Business Entities and Small Business Tax Reform

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Executive Summary

One of the most important decisions that a business faces is choosing its legal organizational form. There are many organizational forms that a business may choose, including pass-through entities. “Pass-through” means that the entity serves as a conduit through which the profits of the business pass through to the investors’ tax returns, escaping taxation at the entity level. Pass-through entities include: sole proprietorships, partnerships, limited liability partnerships (LLPs), S corporations, and limited liability companies (LLCs). Every pass-through entity has different requirements. The most popular pass-through for new companies is the LLC. Comparisons between the LLC and other entities are detailed below.

Another organizational form is a C corporation. The profits of a C corporation are taxed at the corporate level and then shareholders are taxed when they receive dividends. Only C corporations face “double taxation,” i.e., both entity and investor taxation, since pass-through entities are only taxed at the investor level.

To demonstrate the costs of double taxation in a C corporate form, assume a 35 percent corporate tax rate, a 15 percent dividend tax rate, and a 35 percent individual tax rate (the current maximum tax rates). If a C corporation earns one dollar of income, it pays 35 cents in taxes. If it pays the remaining 65 cents as a dividend, its shareholders are left with 55.25 cents [$1(1-0.35)(1-0.15)]. In contrast, if a privately-held firm adopts a pass-through entity, its investors are taxed on the entire one dollar, leaving its investors with 65 cents. No further tax is levied on the pass-through entity. This difference of 9.75 (65-55.25) cents in after-tax returns to investors provides a major tax incentive to avoid the C corporate organizational form. Even if the C corporation never pays dividends, fully avoiding the investor-level taxes, it still pays the same 35 cents of tax at the corporate level that the investors in the pass-through entity pay. Therefore, at best, the C corporate form yields the same after-tax outcome as the pass-through entities.

The pass-through entities further dominate C corporations if the business generates losses, as is common in the early years of a business. In the C corporation, the losses are carried forward until taxable income is generated, if ever. With a pass-through, the investors often can use the losses in the business to offset other income, such as wages, interest income, or dividends.

Only privately-held businesses, i.e., those whose interests are not easily transferable because of the lack of a secondary market, can choose a pass-through entity and avoid double taxation. As a result, privately-held businesses rarely opt for the C corporate form. Some older privately-held businesses may have begun operations as a C corporation, when pass-through options were limited. However, as pass-through options evolved over time, many of the C corporations restructured to avoid the entity tax.

In contrast to privately-held businesses, all publicly-traded businesses (including publicly traded partnerships) are required to use the C corporate form. Consequently, the additional taxes associated with the C corporate status can be considered a special levy for accessing the public capital markets.

Some might favor lower taxation for privately-traded firms as a benefit to small business. Note, however, that while almost all small businesses are privately-held, not all privately-held firms are small. There are many large businesses that are privately-held. Nonetheless, because of their corporate form, these large privately-held firms face lower taxes than their publicly traded competitors. In other words, the option to avoid double taxation depends on trading status, not the size of the firm.

At the risk of gross simplification from ignoring a host of tax details, a pass-through entity can be considered a C corporation, where all of the profits are paid out as dividends and the dividends are fully deductible for the corporation. This deductibility would eliminate any taxable income at the corporate level. Restated, the lack of dividend deductibility for C corporations is their cost for using the public capital markets.

Since there is no justification for taxing private and public businesses differently, I recommend that C corporations be treated the same as pass-through entities for tax purposes. One way to (largely) equate the tax treatments is to permit C corporations to deduct dividends. This would effectively provide them with the same (or similar) tax treatment as pass-through entities. Dividend deductibility would eliminate the primary reason for the various pass-through entities (i.e., double taxation). It also would restore equity between public and private firms, simplify tax planning, compliance and administration, e.g., debt and equity distinctions, and reduce the legal and accounting costs that both small and large businesses face in structuring their organizational form. It would also treat dividend payments the same as other payments to

stakeholders of the firm (e.g., interest and compensation), which are deductible at the entity level and only taxable to the recipient.

If dividend deductibility is not an option, I recommend taxation of all organizational forms (including the current pass-through entities) at the entity level coupled with tax exemption at the investor level, e.g., a reduction of the dividend tax rate to zero. This would shift the burden of tax compliance from investors to the entity. An administrative advantage of this approach is that there are far fewer entities than investors. A disadvantage of this approach is that there are economies of scale in tax evasion, i.e., it is easier for one entity to avoid a single large tax bill than for many investors to shelter small portions of the firm's income. The advantages and disadvantages to both corporate-level dividend deductibility and investor-level dividend exclusion are well understood in the tax community but beyond the scope of my testimony.

If you do not intend to address the primary issue motivating pass-through entities, i.e., double taxation, then I recommend making no changes. Each of the pass-through entities has different nuances that appeal to businesses in different situations. They are well understood in the legal and accounting communities. Changing the rules that apply to pass-through entities without addressing their underlying cause—double taxation—may create additional, unnecessary costs for privately-held firms.

