

THE GAP IN THE EMPLOYMENT TAX GAP

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In 2007, the Internal Revenue Service released a lengthy report on the federal tax gap (the “Tax Gap Report”) to analyze and quantify the difference between what taxpayers collectively owe in tax and what they actually pay on time.¹ Among other things, the Tax Gap Report showed that underreporting of employment taxes accounted for nearly 16% of the total tax gap in 2001, representing approximately \$54 billion of lost revenue.² Although this constitutes a substantial share of the total tax gap and a meaningful amount of lost revenue, the figure substantially understates the true shortfall in collections of federal employment taxes.

All but a miniscule portion of the employment tax gap is a result of underreporting by self-employed individuals. The Tax Gap Report gives substantial attention to only one reason why this is the case: the fact that sole proprietors simply do not report amounts they receive from third parties who are not required to either report the transaction to the government or withhold tax on the payment. According to the report, these least visible amounts go unreported a stunning 53.9% of the time.³

However, the Tax Gap Report fails to acknowledge another reason why the amount of employment tax collected from self-employed individuals falls short of what they ought to pay. When these persons conduct their business through a corporation, limited liability company or partnership, the law permits them to artificially exclude from the employment tax base amounts that would otherwise be included if they operated as a sole proprietor.⁴ A self-employed indi-

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1. INTERNAL REVENUE SERV., REDUCING THE FEDERAL TAX GAP: A REPORT ON IMPROVING VOLUNTARY COMPLIANCE (2007), available at http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf.

2. *Id.* at 10 fig.1. This includes \$1 billion of underreported unemployment tax.

3. *Id.* at 12.

4. This is not to suggest that the law accurately defines the employment tax base for a sole proprietor. There is evidence to suggest that the employment tax base for at least some sole proprietors is overstated because the tax applies to earnings that are more properly classified as income from capital, not labor. See Nicholas Bull & Paul Burnham, *Taxation of Capital and Labor: The Diverse Landscape by Entity Type*, 61 NAT’L TAX J. 397, 415 & tbl.9 (2008) (concluding that over 22% of the average sole proprietor’s income that is subject to employment tax is actually income from capital).

vidual can achieve this objective partly because the employment tax operates in an inconsistent way across business forms. Depending on the business entity that she uses, a self-employed individual can substantially reduce her employment tax liability and often eliminate it entirely. However, the Tax Gap Report does not consider such conduct, or the impact it has on tax collections, in its analysis.

The existence of tax reduction opportunities jeopardizes the integrity of the employment tax base. However, more importantly, it undermines the system's ability to operate in a fair and equitable way. Individuals who are in materially similar situations will pay vastly different amounts in tax solely because the law does not use a uniform rule to define the tax base. That alone offends basic notions of equity. However, it is also difficult, if not impossible, for the interests of equity and fairness to be served when the system permits an individual to determine the rules that will apply to him. When such options are available, tax outcomes will partly reflect how successfully someone has employed strategic measures to artificially reduce her tax liability.

The failure of the Tax Gap Report to adequately measure the employment tax gap is compounded by its failure to identify the full range of measures that should be taken to reduce it. The report emphasizes that any effort to reduce the tax gap cannot rely on any single approach. Instead, the report identifies seven components that any successful strategy must include. Most of them can be implemented by the Internal Revenue Service on its own initiative.⁵ However, two of them require action by Congress: Reducing opportunities for evasion and reforming and simplifying the law. In fact, the report does include a number of legislative proposals directed at achieving these two objectives.⁶ However, none of those proposals address the inconsistencies in the employment tax laws that permit a self-employed person to reduce her employment tax liability by strategically choosing a business form.

Scholars and policymakers have long known that by strategically selecting and using a business entity, a self-employed individual can reduce or otherwise control her employment tax liability. There have also been a number of proposals for correcting the defects in the law. Each of them operates in a slightly different way and none of them was made with the specific intent of closing the employment tax gap. Instead, the goal was simply to eliminate inconsistencies in the law and to provide a clear set of rules to address situations that were not contemplated when the law was drafted. Nevertheless, these suggestions can form the basis for a comprehensive legislative package to effectively reduce the

5. Those five components are (1) make a multi-year commitment to research, (2) continue improvements in information technology, (3) improve compliance activities, (4) enhance taxpayer service, and (5) coordinate with partners and stakeholders. INTERNAL REVENUE SERV., *supra* note 1, at 19.

