TYPES OF INCOME AND BUSINESS ENTITIES

Senate Finance Committee Staff Tax Reform Options for Discussion

June 6, 2013

This document is the eighth in a series of papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. For the sake of brevity, the list does not include options that retain current law. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

CURRENT LAW

Individual Income Taxes

Under current law, individuals are subject to tax on all income received unless the income is specifically excluded from tax. However, different types of income may be taxed at different income tax rates. There are generally three types of income: ordinary income, short-term capital gains and long-term capital gains. Ordinary income includes wages, interest, rents, and royalties and is taxed at rates ranging from 10% to 39.6%. Short-term capital gains are gains on "capital assets" held for one year or less and are taxed at the same rates as ordinary income. Long-term capital gains are gains on capital assets held for more than a year and are generally taxed at preferential rates, ranging from 0% to 20%. In addition, qualified dividend income is taxed at the same preferential rates as long-term capital gains. Finally, net investment income (such as interest, dividends, and capital gains) in excess of $200,000 ($250,000 for joint filers) is taxed at an additional 3.8%. This tax applies to some but not all passthrough business income.

The statutory rates on these different types of income are summarized in the following table.

Type of Income	Tax Rate Bracket						
Wages and salaries	10%	15%	25%	28%	33%	35%	39.6%
Interest, non-qualified dividends, rents, royalties, and short-term capital gains	10%	15%	25%	28%	33%	35%	39.6%
Long-term capital gains	0%	0%	15%	15%	15%	15%	20%
Qualified dividends	0%	0%	15%	15%	15%	15%	20%

Note: The effective marginal rates on different types of income may differ from these statutory rates due to various phase-outs and special provisions like Pease. Also, this chart does not reflect the 3.8% net investment income tax or payroll taxes.

The definition of different categories of income also affects taxpayers in other ways. For example, capital losses are deductible against capital gains, but can only be used to offset $3,000 of ordinary income every year. Unused capital losses may be carried forward.

<u>Business Income Taxes</u>

The income tax treatment of business earnings depends on what kind of entity the business elects to be for tax purposes. Business entities are generally formed under state law, with the most common forms being corporations, partnerships and limited liability companies. In most cases, businesses can elect to be taxed as either a separate entity (i.e., a C corporation) or on a passthrough basis (e.g., a partnership or an S corporation). However, most publicly-traded businesses must pay tax as C corporations.

- **C corporations**: C corporations are subject to the corporate income tax at rates ranging from 15% to 35%. Shareholders also pay tax on dividends they receive from C corporations. As a result, the earnings of a C corporation are subject to two levels of tax: once at the corporate level and a second time at the shareholder level. If a C corporation retains its earnings instead of paying them out as dividends, its stock typically appreciates and its shareholders effectively pay tax on these "retained" earnings when selling their shares at a gain.

  Although the earnings of a C corporation are subject to two levels of tax, in many cases, only a single level of tax or no tax is actually imposed on the earnings. For example, C corporation earnings paid out as interest to creditors are subject to only a single level of tax. The creditor pays tax on the income. But the corporation deducts the interest thereby avoiding tax at the corporate level. Similarly, corporate income distributed as a dividend to tax-exempt shareholders (for example, pension plans) is, in essence, taxed only at the corporate level. The corporation cannot deduct the dividend it pays but its tax-exempt shareholders do not pay tax on their dividend income. Meanwhile, corporate earnings paid out as interest to tax-exempt lenders are not subject to any tax. The corporation deducts the interest, and its tax-exempt lenders are not taxed on their interest income.

- **Passthroughs**: Unlike C corporations, passthrough businesses are not subject to the corporate income tax. Instead, the owners of the business pay tax annually at individual income tax rates on all of the business's income, even if the business does not distribute its earnings. There are three types of businesses taxed on a passthrough basis: sole proprietorships, S corporations and partnerships. In the case of a sole proprietorship (a business that is owned by one individual), the owner pays tax on all of the business's profits as earned. S corporation shareholders pay tax on their pro rata share of the S corporation's income, gains, deductions and losses. In contrast, partners generally pay tax on their share of the partnership's income, gains, deductions, and losses according to the terms of the partnership agreement. However, there are limits on how the partnership agreement can allocate income, gains, deductions and losses for tax purposes to prevent abuse.

- **Other entities:** A third category of business is taxed under a hybrid system where the business is taxed at the entity level but receives a deduction for dividends paid to its shareholders. The owners of these businesses pay tax on dividends they receive from the business at ordinary income rates. This category includes mutual funds (also known as regulated investment companies, or RICs) and real estate investment trusts (REITs). In practice, these businesses pay little to no tax at the entity level because they distribute most of their earnings each year as dividends. In this way, these entities are taxed similarly to passthroughs—their earnings are generally only taxed at the investor level at ordinary income rates. To qualify for this tax treatment, however, the business must fulfill certain requirements regarding the types of investments, the diversity of owners, and the distribution of earnings. Other entities, such as real estate mortgage investment conduits (REMICs), cooperatives, trusts, and some industries (e.g., life insurance), have their own unique rules for taxing business income.

Over time, the relative tax rates on corporate income and passthrough income have varied. Historically, the top individual income tax rate (and thus, the top passthrough income tax rate) was significantly higher than the top corporate tax rate. As a result, many times closely-held businesses would be structured as C corporations to take advantage of lower rates. From 2003 until 2012, the top individual and corporate tax rates were the same. As a result, the earnings of C corporations were generally taxed at higher rates than the earnings of passthroughs when both the corporate and investor-level taxes were taken into account. Today, the top individual tax rate is higher than the top corporate tax rate.

