Subchapter S: Vivé le Difference

Roberta Mann
University of Oregon
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Presentation Outline

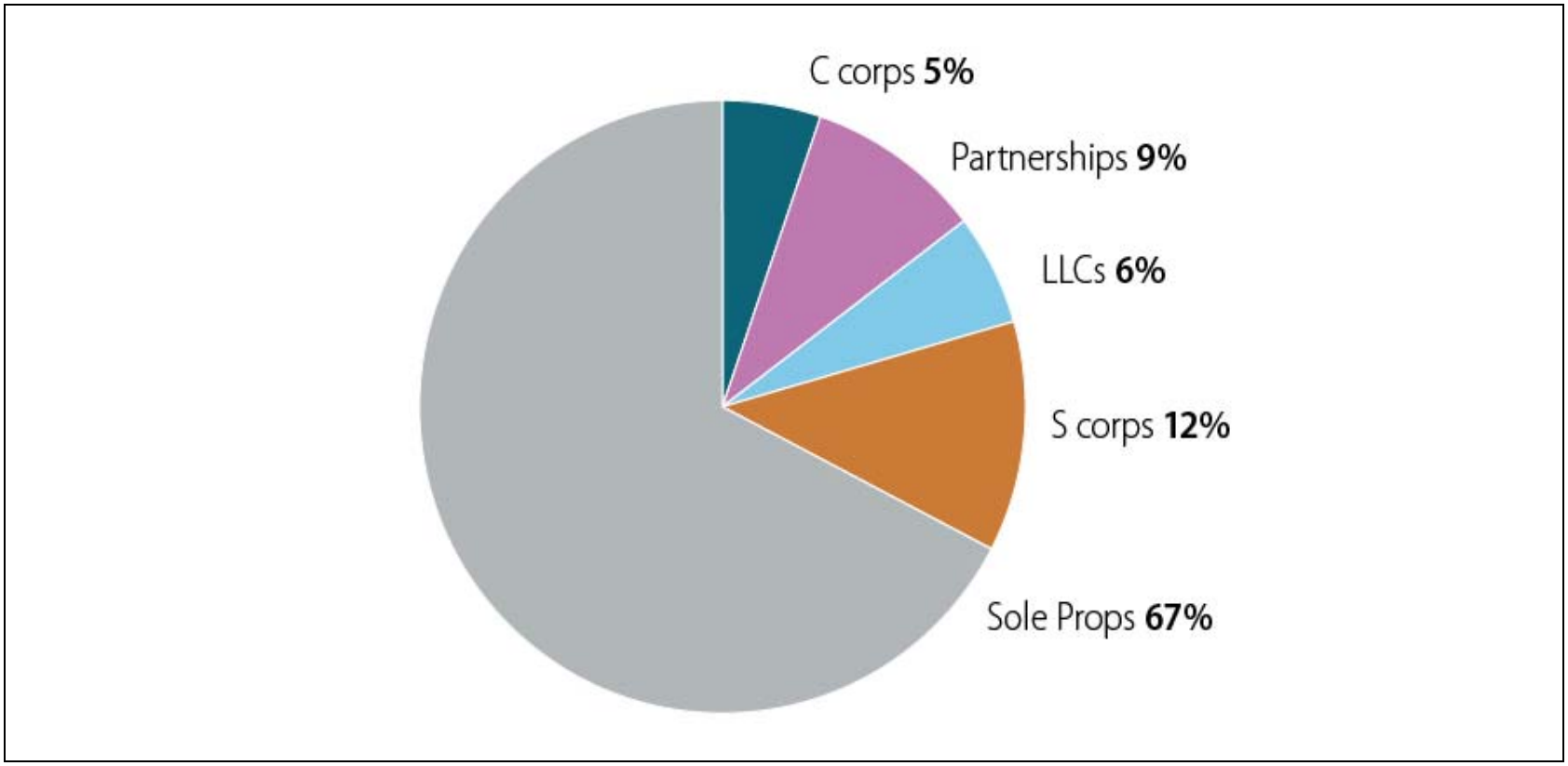
- Why subchapter S?
  - Politicians want to help "small businesses"
    - Why?
  - Does subchapter S help small businesses?
- Statistics – S corps still popular
  - Returns filed by entity type
  - S corps are generally "small"
- Comparing taxation of S corps and LLCs
- Reviewing the arguments for repeal
  - 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