6. *Id.* at 20-25, 50-52.

employment tax gap.

This Article has two objectives. First it will explain how the official employment tax gap understates the amount of revenue lost when self-employed individuals choose to operate through a formal business entity instead of as a sole proprietor. Second, it will offer a legislative proposal designed to substantially reduce these tax reduction opportunities. Part I examines the existing employment tax rules and explains the differences in the way they apply to a self-employed individual depending on the business form used for conducting the business. Part II explains how the inconsistent employment tax rules create substantial tax reduction opportunities for a self-employed person who does not operate as a sole proprietor. Part III shows that the employment tax gap is substantially larger when it takes into account the lost revenue attributable to self-employed individuals who do not operate as sole proprietors. Part IV concludes by exploring possible legislative reforms that can eliminate the tax reduction strategies that now pose the greatest threat to the integrity of the employment tax base.

I. THE FEDERAL EMPLOYMENT TAX SYSTEM AND THE SELF-EMPLOYED INDIVIDUAL

There are several legal forms through which a self-employed individual can conduct a business. These include the sole proprietorship, various forms of the partnership, the limited liability company, and the corporation. Each business form offers a different mix of features that may affect how suitable it may be for any given situation and how attractive it may be to the owners of the business. One factor that the owners of any business are likely to consider is the extent to which the earnings of the business will be subject to tax, including the employment tax.

The employment tax obligation of a self-employed individual will vary depending on the way the business is classified for tax purposes. Each state law business form has a default tax classification. However, in many instances, the owners of the business can choose a tax classification other than the default classification. The relevant tax classifications are the C corporation, the S corporation, the partnership, and the sole proprietorship. The following Subpart describes the default tax classification and the optional tax classification that apply to each state law business form.

A. *Business Forms and Tax Classifications*

Any individual who does not use a formal business entity, such as a corporation or limited liability company, to conduct a business activity that she conducts on her own is considered a sole proprietor under state law. A sole pro-

prietor is disregarded as a separate business entity for tax purposes.⁷ Instead, any income or loss of the business is merely included in the computation of the owner's individual income tax liability.⁸

If an individual (or group of individuals) incorporates a business under a state statute, the business is classified as a C corporation for tax purposes by default.⁹ When a business is a C corporation, the firm and its owners (shareholders) constitute separate taxpaying units. As a result, the firm pays income tax on its profits.¹⁰ Moreover, the profits will be subject to tax again in the event they are paid out to the shareholders as dividends.¹¹ However, if the business satisfies certain eligibility requirements, it can elect to be an S corporation for tax purposes.¹² Such a firm pays no tax on its profits.¹³ Instead, the shareholders are taxed on their share of the profits of the business, whether they receive any or not.¹⁴

An individual (or group of individuals) also has the option to form a limited liability company under state law. The default rules that apply to a limited liability company depend on whether it has one owner (member) or more than one. If it has only one member, the firm will be disregarded for tax purposes and the owner will be treated the same as if it were a sole proprietor, causing the business earnings to be taxed as if they were derived by the owner directly, not through a business entity.¹⁵ However, a single member limited liability company can elect to be classified as a C corporation for tax purposes, causing the business and its owner to be treated as separate and distinct taxpaying units and triggering the two layers of tax.¹⁶ Moreover, such a business can eliminate the firm level tax by making an additional election to be an S corporation, assuming it is eligible to do so.¹⁷

7. By regulation, only those unincorporated business ventures involving more than one person constitute a separate business entity for tax purposes. Treas. Reg. § 301.7701-1(a)(2) (as amended in 2009). As a result, any sole proprietorship is not a separate business entity in the eyes of the tax law because it is a business venture undertaken by only one person.

8. See I.R.C. § 61(a)(2) (West 2009).

9. Treas. Reg. § 301.7701-2(b)(1) (as amended in 2008).

10. I.R.C. § 11 (West 2009).

11. *Id.* § 61(a)(7) (West 2009).

12. *Id.* §§ 1362(a)(1), 1363(a) (West 2009).

13. *Id.* § 1363(a) (West 2009).

