Subchapter S: Vivé le Difference

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Presentation Outline

• Why subchapter S?
  – Politicians want to help “small businesses”
    • Why?
  – Does subchapter S help small businesses?
• Statistics – S corps still popular
  – Returns filed by entity type
  – S corps are generally “small”

• Comparing taxation of S corps and LLCs
• Reviewing the arguments for repeal
  – Having two passthrough regimes is “inefficient”
  – Plain vanilla LLCs are just as simple as S corps
  – The danger of choice vs. the value of choice

• Conclusion
  – Taxpayers should have choice
What’s good for small business?

S Corps

Small is beautiful

LLCs
And third, there have been off and on discussions about moving to a more uniform business tax environment. According to traditional economic theories of taxation there is no reason why otherwise identical businesses should be taxed differently. According to the same theories, when such differences do exist, the result is an inefficient allocation of resources, which occurs at the expense of stronger economic performance. The current tax disparity could be reduced via two general approaches. First, the corporate and individual tax systems could be combined or "integrated" so that corporations were treated similar to pass-throughs. Second, pass-throughs could be subjected to the corporate tax.

It is perhaps useful to briefly quantify the business landscape across the various business forms before proceeding. Figure 1 displays the distribution of business tax returns filed in tax year 2009. The Internal Revenue Service (IRS) reports that there were approximately 29.5 million corporate and pass-through tax returns filed. The majority (67%) were sole proprietorships. The source for Figure 1 is the Internal Revenue Service, Business Tax Statistics, http://www.irs.gov/uac/Tax-Stats-2.


A Brief Overview of Business Types and Their Tax Treatment

Congressional Research Service

The most noticeable trend has been the decline in the share of income generated by C corporations. At the same time, the shares generated by S corporations and partnerships have trended upward. LLCs have also slowly increased their share of business income since 1993, when LLCs first appeared as an option on the partnership tax form.

C Corporations

A popular business structure is the corporate form, of which there are two types; C corporations, which are discussed in this section, and S corporations, which are discussed later. C corporations, also known as ordinary corporations, are named for Subchapter C of the Internal Revenue Code (IRC), which details their tax treatment. Businesses incorporate under state law and the exact requirements for incorporation may vary from state to state. Typically, a business must first file articles of incorporation at the state level in order to incorporate.

Figure 3.—The Number of Small, Medium, and Large Business Entities by Type of Legal Entity, 1993, 1998, 2003, and 2008

Source: Joint Committee on Taxation calculations on SOI data.
Two Passthrough Regimes

Subchapter S

- Limits on ownership
  - 100 maximum shareholders
  - Family members count as one shareholder
  - Individuals, estates, certain trusts and certain non-profit entities
    - No non-resident aliens
    - No corporations
  - Only one class of stock allowed
- Inflexible tax allocations
  - Per share, per day rule
  - Loss allocations limited to basis in stock and debt
- Subchapter C rules apply
  - Contributions
    - § 351 applies
  - Distributions of property
    - § 311 applies
- Transfer of ownership interests
- Employment taxes

Subchapter K

- No limits on ownership
  - Number of owners
  - Category of owners
  - Classes of equity interests
- Flexible tax allocations
  - Subject to “substantial economic effect” test
  - Loss allocations limited to basis, which includes share of partnership liabilities
- Contributions and distributions
  - No control test for tax-free contributions
  - Pre-contribution gain or loss allocated to contributing partner
  - Distributions “generally” not taxed
- Transfer of ownership interests
- Employment taxes

Transfer of ownership interests
- Employment taxes
Is choice inefficient? Is efficiency more important than freedom?

More choice? A better choice?
Can an entity taxed as a partnership be “plain vanilla?”

- Tracking of pre-contribution gain and loss
- Mixing bowl transactions
- Hot asset rules
- Allocations of recourse and non-recourse debt
Would limiting choice limit abuse?

• “The elective treatment of private firms under current law undermines both equity and efficiency objectives for the income tax.”
  — George Yin (1999)

• “There is a significant risk that the uniform system will produce an unhappy combination: rules still too complicated for the less sophisticated and too imprecise and manipulable for the more sophisticated.”
  — George Yin (2013)
Camp Option 2

- Eligible entities: all except
  - Publicly traded
  - Banks
  - Insurance companies
  - DISCs
- No limits on number or class of equity interests
- No ownership eligibility requirements
- Tax allocations “consistent with economic interest”

- Losses limited to owner’s basis (not clear on how entity level debt factors in)
- Contributions
  - No control requirement
- Distributions
  - Gain must be recognized on distribution of appreciated property
  - Pre-contribution gain or loss allocated to contributing partner

- Transfers of equity interests
  - Hot asset rules apply
Conclusion

Á chacun son goût

Recommendations

• Keep subchapter S
  – Simplicity advantages
    • Per share, per day allocation
    • No need to track assets

• Changes
  – Include entity level debt in owner’s basis
  – Eliminate employment tax loophole
    • Either by repeal OR
    • By allowing LLC to use “reasonable compensation” as the base for employment tax

Will this help small businesses?

• Flow through tax treatment not a good proxy for small business
• Small businesses not necessarily “job creators”
• BUT
• Vast majority of S corporations have 3 or fewer shareholders
• Most S corporations are small in terms of asset value