only if that person has no rights to manage the entity at all times during the entity's tax year. *Id.* § 1.469-5(e)(3)(i)(B). At least one scholar generally believes this new rule has merit, largely because it follows the approach adopted in a series of court cases. Donald Williamson, *Material Participation Standards for Small Business LLCs*, 136 TAX NOTES 588, 590 (2012). That scholar also thinks the same approach should be observed for determining whether partners or limited liability company members should be subject to self-employment tax. *Id.* at 593.

228 *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 221, at 57 (excluding rental income, dividends and interest, and certain gains).

229 *See* I.R.C. § 1402(a) (listing the items that are excluded from the base of the FICA tax base).

230 STAFF OF JOINT COMM. ON TAXATION, *supra* note 221, at 57. This list is borrowed from the one that appears in I.R.C. § 448(d)(2)(A).

The JCT Staff Proposal comes about as close as possible to eliminating any opportunity for understating employment tax liability when an individual owns and works for a business entity other than a C corporation. However, because the proposal does not reach individuals who work for C corporations that they own, the JCT Staff Proposal leaves in place the opportunities to avoid the employment tax described in this Article. Those opportunities are particularly relevant in the current environment where (1) the C corporation may be growing in popularity; and (2) the permanent dividend tax cut makes it financially advantageous to substitute a dividend for a salary in a wide range of cases. A more effective and complete proposal for reforming the employment tax system would cover those cases too.

The cases that present the greatest concern are those where the employee exercises control over the corporation that employs him. As a general proposition, this kind of control is most likely to exist when ownership of the firm is concentrated in the hands of a small number of individuals, the hallmark of a closely held corporation.[231] There are already a number of occasions when the Internal Revenue Code suspends the rules that would ordinarily apply to a corporation because the corporation is closely held. These special rules are frequently triggered when five or fewer persons own over 50% of the corporation's stock for the last six months of the year.[232]

Thus, if a corporation meets this "five or fewer" test and also derives passive income that exceeds a certain threshold, the corporation qualifies

231 *See* Lee, *supra* note 157, at 907–08 (describing how closely held corporations are often used to secure tax advantages that are not available to other business entities).

232 *See* I.R.C. § 542(a)(2) (describing the personal holding company rules). This test is incorporated in the tax code's at-risk rules. *Id*. § 465(a)(1)(B) (cross referencing I.R.C. § 542(a)(2)). The test is also incorporated in the passive activity loss limitation rules. *Id*. § 469(j)(1) (cross referencing I.R.C. § 465(a)(1)(B)). A similar "five or fewer" standard is used to determine whether multiple corporations should be disregarded as separate and distinct taxable units. *See id.* § 1561(a) (imposing the corporate tax on a "controlled group of corporations"). Multiple corporations are taxed as one unit when five or fewer persons own over half of the vote or value of each corporation. *Id.* § 1563(a)(2). A variation of the "five or fewer" standard appears in the rules that apply in the international setting. For example, a corporation qualifies as a controlled foreign corporation if over 50% of its vote or value is owned by U.S. persons who own at least ten percent of the corporation's voting stock. *Id*. §§ 951(b), 957(a). In addition, the 2006 Model Tax Treaty limits the benefits of the treaty to certain eligible individuals and entities. *See* UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, art. 22 (2006) (allowing only certain "qualified person[s]" to be eligible for the tax relief available under the treaty). In certain cases, a subsidiary of a publicly traded company will be eligible for treaty benefits if at least 50% of the corporation's vote or value is owned by publicly traded corporations that are entitled to treaty benefits. *Id*. art. 22(2)(c)(ii).

as a personal holding company.[233] As such, it must pay a 15% penalty tax on any amounts that it did not distribute to shareholders.[234] The rule acknowledges the potential for individuals to improperly use the corporate form—and the relatively low rates of tax that apply to it—to accumulate and shelter investment income from the higher rates of tax that would otherwise apply if the shareholders owned the investment assets directly.[235] Other rules simply consider a closely held corporation as the equivalent of an individual and treat it as such. Thus, when a corporation is closely held under the "five or fewer" test, its ability to deduct losses is limited to the same extent as if it were an individual.[236] Along the same lines, when the "five or fewer" test is met, the corporation's ability to deduct losses from passive activities is limited to the same extent as if the corporation were an individual.[237]