14. *Id.* § 1366 (West 2009).

15. Treas. Reg. § 301.7701-3(b)(1)(ii) (as amended in 2006).

16. *Id.* § 301.7701-3(a) (as amended in 2006).

17. See, e.g., I.R.S. Priv. Ltr. Rul. 200818017 (May 2, 2008). The regulations also permit an S election to take effect even when a limited liability company does not also separately elect to be treated as an association. Treas. Reg. § 301.7701-3(c)(1)(v)(C) (as amended in 2006).

If a limited liability company has more than one member, the firm will be classified as a partnership for tax purposes by default.¹⁸ Like an S corporation, such a firm is not a separate taxpaying unit and its profits are taxed directly to the members, whether they receive any or not.¹⁹ However, any multi-member limited liability company can elect to be classified as a C corporation for tax purposes.²⁰ Moreover, just like any other C corporation, the business can make an additional election to be classified as an S corporation, assuming it is eligible to do so.²¹

If two or more individuals conduct a business without using a corporation or limited liability company, they will constitute a partnership under state law.²² A state law partnership is classified as a partnership for tax purposes by default, making the partners, and not the firm, solely liable for the tax on firm profits whether they receive any or not.²³ However, any state law partnership can elect to be classified as a C corporation for federal income tax purposes so that the firm's profits will be subject to tax at both the firm and partner (shareholder) levels.²⁴ Moreover, if the business satisfies certain eligibility requirements, it can make an additional election to be classified as an S corporation, eliminating the firm level of tax.²⁵

Because the income tax and the employment tax apply in different ways to each tax classification of a business, the freedom to opt out of a default tax classification gives a self-employed individual a chance to potentially manage and control their exposure to and liability for both taxes. The next Subpart describes how the employment tax laws apply to the earnings derived by an individual engaged in a business under each tax classification that the business might have.

B. *The Federal Employment Tax Statutes*

There are two federal employment tax statutes that may apply to a self-employed individual. The first is the Federal Insurance Contribution Act ("FICA"), which imposes a tax that is commonly referred to as the social security tax. The second is the Self-Employment Contribution Act ("SECA"), which imposes a tax that is often referred to as the self-employment tax. The amounts collected under both acts are earmarked for funding social security

18. Treas. Reg. § 301.7701-3(b)(1)(i) (as amended in 2006).

19. I.R.C. § 701 (West 2009).

20. Treas. Reg. § 301.7701-3(a) (as amended in 2006).

21. *See supra* note 17.

22. REVISED UNIF. P'SHIP ACT § 202(a) (1997).

23. Treas. Reg. § 301.7701-3(b)(1)(i) (as amended in 2006).

24. *Id.* § 301.7701-3(a).

25. *See supra* note 17.

and Medicare benefits.²⁶ The two acts are mutually exclusive so that only one set of rules will ever apply to any given dollar of earnings. Both statutes are intended to impose a tax on income from labor, as opposed to any returns on capital.²⁷ As a result, each statute attempts to define the tax base in a way that isolates such labor income. However, the two statutes do not define the tax base in a consistent way for all tax classifications that a business might have.

1. The Federal Insurance Contribution Act

The tax imposed by FICA has two components. The first is the old-age, survivors, and disability insurance component, often referred to as OASDI. It is a 12.4% levy on amounts that constitute “wages” from employment.²⁸ One half of the tax is deducted from the employee’s compensation.²⁹ The employer pays the other half.³⁰ This component of the FICA tax is earmarked to cover social security benefits. There is a limit on the amount of wages that can be taxed.³¹ Referred to as the contribution and benefit base, this limit is \$106,800 for 2009.³² Thus, any wages from employment beyond that limit are exempt from the FICA-OASDI tax. The contribution and benefit base is adjusted each year to reflect increases in average wages of the U.S. economy.³³

The second component of the FICA tax is the hospital insurance component. It is a 2.9% levy on an individual’s “wages” from employment. As with the OASDI component, one half of this tax is deducted from the employee’s compensation, while the employer pays the other half. However, unlike the OASDI component, there is no limit on the amount of wages from employment that is subject to the tax. Thus, the hospital insurance tax applies to all amounts that qualify as wages from employment, even amounts that exceed the OASDI contribution and benefit base. The hospital insurance component of the FICA tax is earmarked to cover Medicare benefits.