Payroll Taxes

In addition to income taxes, individuals are subject to payroll taxes on much of their income. The combined employer and employee payroll tax rate is 15.3% on the first $113,700 of compensation (indexed annually), including self-employment income. Compensation between $113,700 and $200,000 ($250,000 for joint filers) is taxed at a rate of 2.9%, and compensation above those amounts is taxed at a rate of 3.8%. The $200,000 and $250,000 thresholds are not indexed for inflation.

Payroll taxes apply differently to different types of passthrough business income. For partnerships, general partners owe payroll tax on their share of the partnership's income at the rates for compensation. All partners owe payroll tax on guaranteed payments they receive for their services. In contrast, limited partners do not owe payroll tax on their share of the partnership's income. For S corporations, shareholders owe payroll tax on any wages they receive from the corporation. But S corporation shareholders do not owe payroll tax on their share of the S corporation's income.

The following table summarizes the statutory payroll tax rates for different types of income.

Types of Income	Social Security Tax	HI (Medicare) Tax
Wages, self-employment income and guaranteed payments to partners	12.4% on income up to $113,700	2.9% on income up to $200,000 for single filers ($250,000 for joint filers); 3.8% on income above
General partner's share of partnership income	12.4% on income up to $113,700	2.9% on income up to $200,000 for single filers ($250,000 for joint filers); 3.8% on income above
Limited partner's share of partnership income	None	None
S corporation shareholder's share of S corporation income	None	None

CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

Tax reform provides an opportunity to rationalize the patchwork of inconsistent rules regarding the taxation of income, investments, and tax structures. Although competing goals for tax reform often point to conflicting solutions, following are some potential broad principles for reform in this area:

- Simplify the law in order to reduce the cost to businesses and individuals of complying with the tax code
- Make the tax code more neutral by reducing or eliminating differences in overall tax burdens across different types of entities, owners, and income
- Reduce or eliminate differences in the tax treatment of debt and equity

Some specific concerns about the taxation of income and business entities include the following:

- **Overall complexity:** The different treatment of various types of income and business entities is confusing for taxpayers and lacks coherence. Some business earnings are subject to two levels of income tax, while others are not. Some types of income are eligible for preferential rates, while others are not. Some types of passthrough income are subject to the payroll tax, while some are exempt. Partially as a result of this complexity, individuals and businesses spend over 6 billion hours a year to comply with the tax code according to the National Taxpayer Advocate. If tax compliance were an industry, it would be one of the largest in the U.S., requiring 3 million full-time workers.

- **Differences in the treatment of different types of business entities:** A general goal in tax policy is that similarly situated taxpayers should be taxed in a similar manner. However, different types of entities often pay tax at very different rates. For example, the earnings of a C corporation are subject to two levels of tax, while a single level of tax applies to the earnings of passthrough businesses. As discussed, this does not necessarily mean that the earnings of C corporations are taxed more heavily than the earnings of passthrough businesses. The individual and corporate income taxes have different rate structures and, in some cases, only a single level of tax or no tax is actually imposed on the earnings of a C corporation or passthrough business. But the tax rate on business earnings does vary significantly depending on whether it is a C corporation or passthrough, how it is financed, and who its investors are. According to a 2005 CBO report, the effective tax rate on corporate investment was 6 percentage points higher than similar non-corporate investment.

Some believe that a business's earnings should be taxed at the same rate regardless of whether it is a C corporation or pass-through, a goal that some refer to as "integration" of the individual and corporate tax systems. Doing so would treat C corporations and passthroughs more neutrally. It would also treat decisions by businesses about whether to finance with debt rather than equity, or to retain earnings rather than distributing earnings, more neutrally. Others believe that certain businesses should pay tax at higher rates, for example, if the business is accessing public equity markets.

- **Tax bias on debt or equity financing**: The current tax system generally taxes equity-financed corporate earnings more heavily than debt-financed corporate earnings because corporations can deduct interest payments but not dividend payments. According to the same 2005 CBO report, the effective tax rate on debt-financed corporate investment was -6%, while the effective tax rate on equity-financed corporate investment was 36%. Some are concerned that the bias between debt and equity financing creates risk in the economy and may hinder economic growth.

- **Lock-in incentives:** Corporations generally have an incentive to retain earnings, rather than distributing earnings through dividends. Retaining earnings allows shareholders to avoid the investor-level tax until they sell their shares. In addition, investors have the incentive to hold appreciated assets rather than sell in order to avoid paying immediate tax on the gain. These twin incentives are sometimes referred to as "lock-in." Some believe lock-in incentives reduce investment in new, higher-producing assets and, as a result, hamper economic growth. Others believe that non-tax incentives may mitigate or cancel out these tax incentives.

- **Fairness**: Income from services is taxed at higher rates than some income from capital. For example, wages are taxed at a top income tax rate of 39.6% whereas long-term capital gains are taxed at a top income tax rate of 20%. Some argue that all income should be taxed the same, for example, because the different tax treatment for income from services and capital income creates economic distortions, complicates the tax code, and provides room for gaming. Others argue that capital income should be taxed at a lower rate than income from services, for example, in order to reduce the bias against savings, mitigate incentives to hold on to underperforming assets, and account for the effects of inflation.

- **Distinguishing service income from capital income:** When owners of a privately-held business contribute both services and capital to the business, it can sometimes be difficult to distinguish how much of their income from the business is attributable to each. This matters because compensation for services is taxed as ordinary income and subject to payroll taxes, while income from capital may be taxed at the preferential capital gains rates and subject to little or no payroll taxes. The different tax treatment can create incentives for taxpayers to characterize income from services as investment income. For example, some S corporation shareholders may avoid payroll taxes if they characterize income they receive from the business as returns on their capital investments instead of reasonable compensation. According to GAO, in 2003 to 2004, about 13% of S corporations did not pay adequate wages to shareholders for their labor.