Thus, the Internal Revenue Code already acknowledges that it is sometimes appropriate to subject a corporation to special rules when the corporation is closely held. Some rules even go so far as to treat a closely held corporation as equivalent to an individual.[238] This Article has shown that an individual can abuse the corporate form to improperly reduce their employment tax liability when the individual works for the firm and is in a position to control it. If the tax law went so far as to treat such a corporation as equivalent to an individual, the employee-shareholders might be subject to employment tax on their entire share of the corporation's profits in all cases.[239] However, that might be going too far.

A far less radical idea would be to extend the uniform rule that appears in the JCT Staff Proposal to any employee-shareholder of a C

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233 I.R.C. § 542(a).

234 *Id.* § 541.

235 The Internal Revenue Code contains a wide range of provisions directed at combatting attempts by taxpayers to abuse the corporate form. *See* Winchester, *supra* note 19, at 289–94 (summarizing such rules). These opportunities to abuse the corporate tax form may pose ethical obligations for corporate counsel as well. *See* John Hasnas, *Between Scylla and Charybdis: Ethical Dilemmas of Corporate Counsel in the World of the Holder Memorandum*, 44 VAL. U. L. REV. 1199, 1211–15 (2010) (discussing ethical dilemmas faced by corporate counsel in situations where the corporation attempts to avoid federal taxes); *see also* Colin P. Marks, *Jiminy Cricket for the Corporation: Understanding the Corporate "Conscience,"* 42 VAL. U. L. REV. 1129, 1144–51 (2008) (discussing the notion of the corporate conscience).

236 I.R.C. § 465(a)(1). The taxpayer's deductions for losses are allowed only to the extent the taxpayer is at risk.

237 *Id.* § 469(a)(2)(A), (B). The deduction is generally allowed only to the extent the corporation has income from passive activities. *Id.* § 469(a)(1), (d).

238 *See supra* text accompanying notes 236–37.

239 This is generally the way a sole proprietor is taxed. *See* I.R.C. § 1402(a) (taxing a sole proprietor on all business income other than certain items of passive income).

corporation that passes the "five or fewer" test. In such a case, the employee-shareholder would be subject to the SECA tax on his share of the corporation's taxable income other than the items of passive income that are currently not subject to tax, including interest, dividends, and rent. The taxes would also apply to any amounts paid to the employee-shareholder for services rendered to the business. However, if the employee-shareholder does not materially participate in the business, only amounts paid to him as reasonable compensation would be subject to the taxes. Because SECA would apply to these cases, FUTA tax would no longer be in play. While not perfect, this approach would establish near complete parity in the way the employment tax rules operate, regardless of the legal entity through which an individual conducts a business.

VI. CONCLUSION

The existence of tax reduction opportunities jeopardizes the integrity of the employment tax base.[240] However, perhaps more importantly, it undermines the system's ability to operate in a fair and equitable way. Individuals who are in materially similar situations will pay vastly different amounts in tax solely because the law does not use a uniform rule to define the tax base. That outcome alone offends basic notions of equity. However, it is also difficult, if not impossible, for the interests of equity and fairness to be served when the system permits an individual to control how much tax he pays. Sadly, that is how the employment tax system operates for many self-employed individuals, and the legislation signed by President Obama did nothing to improve matters. Quite the opposite, the legislation made this situation worse because it made permanent an entirely new employment tax dodge that was scheduled to disappear by the middle of President Obama's first term.