2. The Self-Employment Contribution Act

The SECA tax operates as the FICA tax counterpart for self-employed individuals. Accordingly, like the FICA tax, the SECA tax has two components.

26. 42 U.S.C.A. § 401 (West 2009).

27. Patricia E. Dille, *Breaking the Glass Slipper—Reflections on the Self-Employment Tax*, 54 TAX LAW. 65 (2000).

28. I.R.C. §§ 3101(a), 3111(a).

29. *Id.* § 3102(a).

30. *Id.* § 3111(a).

31. *Id.* § 3121(a)(1).

32. Notice 2008-103, 2008-46 I.R.B. 1156.

33. 42 U.S.C.A. § 430 (West 2009).

The first component is a 12.4% tax earmarked to finance social security benefits. Its counterpart is the OASDI component of the FICA tax. The second component is a 2.9% tax earmarked to fund the Medicare insurance program.³⁴ Both components of the SECA tax are the sole responsibility of the self-employed individual; no portion of the tax is shared by an employer, as is the case with the FICA tax.

The contribution and benefit base that applies to the OASDI component of the FICA tax also applies to the OASDI component of the SECA tax. Thus, the OASDI tax applies to no more than \$106,800 in 2009.³⁵ The SECA and FICA statutes are designed so that the OASDI component of the taxes will never apply to more than the FICA contribution and benefit base in effect for any year.³⁶ By operating in this way, the rules ensure that anyone whose income includes both wages from employment and income from self-employment will never be at a disadvantage to someone who does not have income from both sources.

Both components of the SECA tax apply to an individual's "income from self-employment."³⁷ The term does not include any amounts that are subject to the FICA tax.³⁸ In addition, in order to count as income from self employment, an item must qualify as net earnings from self-employment ("NESE").³⁹ NESE does not include certain types of passive income, like rentals from real estate in certain cases, dividends and interest, and gains or loss from the sale of a capital

34. I.R.C. § 1401(b) (West 2009).

35. Notice 2008-103, 2008-46 I.R.B. 1156. The fact that the OASDI component of the employment tax does not apply to amounts in excess of the annually contribution and benefit base distinguishes it from the generally progressive way in which the federal income tax operates. The income tax applies only to the extent an individual has income that exceeds certain amounts that are either excluded, exempt, or deducted from gross income. I.R.C. § 63 (West 2009). The two federal employment taxes have been criticized for being regressive. *See, e.g.,* Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1 (2002).

36. Thus, if an individual has \$115,000 of wages from employment in 2009, the FICA-OASDI tax would apply to the first \$108,600, leaving no portion of any self-employment income to be taxed under SECA. Conversely, if an individual has no wages from employment in 2009, there would be nothing to tax under FICA, while the SECA-OASDI tax would apply to up to \$108,600 of any income the individual may have from self-employment. If, however, an individual has \$40,000 of wages from employment in 2009, the entire amount would be subject to the FICA-OASDI tax, while up to \$68,600 of self-employment income would be subject to the SECA-OASDI tax, resulting in a tax on no more than the \$108,600 contribution and benefit base in effect for the year. *See* I.R.C. § 1402(b) (West 2009).

37. *Id.* § 1401(a), (b).

38. *Id.* § 1402(b)(1).

39. *Id.* § 1402(b). A taxpayer is allowed a deduction in computing net earnings from self-employment. The deduction is equal to one-half of the taxpayer's OASDI and HI tax, determined before taking this deduction into account. *Id.* § 1402(a)(12).

asset or from timber, certain minerals, or other property that is neither inventory nor property held primarily for sale to customers.⁴⁰ Certain additional exclusions will apply depending on the kind of legal entity used to conduct the business enterprise and the kind of ownership interest the individual may have in the business. Those variations are described below.

However, in no event will the SECA tax ever apply to amounts generated by a self-employed individual who conducts his business through either a C corporation or an S corporation. Any dividends received by a shareholder in a C corporation are expressly excluded from the reach of the SECA tax.⁴¹ Furthermore, SECA has no provision that would count as part of the tax base of an individual's pro rata share from an S corporation.⁴² In both cases, only the payments made to the owner as compensation will be subject to the FICA tax. This will be the case even if other amounts derived by the business for the employee-shareholder represent earnings from his labor. Thus, FICA is designed in a way that permits a self-employed individual to have her cake and eat it too.