- **Differences in the treatment of economically-similar financial instruments:** The taxation of financial instruments is based on the categorization of the instrument. As the financial products markets have evolved, tax categories of financial instruments have been created or expanded. These rules often depend on a particular description of the economic characteristics of an instrument. Financial instruments may be structured with existing law in mind to allow taxpayers flexibility in controlling the timing and character of income from the instruments. Therefore, economically similar investments may have dramatically different, and largely elective, U.S. tax consequences. The principal goals of financial product tax reform could be to provide uniform rules for broad classes of financial products and risk management activity that would simplify the area and provide for consistent tax treatment.

REFORM OPTIONS

I. TAXATION OF DIFFERENT TYPES OF INCOME AND ENTITIES

1. **Treat all or most types of income the same, while maintaining the two levels of tax on the earnings of C corporations**

    a. Tax capital gains, dividends, and ordinary income at the same rates (Testimony of Dr. Leonard Burman before Joint Finance Committee and Ways and Means Committee Hearing, September 20, 2012; Domenici and Rivlin, "Restoring America's Future," Bipartisan Policy Center, November 2010)

   i. For example, capital gains and dividends could be taxed as ordinary income, excluding the first $1,000 of realized net capital gains (Domenici and Rivlin, "Restoring America's Future," Bipartisan Policy Center, November 2010)

b. Tax dividends as ordinary income (Altman, et al., "Reforming Our Tax System, Reducing Our Deficit, Center for American Progress," December 2012)
c. Narrow the difference between ordinary income rates and capital gain and dividend rates (Testimony of Dr. Lawrence B. Lindsey before Joint Finance Committee and Ways and Means Committee Hearing, September 20, 2012, coupled with reducing ordinary income tax rates; Altman, et al., "Reforming Our Tax System, Reducing Our Deficit," Center for American Progress, December 2012)

2. Fully integrate the corporate and individual income taxes through one of the following approaches

As discussed above, some people believe that a business's earnings should be taxed at the same rate regardless of whether it is a C corporation or passthrough. This is a goal that some refer to as "integration" of the individual and corporate tax systems. There are a number of different proposals for integration, each with its own set of complexities due to the number of structural issues that need to be addressed. Those issues include how to treat capital gains, foreign corporations, tax-exempt and foreign shareholders, and corporations that reduce the corporate level tax on their earnings through tax preferences.

a. Tax dividends as ordinary income and provide shareholders with a tax credit for corporate taxes paid, sometimes called an "imputation credit" (Warren, "Integration of the Individual and Corporate Income Tax Laws," American Law Institute, 1993)
   i. Treats the corporate tax as a withholding tax on dividends paid to shareholders
   ii. Tax-exempt shareholders such as nonprofits, retirement plans and foreign investors would not benefit from the credit
   iii. Treatment of capital gains would be adjusted to ensure that corporate earnings are taxed once at the individual level
b. Tax dividends as ordinary income and allow corporations to deduct dividends paid to the extent that earnings were taxed at the corporate level, sometimes

called a "dividends paid deduction" (Treasury Department, "Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984)

    i. No deduction would be allowed for dividends paid to tax-exempt shareholders, such as nonprofits, retirement plans and foreign investors
    ii. Treatment of capital gains would be adjusted to ensure that corporate earnings are taxed once at the individual level

c. Allow shareholders to exclude dividends received to the extent the dividend is from previously taxed corporate income (President's Advisory Panel on Federal Tax Reform, 2005; Treasury Department, "Integration of Individual and Corporate Tax Systems," 1992)
    i. Dividends from non-previously taxed income would be taxed at ordinary rates
    ii. Retain current system of taxing foreign shareholders under withholding tax regime
    iii. Shareholders could exclude some capital gains on the sale of stock
d. Disallow interest and dividend deductions for all businesses and allow investors to exclude both interest and dividends, sometimes called a comprehensive business income tax (CBIT) (Treasury Department, "Integration of Individual and Corporate Tax Systems," 1992; Organisation for Economic Cooperation and Development, "Reforming Corporate Income Tax," 2008)
    i. Treats business income paid as interest or dividends the same
    ii. Rules would apply to both passthroughs and C corporations
e. Allow corporations to deduct a percentage of the amount they have raised through equity markets each year, sometimes referred to as an "allowance for corporate equity" (ACE) (Warren, "Integration of the Individual and Corporate Income Tax Laws," American Law Institute, 1993; Organisation for Economic Cooperation and Development, "Reforming Corporate Income Tax," 2008; Kleinbard, "Rehabilitating the Business Income Tax," The Hamilton Project, June 2007; similar to the law in Brazil)
    i. Allows corporations to deduct a fixed return on the capital they raise from shareholders, similar to how they can deduct interest they pay on capital they raise from bondholders
    ii. Either tax investors:
        1. Under current tax principles, or
        2. Impose tax annually on an amount equal to the deduction claimed by the business and exempt all other income at the investor level
    iii. System could apply to all businesses or just C corporations

f. Treat all business entities as passthrough entities so that all business income is directly taxed to the owners, sometimes called "shareholder allocation" (Congressional Budget Office, "Taxing Businesses Through the Individual Income Tax," 2012)
    i. Shareholders include allocated amounts of income, and credit corporate taxes paid and corporate tax credits against their tax liability (McNulty, Commentary; Preserving the Virtues of Subchapter S in an Integrated World, Tax Law Review, 1992)