Further, because this new tax dodge favors the rich over individuals in the middle and lower tax brackets, it operates at cross purposes to the President's stated goals of making the tax system more progressive so that the cost of government is distributed more fairly among taxpayers of different income levels. The President consistently proposed increasing the tax rates on high-income individuals from the levels in

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240 By one estimate, the government could collect between $50 billion and $60 billion over ten years if the SECA tax applied uniformly across all partnerships and S corporations. THE PRESIDENT'S ECON. RECOVERY ADVISORY BD., *supra* note 225, at 62; *see* Winchester, *supra* note 220, at 142–43 (2009) (estimating the additional revenue that the government could collect if SECA applied to employee-shareholders of closely held C corporations).

place when he took office.[241] In addition, President Obama was the driving force behind the health insurance reform legislation that included an array of new taxes on the rich.[242] Given the President's consistent efforts to rebalance the tax system in favor of the middle and lower classes, it is ironic—to say the least—that the President ultimately signed legislation that in some ways achieves the opposite result.

The nation's employment tax system is long overdue for reform so that the rules apply in a uniform way to individuals who work for themselves. Until this year, the President had not advocated any measures in this regard.[243] However, his most recent budget contains a relatively narrow proposal to apply uniform rules to individuals who operate a professional service or business through a limited liability company, an S Corporation, or a state law partnership.[244] By contrast, the JCT Staff Proposal applies to the owners of any business operated in those business forms, not just the professional service firms.[245] Because the President's plan reaches a far fewer range of cases, it will not be as effective in restoring a measure of equity to the way the rules apply to self-employed individuals. However, because neither plan applies to

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241 *E.g.*, DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2011 REVENUE PROPOSALS 127–28 (2010) (proposing the reinstatement of the 39.6% and 36% tax rates for high-income taxpayers). The proposed budget also proposed: (1) reinstating the limitation on itemized deductions for high-income taxpayers; (2) reinstating the personal exemption phase-out for high-income taxpayers; (3) reducing the tax savings that high-income individuals would otherwise enjoy from claiming itemized deductions; and (4) increasing the tax on capital gains and qualified dividends received by high-income individuals. *Id.* at 129–33. In each case, the administration defined a high-income taxpayer as either a married couple with over $250,000 of income (indexed for inflation from 2009) or an unmarried individual with over $200,000 of income (indexed for inflation from 2009). *Id.*

242 Specifically, the legislation adopting Obamacare includes a new 0.9% Medicare surtax on a portion of the earned income of high-income taxpayers. I.R.C. § 3101(b)(2), *amended by* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, §§ 9015(a), 10906(a), 124 Stat. 119, 870–71, 1020 (2010); *id.* § 1401(b)(2)(A), *amended by* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, §§ 9015(b), 10906(b), 124 Stat. at 871–72, 1020 (2010). The tax applies to married couples with over $250,000 in income and unmarried individuals with over $200,000 in income. *Id.* §§ 3101(b)(2)(A), (C), 1401(b)(2)(A)(i), (iii). A separate piece of legislation imposes a 3.8% Medicare surtax on the investment income of high-income taxpayers. *Id.* § 1411(a)(1) (Supp. 2011), *added by* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1402(a), 124 Stat. 1029, 1060–63. The tax applies to the portion of a married couple's earned income in excess of $250,000, and to the portion of an unmarried individual's earned income in excess of $200,000. *Id.* § 1411(b).

243 *See, e.g.*, DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS (2013).

244 DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS 184–86 (2014).

245 *See supra* text accompanying notes 221–30 (explaining the application of the JCT Staff Proposal).

cases where a self-employed individual operates through a corporation, both fall short of offering the kind of comprehensive rule that will entirely eliminate the inequities that plague the system.

It is a good sign that the President now wants to address the defects in the employment tax rules. However, his plan leaves much to be desired. Because it is less ambitious than it could or should be, it will not address the full range of dysfunctions that prevent the system from operating in an equitable way. In fact, it leaves in place the one defect that seems to favor the rich over everyone else. Therefore, if he succeeds in getting this measure enacted, one could view it as yet another gift to the very people who voted for his opponent in larger numbers than they did for him.