40. *Id.* § 1402(a)(1)–(3).

41. *Id.* § 1402(a)(2). The Internal Revenue Service has had limited success convincing courts to treat dividends as disguised remuneration for services rendered so that such amounts would be subject to the FICA tax. *E.g.*, *Nu-Look Design, Inc. v. Comm'r*, 356 F.3d 290 (3d Cir. 2004); *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990); *Radtke v. United States*, 712 F.Supp. 143 (E.D. Wis. 1989); *see also* Burgess J.W. Raby & William L. Raby, *Shareholder Compensation: How Low Can You Go?*, 1996 TAX NOTES TODAY 116-62 (June 13, 1996).

42. Because the S corporation is a flow-through entity, one would expect that the SECA rules would control to determine the employment tax liability of any shareholder, just as they do to partners in a partnership. The fact that it does not is largely a relic of a bygone era. When the self-employment tax was enacted, the S corporation did not exist, so the tax base could not be defined by reference to amounts earned through such a business. Furthermore, when subchapter S was adopted, a shareholder's pro rata share was treated as a dividend. I.R.C. § 1373(b) (1958) (amended 1982). The SECA statute expressly states that net earnings from self employment do not include dividends. *Id.* § 1402(a)(2). In addition, the Internal Revenue Service concluded that such an item did not count as part of the shareholder's net earnings from self-employment. Rev. Rul. 59-221, 1959-1 C.B. 225. However, subchapter S was later revised to modify the tax character of an S corporation's pro rata share. Today, a pro rata share is no longer regarded as a dividend. Instead, the individual items of S corporation taxable income flow through to the shareholders, retaining their character in the hands of the shareholder. *id.* § 1366(b). Even though this made a shareholder's pro rata share virtually identical to a partner's distributive share, Congress never updated the self-employment tax statute to establish parity in the way the law applies to the two situations. Thus, today the statute does not define net earnings from self-employment to include an S corporation shareholder's pro rata share, while it does expressly include a partner's distributive share of partnership income as such. *Id.* § 1402(a). Clearly, Congress could update the law if it could. It has been suggested that Congress has not done so partly because it views the separate existence of the S corporation as a sufficient basis for treating pro rata share allocations as investment income, not income from labor. Thomas E. Fritz, *Flowthrough Entities and the Self-Employment Tax: Is it Time for a Uniform Standard?*, 17 VA. TAX REV. 811, 825 (1998). However, there is no evidence that Congress has declined to act for that reason.

The firm can generate income that represents nothing other than the product of the owner's labor. However, those earnings will not be subject to the FICA tax as long as the firm does not pay them out to its owner as compensation for the services rendered to the business.

II. BUSINESS ENTITIES AND THE SHRINKING EMPLOYMENT TAX BASE

All non-passive business profits derived by a sole proprietor (including a single member limited liability company that is not classified as either a C or an S corporation) count as NESE under the self-employment tax.⁴³ Thus, the tax will apply to the entire amount. As long as an individual operates as a sole proprietor, there is virtually nothing she can do to manage, control or otherwise artificially reduce her employment tax liability, short of simply not reporting her earnings to the government. However, her options for reducing her employment tax bill grow if the business simply had a different tax classification. She can avail herself of those tax classifications by operating the business through a state law corporation or limited liability company.

A. C Corporations

The FICA tax will apply to a self-employed individual when that person operates a business that is classified as a C corporation for tax purposes. In that situation, only amounts that the firm pays to the employee-shareholder as remuneration for employment count as "wages" from employment.⁴⁴ Thus, only those amounts are subject to the FICA tax. The individual's share of any other profits of the business may simply escape the FICA tax, even if it could be considered the product of the employee-shareholder's labor. As a result, earnings that the corporation retains are not subject to the FICA tax. By defining the tax base as it does, FICA presents the opportunity for individuals to manage or control their employment tax liability when they work for a corporation that they also own and control. In such cases, the individual can determine whether compensation is paid, when it gets paid, and how much is paid. By exercising this power, the individual necessarily controls whether he must pay the FICA tax, when he must pay the FICA tax, and how much tax he must pay. If the business were classified as a sole proprietorship, then the employee-owner would not enjoy that kind of flexibility.