Review and Comparison of Entity Classifications

The remainder of my testimony reviews the primary entity classifications, their genesis, advantages, and disadvantages.[1] Three organizational forms have the longest existence: the sole proprietorship, the (general) partnership, and the C corporation. Over time, other entities were created to marry the tax advantages of the sole proprietorship and partnership with the limited liability and other legal advantages of the C corporation. Limited Partnerships (LPs) developed in the early 1900s, protecting partners who were uninvolved in the management of the business from unlimited liability. Federal statute in 1958 created the first corporation with pass-through taxation, the S corporation. Today, most small business entrepreneurs opt for the limited liability company (LLC), whose popularity dates back to a 1988 Internal Revenue Service ruling, in

[1] Entity treatment varies across states. Throughout thisy testimony, I assume that North Carolina state law applies.

which the IRS affirmed that it would treat LLCs as pass-through entities for tax purposes.[2] Since LLCs have become the entity of choice for many new, privately-held businesses, I will discuss the alternative entity options by comparing them with LLCs.

LLCs

LLCs are hybrid entities that are neither partnerships nor corporations under state law. They offer all shareholders limited liability (i.e., protection from personal liability for debts) and can elect to be taxed as a partnership under present tax law. If treated as a partnership for tax purposes, the LLC offers the advantages of pass-through taxation and limited liability.

The LLC dates back to a limited liability company act in Wyoming in 1977. However, it was not widely adopted until some of the uncertainty of the new organizational form was eliminated with the 1988 IRS issuance of a revenue ruling stating that it would treat a Wyoming-style LLC as a partnership for tax purposes. Since then, the LLC has become recognized as the entity that best blends the advantages of pass-through taxation with legal advantages of a corporation.

LLCs compared with Sole Proprietorships and General Partnerships

A sole proprietorship (general partnership) is an unincorporated business owned and completely controlled by (more than) one person. It is formed without any formality and no documents need to be filed. Because sole proprietorships and general partnerships expose all investors to unlimited liability, LLCs dominate them from a legal perspective. As a result, sole proprietorships and general partnerships are rare. A danger to investors who start a business without addressing the choice of entity is that they will have chosen a sole proprietorship or general partnership by default (and, thus, be exposed to unlimited liability).

LLCs compared with C corporations

As discussed above, the primary advantage of an LLC (and all other pass-through entities) over a C corporation is that an LLC avoids double taxation. Furthermore, the use of an

[2] Note that some states, e.g., Texas and California, tax LLCs in an unfavorable manner. LLCs also face some disadvantages arising from treaties, including the Canadian/U.S. Tax Treaty.

LLC permits losses to pass-through to the investors (subject to various restrictions) while the use of a C corporation does not.

The disadvantage of double taxation tends to dominate any advantages of the C corporate form compared with the LLC. However, C corporations enjoy a few advantages compared with LLCs:

- C corporations can provide employees/shareholders with certain tax-free fringe benefits that LLCs cannot provide.
- The graduated tax rates for the first $100,000 of C corporate profit may enable it to provide a lower tax than an LLC whose earnings are uniformly taxed at the investors' potentially higher tax rates.
- Unlike an LLC, a C corporation can engage in a tax-free reorganization with another corporation.
- Unlike a C corporation, investors in LLCs may have to file tax returns in each state in which the company does business.

LLCs compared with S corporations

Before 1958, investors were limited to the corporate or partnership organizational form and the corresponding tradeoff between double taxation and unlimited liability. In 1958, subchapter S was added to the tax code, introducing limited liability corporations with pass-through taxation. Since their inception, S corporations have had restrictive ownership provisions. Presently, S corporations cannot have more than one class of stock, more than 100 shareholders, or any shareholders who are foreign persons, corporations, partnerships or certain trusts. These restrictions are a major disadvantage for the S corporation compared with the relatively unrestricted LLCs.

LLCs also dominate S corporations along several technical dimensions, including:

- Unlike LLCs, the basis of an S corporation's assets cannot be stepped-up to fair market value upon a sale of stock or the death of a shareholder.
- Unlike LLCs, S shareholders do not include third-party debt in the bases of their stock (which limits the investor's ability to utilize losses).
- An employee who receives S corporate stock is immediately taxed upon the receipt or the vesting of the stock, but a member in an LLC can receive a profits-only interest without being taxed.

On the other hand, S corporations have a few advantages compared with LLCs:

- An S corporation may face lower FICA taxes than an LLC faces because there is some uncertainty about how self-employment taxes should apply to investors in LLCs.
- An S corporation can engage in a tax-free reorganization with a publicly traded company, but an LLC cannot.
- For several technical non-tax reasons, an S corporation may be more suitable than an LLC for start-up companies intending to engage quickly in an IPO or obtain venture capital investments.

LLCs compared with Limited Partnerships (LPs)

LPs provide limited liability for partners who do not participate in the management of the firm. LPs have a long history, dating back to at least the 1916 Uniform Limited Partnership Act (ULPA). Compared with LLCs, there are two key disadvantages of LPs: (1) there must be at least one general partner who faces unlimited liability, and (2) limited partners cannot participate in the management of the partnership. Over time, to avoid having any investor face unlimited liability, LPs began using an S corporation as the general partner. In some states, limited liability limited partnerships (LLLPs) arose, providing limited liability for all general partners. Nonetheless, LLCs dominate LLLPs because general partners in LLLPs may still be liable for their own negligence or malpractice and limited partners still cannot participate in management. Neither restriction applies to LLCs.