3. Partially integrate the corporate and individual income taxes

Currently, the U.S. partially integrates the corporate and individual income taxes by applying a lower rate of tax to certain dividends and long-term capital gains on the sale of C corporation stock.

a. Tax dividends as ordinary income and allow a partial imputation credit or dividends paid deduction, as described above
b. Adjust the rates under the corporate and individual income taxes so that the combined rate on corporate income and dividends received is closer to the rate on passthrough business income
    i. For example, the difference in the top individual and corporate tax rates could be increased (President's Economic Recovery Advisory Board, 2010)
    ii. Alternatively, taxes on dividends and capital gains on C corporation stock could be lowered or repealed (H.R.4529 (111th Congress), Roadmap for America's Future Act of 2010, sponsored by Rep. Ryan; Gingrich, American Enterprise Institute, "Capital Gains: An Argument for Repeal," August 2009; Institute on Taxation and Economic Policy, "A Capital Idea," January 2011)
c. Tax capital gains at ordinary income rates except those from the sale of C corporation stock (President's Advisory Panel on Federal Tax Reform, 2005)

4. Redraw line between passthroughs and C corporations

a. Require more or all publicly-traded partnerships to pay tax as C corporations (S.1624 (110th Congress), A bill to … provide that the exception from the treatment of publicly traded partnerships as corporations for partnerships with passive-type income shall not apply to partnerships directly …, sponsored by Sens. Baucus, Grassley, Brown, and others; Lee, "Entity Classification and

Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process," Virginia Tax Review, 1988)

b. Require larger passthrough businesses to pay tax as C corporations
    i. Although there is currently no uniform definition of larger businesses, size could be defined based on gross revenues, number of owners, or access to capital markets or the equivalent (President's Framework for Business Tax Reform, 2012; President's Economic Recovery Advisory Board, 2010)
    ii. Alternatively, allow businesses to be taxed as a passthrough if the owners materially participate in the business or the business is closely-held (Lee, "Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process," Virginia Tax Review, 1988; Yin, "Publicly Traded Partnerships, Closely Held Corporations, and Entity Classification for Tax Purposes," Virginia Law and Economics Research Paper, January 2010)

c. Modify the rules on how partnerships are taxed; for example:
    i. Extend partnership basis limitation rules to nondeductible expenditures (FY2014 Administration Budget Proposal; estimated in 2013 to raise $1 billion over 10 years)
    ii. Expand the definition of built-in loss for purposes of partnership loss transfers (FY2014 Administration Budget Proposal; estimated in 2013 to raise $1 billion over 10 years)
    iii. Enact other specific rules, including requiring basis adjustments when interests are transferred or property is distributed, and repealing the 7-year limitation so that a contributing partner recognizes gain when appreciated property is distributed to another partner (Ways and Means Committee Discussion Draft on Small Business and Passthrough Entity Tax Reform, 2013)

d. Allow or require more businesses to pay tax on a passthrough basis
    i. If the top corporate rate is significantly reduced, discourage businesses from electing C corporation taxation
        1. Only allow publicly-traded companies to pay tax as C corporations (Burke, "Passthrough Entities: The Missing Element in Business Tax Reform," Pepperdine Law Review, 2013; Yin, "Corporate Tax Reform, Finally, After 100 Years," Virginia Law and Economics Research Paper, September 2009)
        2. Eliminate the low rate brackets for C corporations (Congressional Budget Office, "Reducing the Deficit: Spending and Revenue

Options," March 2011, estimated in 2011 to raise $24 billion over 10 years; Ways and Means Committee Discussion Draft on International Tax Reform, 2011)

ii. Ease the rules on S corporations, so that more entities can benefit from passthrough taxation

1. Loosen the requirements for electing to pay tax as an S corporation, for example, by reducing the holding period for built-in gains, repealing excessive passive income as a termination event, and expanding who may be an eligible shareholder (Ways and Means Committee Discussion Draft on Small Business and Passthrough Entity Tax Reform, 2013; H.R.892, (113th Congress), S Corporation Modernization Act of 2013, sponsored by Reps. Reichert, Kind, and others)

e. Revise rules regarding RICs and REITs

i. Reduce amount and type of activity that can be conducted in a REIT or RIC subsidiary (Taylor, "'Blockers,' 'Stoppers,' and the Entity Classification Rules," Tax Lawyer, July 2011)

ii. Expand REITs by expanding amount of property REIT may sell (H.R.5746 (112th Congress), Update and Streamline REIT Act of 2012, sponsored by Reps. Tiberi and others)

iii. Repeal the preferential dividend rule for publicly-offered REITs (FY2014 Administration Budget Proposal; estimated in 2013 to raise less than $1 billion over 10 years)

5. Simplify other rules related to types of income and entities

a. Conform rules for S corporations and partnerships (Ways and Means Committee Discussion Draft on Small Business and Passthrough Entity Tax Reform, 2013; President's Advisory Panel on Federal Tax Reform, 2005)

b. Harmonize the different rates on capital gains (President's Economic Recovery Advisory Board, 2010)

i. For example, apply the same rates to collectibles, section 1202 qualified small business stock, section 1256 contracts, and section 1250 property

c. Equalize the tax treatment between corporate and non-corporate entities for the exclusion from income of government incentives and other contributions to taxpayers (Blanchard, "The Taxability of Capital Subsidies and Other Targeted Incentives," Tax Notes, November 1999; Letter from Reps. Conway and others to

Ways and Means Committee Chairman Camp and Ranking Member Levin regarding Clean Coal Power Initiatives, October 12, 2012)