According to two government economists, there is an incentive for a C corporation to understate reasonable compensation when its marginal tax rate is

43. I.R.C. § 1402(a) (West 2009).

44. *Id.* § 3121(a); *see also* Rev. Rul. 59-221, 1959-1 C.B. 225.

15% or less.⁴⁵ A corporation is taxed at 15% or less when its taxable income does not exceed \$50,000.⁴⁶ There are no definitive statistics on the number or prevalence of corporations with net incomes at or below that level. However, the number appears to be quite high based on the available evidence. Nearly 30% of all C corporations had gross receipts not exceeding \$50,000 in 2005.⁴⁷ The taxable income (receipts reduced by deductible expenses) of any such corporation would likewise not exceed \$50,000. Another 35% of all C corporations had gross receipts over \$50,000 and up to \$500,000.⁴⁸ However, it is very common for such firms to operate at a loss, suggesting that an equally large portion of them are likely to have taxable incomes that are very low, even below the \$50,000 threshold.⁴⁹

There are even more sinister ways that a C corporation can be used to escape the FICA tax. The corporation may simply pay the employee-shareholder amounts that are not designated as “wages,” even though they constitute just that. For example, amounts paid out as dividends, royalties or rents may represent nothing more than a substitute for wage income.⁵⁰ In fact, C corporations have faced an even stronger incentive to substitute dividends for wages ever since 2003, when the tax on most corporate dividends was reduced to 15%.⁵¹ High-income employee-shareholders of low-income corporations are the most likely to gain from this technique.⁵² The temporary dividend tax cut is set to expire by 2010.⁵³ However, there is a strong chance that low-income corporations will continue to find it more attractive to substitute a dividend for any salary it might pay to a controlling owner. President Obama’s first budget contains a proposal to cap the tax on dividends at 20% for individuals earning over

45. Bull & Burnham, *supra* note 4, at 402 & tbl.1. The same economists concluded that a C corporation has an incentive to overstate compensation when the corporation’s marginal tax rate is at least 35%. *Id.*

46. I.R.C. § 11(b)(1)(A).

47. JOINT COMM. ON TAXATION, TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY 14 tbl.3 (2008).

48. *Id.*

49. Firms with net losses accounted for 45% of C corporations with gross receipts over \$50,000 and up to \$100,000 in 2005. Net loss firms accounted for 43% of C corporations with gross receipts over \$100,000 and up to \$250,000 in the same year. Net loss firms accounted for 38% of C corporations with gross receipts over \$250,000 and up to \$500,000 that year. *Id.* at 21 tbl.9b.

50. See, e.g., Richard Winchester, *Working for Free: It Ought to be Against the (Tax) Law*, 76 Miss. L.J. 227 (2006) (discussing the incentives for closely held C corporations to substitute dividends for compensation paid to employee-shareholders).

51. I.R.C. § 1(h)(11)(A), amended by Pub. L. No. 108-27, § 302(a), 117 Stat. 752, 760-61 (2003); I.R.C. § 1(h)(3)(B), amended by Pub. L. No. 108-27, § 302(e)(1), 117 Stat. 752, 763 (2003). Section 303 of Pub. L. No. 108-27 sunsets this provision after 2008.

52. Winchester, *supra* note 50, at 278.

53. Pub. L. No. 109-222, § 102, 120 Stat. 345 (2006).

\$200,000 and married couples earning over \$250,000.⁵⁴

To be sure, the government could rightfully challenge whether a payment should be treated as nothing more than disguised wages. However, because the government is in no position to audit every tax return filed by a closely held corporation, the vast majority of these cases probably go undetected and unprosecuted.⁵⁵ When a business is selected for audit, the government must engage in a complex inquiry into the facts and circumstances of each case, draining scarce resources and sometimes leading to costly litigation.⁵⁶

Even when it does pay compensation to an employee-shareholder, a C corporation can also limit the employment tax liability if it pays careful attention to the timing of the payment. Because compensation in excess of the FICA contribution and benefit base is exempt from the OASDI component of the tax, employment taxes can be saved by compressing multiple years' worth of compensation into a single year. Thus, if the owner received \$180,000 in compensation in 2009, only \$106,800 would be subject to the 12.4% OASDI tax. The rest would be exempt from that tax, even though it may relate to services performed during a year when the corporation did not pay the owner a salary. Therefore, even when the employment tax is triggered, the tax liability can be managed and minimized by an individual who owns and controls the corporation that employs him.