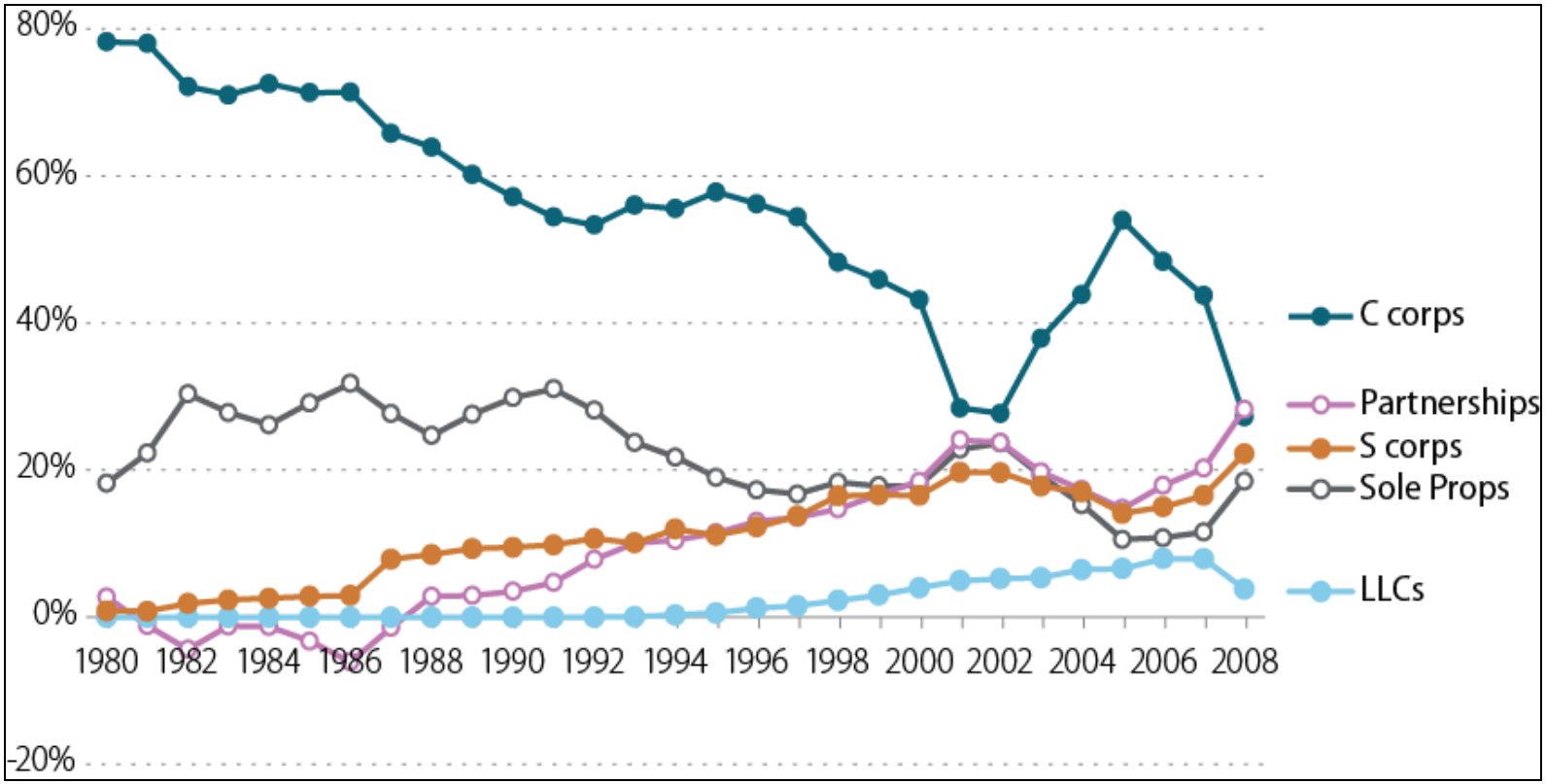
LLCs

Figure 1. Distribution of Business Tax Returns Filed in 2009



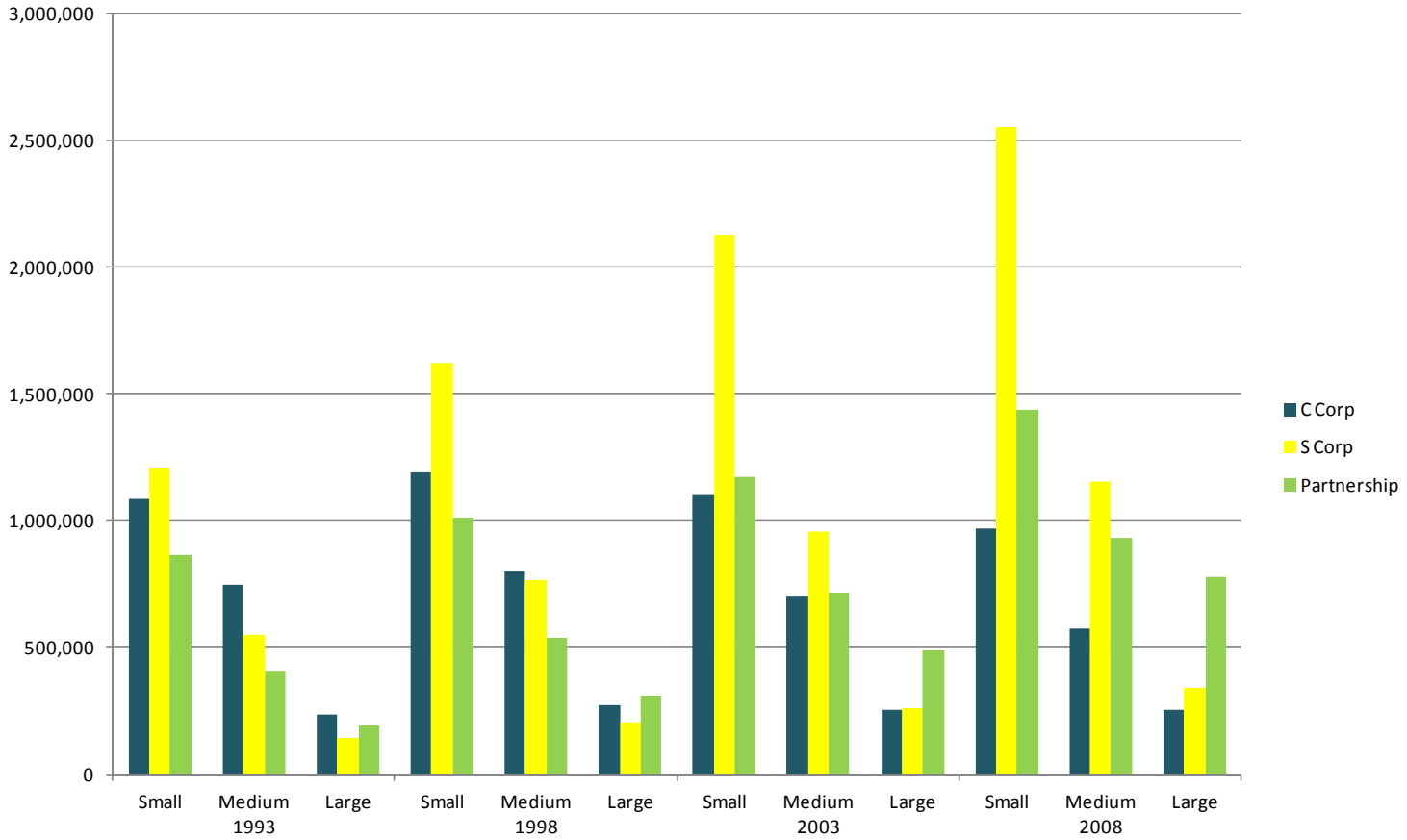
Source: CRS Analysis of Internal Revenue Service, Business Tax Statistics, http://www.irs.gov/uac/Tax-Stats-2.

Figure 2. Net Business Income By Business Type, 1980-2008



Source: CRS analysis of Internal Revenue Service, Statistics of Income, Integrated Business Data, http://www.irs.gov/pub/irs-soi/80ot1all.xls.

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



For this purpose, small businesses are those with less than $100,000 in assets; medium businesses have between $100,000 and $1 million in assets; and, large businesses have more than $1 million in assets.

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

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