II. CORPORATE FINANCE DECISIONS

1. Expand thin capitalization rules to limit deductions attributable to excessive debt financing

a. Disallow interest expense deductions for a U.S. corporation or a foreign corporation engaged in a U.S. trade or business to the extent the interest expense exceeds, for example, 25% of adjusted taxable income, as described in the International Competitiveness options paper (similar to the laws of Germany and Italy)

2. Further limit deductions associated with exempt or deferred income

a. Offshore earnings
    i. Defer interest deduction associated with unrepatriated foreign earnings (FY2014 Administration Budget Proposal; estimated in 2013 to raise $60 billion over 10 years)
    ii. Deny interest deduction on debt incurred to acquire tax-exempt foreign operations (Fleming, Peroni, and Shay, "Designing a U.S. Exemption System for Foreign Income When the Treasury is Empty," Florida Tax Review, 2012; similar to proposals and laws in France, Spain, and the Netherlands)

b. Limit interest deductions to the extent attributable to loans used for capital expenditures eligible for expensing (Geier, "Expensing and the Interest Deduction," Tax Notes, September 2007)

3. Create greater parity between debt and equity financing for C corporations

a. Reduce the amount of interest payments that C corporations can deduct by, for example, 10% (President's Economic Recovery Advisory Board, 2010; Pozen, "Reform Tax Code by Limiting Corporate Interest Deduction," Newsday, October 2012; Viard, "The Quickest Way to Wreck Corporate Tax Reform," American Enterprise Institute, March 2013; Brill, "A Pro-Growth, Progressive, and Practical

Proposal to Cut Business Tax Rates," American Enterprise Institute, January 2012)

   i. Could provide a floor allowing full deductibility for interest payments up to, for example, $5 million
   ii. Could apply to gross or net interest payments
   iii. Could treat business rental expense as interest for purposes of the rule

b. Disallow interest deductions for interest paid on debt used to redeem corporate equity (Joint Committee on Taxation, "Federal Income Tax Aspects of Corporate Financial Structures," January 1989)
c. Fully integrate the corporate and individual income taxes, as described above, so that debt and equity are taxed the same

4. Create greater parity between retaining and distributing earnings for C corporations and reduce lock-in incentives

a. Apply a lower rate to dividends than applies to capital gains on C corporation stock (Gravelle, "The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues," Congressional Research Service, April 2008)
b. Expand mark-to-market by, for example, requiring private companies with more than $50 million in net assets and individuals representing the wealthiest 0.1 percent of Americans to mark-to-market publicly-traded property and derivatives (Miller, "A Progressive System of Mark-to-Market Taxation," Tax Notes, October 2010)
c. Repeal the one-year holding period requirement for preferential capital gains rates (Paschall, "U.S. Capital Gains Taxes: Arbitrary Holding Periods, Debatable Tax Rates," Southern California Law Review, 2000)
d. Strengthen the accumulated earnings tax applicable to excess retained earnings of a C corporation (Elliott, "The Accumulated Earnings Tax and the Reasonable Needs of the Business: A Proposal," William and Mary Law Review, 1970)

e. Repeal the rule that exempts capital gains from tax when asset is transferred upon death (sometimes referred to as "stepped-up basis") (Testimony of Dr. Leonard Burman before Joint Finance Committee and Ways and Means Committee Hearing, September 20, 2012; McCaffery, "A Progressive's Silver Linings Playbook: Repeal Stepped-Up Basis," Tax Notes, February 2013)

   i. Replace with a rule where the recipient pays tax on capital gain upon receipt or when the recipient sells the asset (sometimes referred to as "realization" and "carryover basis")

III. COMPENSATION

1. **Reform treatment of carried interest and other partnership interests received in whole or in part in exchange for services**

    a. Tax all interests in partnerships that are received solely in exchange for services as compensation rather than capital gains (FY2011 Administration Budget Proposal; estimated in 2010 to raise $29 billion over 10 years; Testimony of Mark Gergen before the Finance Committee, July 11, 2007)

    b. Tax carried interest earned by investment managers in exchange for providing services to an investment partnership as compensation rather than capital gains (FY2014 Administration Budget Proposal; estimated in 2013 to raise $17 billion over 10 years; S.268 (113th Congress) CUT Loopholes Act of 2013, sponsored by Sens. Levin and Whitehouse; Amendment to H.R.4213 (111th Congress), American Jobs and Closing Tax Loopholes Act of 2010, sponsored by Sen. Baucus; Congressional Budget Office, "Reducing the Deficit: Revenue and Spending Options," 2011)

    c. Disallow conversion of management fees taxed as ordinary income into partnership shares taxed at capital gains rates (Polsky, "Private Equity Management Fee Conversions," Tax Notes, February 2009)

2. **Reform treatment of S corporation income received in whole or in part in exchange for services**

    a. Apply self-employment taxes to income of passthroughs engaged in personal service businesses (S.3793 (111th Congress), Job Creation and Tax Cuts Act of 2010, sponsored by Sen. Baucus; FY2013 Administration Budget Proposal; estimated in 2012 to raise $8 billion over 10 years)

        i. Limit taxable amounts to passthrough business owners who provide substantial professional services to the business