A limited liability company that is classified as a C corporation enjoys additional tax planning opportunities. Because shares in a state law corporation belong to designated classes, all owners of shares in a given class must share in any distribution paid to one class member; the corporation cannot single out an individual shareholder to receive a dividend distribution. No such restriction applies to a limited liability company. Thus, the company is entirely free to single out one of its members for a distribution. Similarly, the company could make a distribution to several members and not be obligated to allocate the payment in any particular way. This flexibility magnifies the chances that an employee-member will receive a distribution as disguised compensation for services rendered to company, potentially avoiding the member's employment tax liability.

54. OFFICE OF MGMT. & BUDGET, A NEW ERA OF RESPONSIBILITY: RENEWING AMERICA'S PROMISE 123, tbl. S-6 (February 26, 2009).

55. In fact, the audit rate appears to be disturbingly low, at least for S corporations. Between fiscal years 1996 and 2003, the examination coverage rates for S corporation returns ranged from a high of 1.04% to a low of 0.30% in 2003. TREASURY INSPECTOR GEN. FOR TAX ADMIN., ACTIONS ARE NEEDED TO ELIMINATE INEQUITIES IN THE EMPLOYMENT TAX LIABILITIES OF SOLE PROPRIETORSHIPS AND SINGLE-SHAREHOLDER S CORPORATIONS 9 (2005).

56. *E.g.*, *Charlotte's Office Boutique, Inc. v. Comm'r*, 121 T.C. 89 (2003) (holding that royalties paid to sole shareholder-employee should be treated as wages subject to FICA tax), *aff'd*, 425 F.3d 1203 (9th Cir. 2005).

Clearly, then, one way a self-employed individual can eliminate her employment tax liability is by taking advantage of the option to classify the business as a C corporation and for the firm to pay no salary to her. The firm can also substitute a dividend (or other type of non-wage payment) for a salary and achieve the same employment tax savings while at the same time gaining access to the profits of the business.

B. S Corporations

The FICA tax will also apply to a self-employed individual when that person's business is classified as an S corporation for tax purposes. As in the case of a C corporation, only amounts that the firm pays to the employee-shareholder as remuneration for employment count as "wages" from employment.⁵⁷ Thus, the FICA tax will only apply to those amounts and not to any profits that the business either retains or pays out to the shareholder in some other form. As a result, an individual who works for an S corporation that she also owns and controls can manage or control her employment tax liability to the same degree as if the business were classified as a C corporation, permitting her to avoid the employment tax she would pay if the business were a sole proprietor.

An S corporation represents a more serious threat to the employment tax base than does a C corporation, however, because there is never a tax incentive for an S corporation to pay a salary to an employee who also controls the corporation. Instead, the corporation and its controlling employee-owner will always pay the least tax if the firm pays its earnings to the employee-owner as a distribution. In fact, there is overwhelming evidence that this occurs with alarming frequency. Fifty-six percent of S corporations had one shareholder in 2006, while another 28% had two shareholders.⁵⁸ These closely held firms routinely pay nothing to their officers in the form of compensation. For single shareholder S corporations, the rate was 58% in 2005, while the rate was 29% when the corporation had two shareholders.⁵⁹ A separate study from 2000 revealed a similar pattern. In that year, 78.9% of all S corporations were either fully owned by a single shareholder (69.5%) or more than 50% owned by one (9.5%).⁶⁰ Moreover, when the corporation had only one owner, the average salary paid out to the owner equaled only 41.5% of firm profits.⁶¹

57. I.R.C. § 3121(a); *see also* Rev. Rul. 59-221, 1959-1 C.B. 225.

58. 1 NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS 313 chart 1.20.7.

59. *Id.* at 314 chart 1.20.8.

60. TREASURY INSPECTOR GEN. FOR TAX ADMIN., *supra* note 5, at 3-4.

61. *Id.* at 5.

