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If taxpayers want to do away with the annuity function and emphasize the welfare function, they must be prepared to receive a small pension if they have been frugal and otherwise provided for their retirement. Richer people would pay into the plan and receive no benefits. It is doubtful that most working middle-class people would accept such a plan. It might result in a national phobia of "live fast, love hard and spend everything because social security will pay only if you are broke."

Another possibility is to ignore the welfare function and compensate with a negative income tax. With the passage of the low-income credit last year this approach may be the one Congress decides upon.

One rather elaborate suggestion[10] is to pair young workers, say, age 20, with retired people on a one-to-one basis. The young worker would pay in for the retired worker until the latter's death, then the young worker could continue paying into an annuity for her-or himself. With an estimated thirty to thirty-five years left to pay in, the young worker would have time to build a nice pension. After two or three generations, all workers would be on an annuity basis, and the whole problem of what to do with the welfare function would presumably disappear.

Another possibility is to determine statistically at what age a straight pension would be more beneficial for workers and drop those under that age from social security coverage and require them to pay an equal amount into a private pension plan of their choice, rather like the existing IRA, for their working lives. They would lose all they've paid in to social security but would have a guaranteed pension, or lump-sum payment, at age sixty-five. The people over this statistically determined age would receive social security benefits under today's schedule. The huge amounts needed to fund the older workers would have to be raised with a massive, very long-term government debt to be paid off out of general revenues over the next one or two hundred years. This prohibitive cost could be met only over the long term. But if it is not done the long term does not hold much future for anybody, including workers and retirees and especially for women.

Small Business

To Incorporate Or Not To Incorporate

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The 1976 Tax Reform Act provides for the continuation of reduction in corporate tax rates and increase in corporate surtax exemption. This brings up the question once again whether it is advisable for the small business to be incorporated or to continue operating as a single proprietorship or a partnership.

Prior to the Tax Reduction Act of 1975, corporate income was subject to 22 percent normal tax on the first $25,000 of net income and to 22 percent normal tax plus 26 percent surtax on net income exceeding $25,000, for a total of 48 percent on income over $25,000.

The Tax Reduction Act of 1975 increased the corporate surtax exemption from $25,000 to $50,000 and reduced the normal tax to 20 percent on the first $25,000 of taxable income. This resulted in a 20 percent rate of tax on the initial $25,000 of taxable income, a 22 percent rate on the next $25,000 of taxable income and a 48 percent rate on taxable income in excess of $50,000. These tax reductions applied for 1975 and were extended for the first six months of 1976 by the Revenue Adjustment Act of 1975.

The 1976 Tax Reform Act extends the 20 percent corporate tax rate on the first $25,000 of taxable income and the $50,000 corporate surtax exemption through December 31, 1977.

Thus, in 1976 and 1977 and possibly in future years, if the reduction is extended again a corporation with yearly taxable income of $50,000 pays federal income tax of $10,500 per year. A married couple with $50,000 of taxable income pays Federal income tax of $17,060 less a personal exemption credit which is, at this income level, the greater of $35 per capita or $180. It must be mentioned that a corporation is not allowed to reduce its income by personal exemptions and itemized or standard deductions, nor is it allowed a personal exemption credit Nevertheless, the difference in tax is sizeable, and it would seem that if an individually owned business nets upward of, say, $35,000 per year, incorportaiton shoould at least be considered.

Other advantages of the corporate form of business are of longer standing than the reduction of the tax rate, but

they should also be remembered in the decision making process.

Pension and profit sharing plan legislation has long favored the corporation over the proprietorship or partnership. ERISA has made some changes in favor of the non-corporate business owner, as far as the allowable amounts of contributions to a profit sharing or pension plan are concerned. But the vesting provisions for Keogh Plans are still as harsh as they ever were. Immediate 100 percent vesting is required, while in corporate plans full vesting sometimes does not take palce for fifteen years. This, of course, gives the corporate employee a strong incentive to stay with the employer who has made contributions for him or her, while the employee of an individual proprietor who pays contributions to a Keogh Plan has no such incentive. For individual proprietors with more than one or two employees, Keogh Plans become very expensive without the benefit of retaining valuable employees who want to protect their pension plan investments. These employees can take their fund with them in full one day after it was contributed for their benefit. In addition, they can take advantage of rollover provisions and thereby escape immediate tax consequences.

There are also fringe benefits for corporations which are not available to individual proprietors or partnerships. The cost of group-term life insurance for corporate employees is deductible to the corporation. The employee is not taxed on group-term life insurance coverage up to $50,000 (Section 79, IRS Code).

Under Section 162, a corporate employer can take a business deduction for amounts paid or accrued under an employee medical expense plan or under an employee sickness, accident, or hospitalization plan, and the premiums paid are not taxable income to the employee. In a partnership or proprietorship only the premiums paid for common-law employees are deductible business expenses. Owners or partners can deduct one-half of their health insurance and possibly more on their individual income tax return if they itemize their deductions.

Deferment of tax is sometimes the result of an incorporation in the middle of a calendar year. When a business is being incorporated on, say, October 1, 1976, the tax on the income for the last three months of 1976 is deferred to 1977 except for the tax on the officers' salaries.

Among the non-tax advantages of operating as a corporation, the limited liability of the stockholders comes to mind. However, in a closely held corporation, this advantage is usually all but eliminated by the personal guarantee required of the stockholder by the creditors when corporate loans are negotiated.

We would do the client who is considering incorporation a disservice if we did not point out the disadvantages. First, there is the cost. Legal and accounting services required to make a changeover can cost between $500 and $1,000.

Corporate losses (unless the business is operated as a sub-chapter S corporation), cannot be deducted from the stockholder's other income to arrive at taxable income. These losses are available for carrybacks and carryovers only.

The owner of a business who has been operating as a single proprietor for some time, will often find it difficult to make the transition from individual owner to corporate officer and stockholder. Officers' salaries will have to be determined in meetings with other corporate officials. Records have to be maintained on these meetings. It will no longer be acceptable to dip into the petty cash fund and call it a "draw," or to write a business check for personal expenditures, such as vacations or a down payment on the family car. The corporation is a much more sophisticated form of business than a proprietorship or even a partnership, and the former proprietor turned stockholder often cannot get used to the idea that the person and the corporation are two separate legal entities.

There is also the problem of double taxation. Once a business is incorporated, the assets belong to the corporation, not the stockholder. If an asset is sold at a gain, the corporation pays income tax on the gain. When the money is distributed to the stockholder by way of a dividend, he or she pays income tax on the distribution. When a corporation is liquidated, there is the danger of double taxation even though this can often be minimized or even eliminated by liquidating under Section 333 (one-month liquidation) or Section 337 (twelve-month liquidation). These IRS Code sections contain relief provisions for corporate liquidations.

Considering and weighing the advantages and disadvantages of incorporation for the small business, it may be predicted the successful owner of a business, after seeking the advice of a capable accountant, an equally capable attorney and a conscientious and knowledgeable insurance advisor, may well find that there will be after-tax dollars along the corporate route. But he or she must be aware that running the business "by the seat of one's pants" is OUT and "playing it by the rules of the book" is IN if the corporate form of business is to be successful.

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