            1. Professional services defined to include any trade or business providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or brokerage

        ii. Impose payroll taxes only on S corporations that derive 75% or more of their gross revenues from services of 3 or fewer shareholders or when the S corporation is a partner in a professional service business

        iii. Could also limit to taxpayers with income greater than $200,000 for individuals and $250,000 for married couples filing jointly

b. Treat wages as well as any ordinary income flowing through to S corporation shareholders as subject to self-employment taxes when the shareholder owns at least 10% of the stock or materially participates in the business (Hennig et al., "S Corp Taxation: Level the Playing Field," Tax Notes, March 2013)

c. Treat S corporation earnings either as wages subject to the 3.8% Medicare tax or as net investment income subject to the 3.8% net investment tax, at the shareholder's election (Hennig et al., "S Corp Taxation: Level the Playing Field," Tax Notes, March 2013)
    i. Expand the definition of net investment income to include S corporation flow-through income for purposes of the 3.8% net investment tax
    ii. Modify the definition of wages to include any distributions by the corporation within 2.5 months after the close of the tax year

IV. FINANCIAL PRODUCTS

Financial products are transactions allowing a person to make an investment or to manage a financial risk. Financial products include stock and bonds. They also include derivatives, which are contracts the value of which is determined by reference to a specified asset, such as a stock, bond, commodity, or currency. There are three central issues associated with the taxation of financial products. The first relates to timing, meaning when a taxpayer is required to (or is allowed to) take income or expense from the financial product into account in determining tax liability. The second relates to character. Dividends and capital gains may be eligible for reduced rates as compared with ordinary income. Losses from capital assets ("capital losses") first offset a taxpayer's capital gains to the extent thereof and then $3,000 of ordinary income. Capital gains and ordinary income are taxed at the same rate for corporations. Corporations can only offset capital losses against capital gains. The third issue is the source of income. Foreign investors in financial products may be subject to U.S. tax on payments on a financial product if those payments are considered to be from United States sources. This options paper focuses on the timing and character issues.

Tax rules for derivatives

The following is a description of certain common derivatives and their tax treatment. Many derivatives are combinations, or hybrids, of the derivatives described below.

- **Options.** An option is a contract that gives the holder the right, but not the obligation, to buy or sell property at a designated price within a set period or at a specified date. A right to buy is generally called a "call" option, while a right to sell is generally called a "put" option. Typically, the option holder pays the option issuer a fee (called a "premium") upon entering into the contract. Under current law, an option holder generally recognizes gain or loss on the contract only when the holder sells the option or when it expires unexercised. The character of any such gain or loss is determined by reference to what the character of the gain or loss would be if the holder owned the underlying property. If the option is exercised, the premium is considered part of the holder's purchase price for the property. Similarly, tax consequences to the option issuer from receiving the premium only arise when the option is exercised or expires. If the option is exercised, the issuer sells the property to the option holder, and the issuer's income is treated as capital gain. If the option expires, the issuer is taxed on the premium as a short-term capital gain even though no sale takes place.

- **Forward and futures contracts**. A forward contract is an agreement by a buyer to purchase specified property from the seller at a fixed price on a specified date in the future. A "futures contract" is a standardized forward contract that is traded on an exchange and is subject to a variety of special terms to minimize the risk that a party would default on the contract. Futures contracts are subject to special rules regarding timing and character (discussed in the options below).

  Forward contracts can be physically settled, whereby the buyer acquires the specified property, or cash settled, whereby the specified property is not exchanged but a payment is made from the buyer or seller to the other to reflect the difference between the price specified in the contract and the price of the underlying property on the settlement date. Similar to an option, under current law, the buyer and seller do not recognize income on the contract until settlement. If a contract physically settles, the specified property is transferred, and the seller has gain or loss from the transaction. If the contract cash settles, the party receiving the cash determines the character of the income by reference to what the character of the income would be if the party owned the underlying property.

- **Swaps and other notional principal contracts**. Notional principal contracts are contracts that provide for periodic payments by one party to another calculated by reference to a specified index and a notional amount of property that the parties to the contract may not own. A "swap" is a common form of notional principal contract. The timing of income under a notional principal contract depends on whether a payment is made pursuant to the terms of the agreement or is made to end the agreement or assign the obligations under the agreement ("termination payments"). Payments pursuant to the agreement, whether periodic or nonperiodic, are included in a taxpayer's income or are deductible on an accrual basis. For example, for payments expected to be received, a taxpayer must take a ratable portion of an expected payment into income each day and include such amount in taxable income. Large nonperiodic payments may, in certain circumstances, be treated as a loan that is separate from the notional principal contracts and subject to the rules for debt instruments. Termination payments are taken into account as income or as a deduction when paid. Proposed Treasury regulations, which are not binding on taxpayers, provide that payments made pursuant to the terms of the agreement are ordinary, while termination payments are capital.

1. Harmonize the tax rules governing most or all derivatives

a. Harmonize the timing rules governing when taxpayers must recognize income on derivatives through one of the following reforms (Testimony of Alex Raskolnikov before Joint Finance Committee and Ways and Means Committee Hearing, December 6, 2011)
    i. Require taxpayers holding derivatives to mark-to-market the derivative each year, meaning that the derivative is treated as sold at the end of each year and gains or losses from the deemed sale are taken into income (Ways and Means Committee Discussion Draft on Financial Product Tax Reform, 2013; FY2014 Administration Budget Proposal; estimated in 2013 to raise $16 billion over 10 years)
    ii. Require taxpayers holding derivatives to recognize income ratably each year based on the expected payouts on the derivative
    iii. Require taxpayers holding derivatives to pay an interest charge on gains from derivatives to undo any timing benefits
b. Harmonize the rules governing the character of income from derivatives
    i. Treat all income from derivatives as ordinary income (Ways and Means Committee Discussion Draft on Financial Product Tax Reform, 2013; FY2014 Administration Budget Proposal; estimated in 2013 to raise $16 billion over 10 years)
    ii. Treat all income from derivatives as capital or ordinary based on the underlying investment (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011)

c. Apply harmonized rules to all derivatives (Ways and Means Committee Discussion Draft on Financial Product Tax Reform, 2013)
   i. Alternatively, could only apply harmonized rules to:
      1. Derivatives that are actively traded or based on property that is actively traded (FY2014 Administration Budget Proposal; estimated in 2013 to raise $16 billion over 10 years)
      2. Exchange-traded derivatives (Testimony of Alex Raskolnikov before Joint Finance Committee and Ways and Means Committee Hearing, December 6, 2011)
      3. Derivatives entered into with dealers (Testimony of Steve Rosenthal before the Ways and Means Committee, March 20, 2013)
         I. Dealers would be required to report valuations to their counterparties
         II. Derivatives that are marked to market for financial accounting purposes
   ii. Exempt ordinary course transactions from harmonized rules (for example, transactions in American Depository Receipts or one corporation's acquisition of another corporation that is undertaken through a stock purchase agreement that otherwise qualifies as a forward contract) (Miller, "Toward an Economic Model for the Taxation of Derivatives and Other Financial Instruments," Harvard Business Review, 2013; Testimony of William Paul before the Ways and Means Committee, March 20, 2013)
      1. Could also define ordinary course transactions to be those eligible for the financial accounting exception to mark-to-market treatment

2. Reform mark-to-market treatment (section 475)

Dealers and market makers in securities are required to "mark-to-market" annually their financial assets other than those that are held for investment. Any gain or loss recognized is treated as ordinary unless the financial instrument is not held as part of the taxpayer's dealer operations. Dealers in commodities and traders in securities or commodities can elect mark-to-market and ordinary treatment.

a. Expand ability of taxpayers to elect mark-to-market and ordinary income treatment

i. Allow all taxpayers to elect mark-to-market and ordinary income treatment (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011)

3. **Reform rules governing certain futures and other contracts (section 1256)** (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011)

Futures contracts generally must be "marked-to-market" annually. Gains and losses on futures contracts are treated as 60% long-term capital gain or loss, and 40% short-term capital gain or loss. Certain foreign currency contracts and non-equity options are also subject to this treatment. In addition, with respect to dealers or market makers, this tax regime also applies to dealer equity options and dealer securities futures contracts. Rules also coordinate this mark-to-market regime with the mark-to-market rules applicable to dealers and market makers.

a. Put dealers and market makers under one set of mark-to-market and ordinary income rules
b. Repeal the 60% long-term capital gain or loss and 40% short-term capital gain or loss characterization, making income on these contracts ordinary income for all taxpayers
c. Expand the scope of mark-to-market treatment, for example, by extending rules to other exchange-traded instruments

4. **Simplify and expand hedging treatment**

Taxpayers that use a financial instrument to hedge the risk of holding ordinary property or liabilities are subject to special tax rules. Typical risks that are hedged are the risk of interest rate or price changes, and risks regarding foreign currency fluctuations. When a taxpayer uses a financial instrument (typically a derivative) to hedge another risk, a taxpayer can choose (or the tax law may require) the integration of the derivative and the item being hedged. This means that the derivative and the underlying item are treated as one investment in order to match the timing and character of the income from the derivative and the income from the underlying item. Under current law, hedging treatment (that is, the matching of timing and character between the derivative and the underlying property) is allowed for limited classes of property that give rise to ordinary income, loss, or deduction. In addition, the tax rules generally require that the hedging relationship be identified by the taxpayer at the outset of the hedge.

a. Allow book hedging (that is hedging for financial accounting purposes) to qualify as identification (Ways and Means Committee Discussion Draft on Financial Product Tax Reform, 2013; Testimony of Steve Rosenthal before the Ways and Means Committee, March 20, 2013)
b. Allow capital asset hedging (Testimony of Andrea Kramer before Joint Finance Committee and Ways and Means Committee Hearing, December 6, 2011)
c. Allow affiliated group risk consolidation and hedging, including for both domestic and foreign affiliated groups (Testimony of Andrea Kramer before Joint Finance Committee and Ways and Means Committee Hearing, December 6, 2011)

5. Reform treatment of debt

The primary income from debt instruments is interest and original issue discount. Original issue discount generally arises when there is a difference between the issue price of the debt and the amount that will be paid at maturity. For example, if a corporation issues a 5-year bond for $80 with a single payment of $100 due at maturity, the original issue discount is $20. Generally, interest income is taxed annually based on the actual amount paid. Original issue discount is taxed on an accrual basis. In the above example, the $20 of original issue discount would be taken into income over the five years the instrument is outstanding. Interest and original issue discount are ordinary income. Gains and losses on the sale of debt are generally capital. Under current law, if an issuer modifies existing debt or exchanges existing debt for new debt, the transaction is generally taxable to the debt holder unless certain narrow exceptions apply for corporate issued debt that qualifies as a security for tax purposes.

When debt is purchased after issuance at a discount to its face amount (that is, the amount that will be paid at maturity), the difference between the debt instrument's purchase price and the face amount is referred to as "market discount." Market discount can arise if market interest rates rise after a fixed rate debt instrument is issued. Alternatively, market discount can arise if the creditworthiness of the issuer declines. Current rules treat gain on the sale or exchange of a debt instrument, or upon a principal payment of the debt instrument, as ordinary income rather than as capital gain to the extent of accrued market discount at the time of the sale or payment. A taxpayer can elect to accrue the market discount into income (i) by applying the principles of the original issue discount rules or (ii) on a straight line basis if the debt instrument only provides for regular interest payments prior to maturity. Nevertheless, some commentators have argued that even with these elections, the market discount rules lead to inappropriate timing and measurement of income to the extent market discount is from a decline in the creditworthiness of the issuer rather than from a change in market interest rates.

a. Because most income from debt is ordinary income, treat losses on debt as ordinary losses, potentially just to the extent of interest income recognized on the debt (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011)
b. Expand the scope of tax-free debt-for-debt exchanges to include exchanges involving noncorporate debt issuers and non-securitized debt (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011; Testimony of David Garlock before the Ways and Means Committee, March 20, 2013)
c. Reform treatment of distressed debt
    i. Reduce situations in which cancellation of indebtedness income is recognized on debt modifications if the principal amount of the debt has not changed (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011; Ways and Means Committee Discussion Draft on Financial Product Tax Reform, 2013)
    ii. Revise market discount rules to better distinguish market discount arising from changes in interest rates from market discount attributable to credit risk (Ways and Means Committee Discussion Draft on Financial Product Tax Reform, 2013)
        1. Make accrual of market discount mandatory,
        2. Limit rate of accrual to a time value return (therefore reducing the effect of creditworthiness on the amount of income subject to the market discount rules), or
        3. Eliminate accrual for severely distressed debt

6. Reform "wash sales" rules (American Bar Association, "Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code," December 2011; Testimony of Steve Rosenthal before the Ways and Means Committee, March 20, 2013)

The "wash sale" rules prevent a taxpayer from selling an asset to recognize a built-in loss and then repurchasing the same or a substantially identical asset. Essentially, this rule allows a taxpayer to recognize a loss only when a taxpayer has truly disposed of an asset. The wash sale rules defer the recognition of a loss on the sale of stock or securities if a taxpayer acquires, or enters into an option to acquire, shares of substantially identical stock or securities within 30 days before or after the loss transaction. The wash sale rules also apply to short sales of stock or securities (borrowing and selling stock or securities) and securities futures contracts to sell stock or securities.

a. Expand rules to cover either exchange-traded derivatives or all derivatives
b. Provide that taxpayers can enter into wash sales effected through taxable, tax-exempt, or tax-deferred accounts, and through sales by related persons
c. Apply wash sale rules to other short positions in financial instruments, such as "put" options and entering into a forward contract to sell stock or securities
d. Expand the "substantially identical" standard to apply to more replacement securities, for example, by treating indexed mutual funds and exchange-traded funds as substantially identical in appropriate circumstances

V. OTHER

1. Streamline partnership audits

a. Streamline audit and adjustment procedures for larger partnerships (FY2014 Administration Budget Proposal; estimated in 2013 to raise $2 billion over 10 years)

2. Mergers and acquisitions

Under current law, a complex set of rules for "tax-free reorganizations" allows taxpayers to defer taxation of gain or loss on certain exchanges of stock for the stock of another corporation or certain transfers of assets in exchange for stock or securities of another corporation. These rules are intended to apply in the case of an exchange which is incident to a restructuring of one or more corporations and where the assets remain held by a corporation, the shareholders of both combining businesses remain shareholders in the surviving corporation, and there is a valid business purpose for the transaction. According to CNN Money, there was almost $1 trillion of U.S.-based mergers and acquisition activity in 2012.

a. Modernize and simplify the tax-free reorganization provisions (Senate Finance Committee, "The Subchapter C Revision Act of 1985: A Final Report," 1985)
    i. Allow C corporations to elect whether to treat a reorganization transaction as tax-free or taxable

ii. Allow C corporation shareholders to elect whether to treat a reorganization transaction as tax-free or taxable

b. Amend the related party redemption rules for corporate shareholders to deny dividend treatment on certain sales of stock (section 304) (Bittker and Eustice, "Federal Income Taxation of Corporations and Shareholders," 2000)
c. Amend the reorganization rules relating to spin-offs and similar distributions so that the distributing corporation has taxable gain upon the receipt of securities or nonqualified preferred stock (i.e., preferred stock with debt-like attributes) of certain newly formed controlled companies (S.1813 (112th Congress), Moving Ahead for Progress in the 21st Century Act, sponsored by Sens. Boxer, Baucus, and others; amendment to H.R.4213 (111th Congress), American Jobs and Closing Tax Loopholes Act of 2010, sponsored by Sen. Baucus)
d. Repeal the dividend within gain limitation in reorganizations (FY2014 Administration Budget Proposal; estimated in 2013 to raise $1 billion over 10 years; Amendment to H.R.4213 (111th Congress), American Jobs and Closing Tax Loopholes Act of 2010, sponsored by Sen. Baucus)

3. Other tax administration or tax gap issues

a. Permit S corporation elections to be made on the business's first federal tax return (S.2271 (112th Congress), Small Business Election Simplification Act, sponsored by Sens. Franken, Enzi, and Snowe; Ways and Means Committee Discussion Draft on Small Business and Passthrough Entity Tax Reform, 2013; American Bar Association, "Options for Tax Reform in Subchapter S of the Internal Revenue Code," April 2013; National Taxpayer Advocate, "2012 Annual Report to Congress," January 2012)
b. Alter deadlines of S corporation and partnership returns (S.420 (113th Congress), Tax Reform Due Date Simplification and Modernization Act of 2013, sponsored by Sens. Enzi, Stabenow, and others; Ways and Means Committee Discussion Draft on Small Business and Passthrough Entity Tax Reform, 2013; Testimony of Troy Lewis before the Finance Committee, April 26, 2012)
c. Require S corporations to calculate shareholder basis in the corporation's stock and report the information on Schedule K-1s (Government Accountability Office, "Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules," December 2009)