If the firm distributes its earnings to an employee-owner who received no wages or salary for her work, the government could rightfully attack the distribution as being nothing more than disguised compensation that should be subject to the FICA tax.⁶² However, the government is ill-equipped to perform the kind of audits that would help detect all potential instances of disguised compensation.⁶³ As a result, the vast majority of these cases probably go unchallenged. The few that are caught have the potential to draw the government into protracted litigation, putting further pressure on the government's limited resources.⁶⁴

Had each of these single owner businesses been conducted as a sole proprietorship, all of the firm's profits would have been subject to employment tax. Clearly, there are a number of self-employed individuals who are taking advantage of the opportunity to reduce their employment tax bill by operating as an S corporation and by grossly understating their earnings from labor.

C. Partnerships

The self-employment tax will apply if a business is classified as a partnership for tax purposes. The tax will be the sole responsibility of the individual partner. However, the partner's tax base will depend on whether the partner is a general partner or a limited partner. If a partner is a general partner, the self-employment tax will apply to the partner's share of partnership income.⁶⁵ The tax will also apply to any guaranteed payment the partner receives, whether for the use of capital or for the performance of services.⁶⁶ For a limited partner, the

62. *E.g.*, *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990) (affirming district court decision for the government); *Radtke v. United States*, 712 F.Supp. 143 (E.D. Wis. 1989) (summary judgment for the government), *aff'd*, 895 F.2d 1196 (7th Cir. 1990); *NuLook Design, Inc. v. Comm'r*, 85 T.C.M. (CCH) 927 (2003) (decision for the government), *aff'd*, 356 F.3d 290 (3d Cir. 2004).

63. See TREASURY INSPECTOR GEN. FOR TAX ADMIN., *supra* note 5.

64. See, *e.g.*, *Spicer Accounting, Inc.*, 918 F.2d 90; *Radtke*, 712 F.Supp. 143; *NuLook Design, Inc.*, 85 T.C.M. (CCH) 927.

65. I.R.C. § 1402(a) (West 2009). Certain adjustments are made to the partner's distributive share to determine the amount that is subject to the self-employment tax. The adjustments generally prevent the tax from applying to certain passive items of income that do not represent income from labor. Thus, in computing the self-employment income of a partner, the distributive share is adjusted to exclude, among other things, interest and dividends, and gains and losses from the sale of capital assets. *Id.* § 1402(a)(2)–(3).

66. Treas. Reg. § 1.1402(a)-1(b) (as amended in 1974). The regulation predates a 1977 amendment that redefined what counts as self-employment income to a partner. Social Security Amendments of 1977, Pub. L. No. 95-216, § 313(b), 91 Stat. 1509 (current version at I.R.C. § 1402(a)(13) (West 2009)). (This paragraph was originally added as paragraph 12. However, Pub. L. No. 98-21, § 124(c)(2), 97 Stat. 65 (1983), redesignated paragraph 12 as paragraph 13. The change only affected what counts as self-employment income to a limited partner. The legislative history does not elaborate on the intended scope of the change. See

self employment tax applies only to the guaranteed payments received for the performance of services; it does not apply to the partner's share of partnership income.⁶⁷

There are no provisions in the self-employment tax statute or regulations that specify what distinguishes a limited partner from a general partner for purposes of the statute.⁶⁸ This stands in contrast to the standard articulated in the Revised Uniform Partnership Act. Under those rules, a limited partner is not liable for the debts and obligations of the partnership, while a general partner is.⁶⁹ Thus, under current law, a partner's exposure for the self-employment tax is purely a matter of the nature of the interest the partner owns in the partnership.⁷⁰

Someone who is a general partner in a partnership can limit her employment tax exposure by holding the lion's share of her investment as a limited interest. If a partner owns both a general partnership interest and a limited partnership interest, the self-employment tax applies to that portion of the partner's distributive share associated with the general partnership interest only.⁷¹ Thus a token interest as a general partner combined with a much larger interest as a limited partner will cause the employment tax to apply only to the token amount of partnership profits associated with the general interest. A sole proprietor enjoys no such flexibility.

Because a multi-member limited liability company is classified as a partnership for federal income tax purposes by default, any member is treated as a partner in a partnership for purposes of the self-employment tax. However, treating the firm as a partnership for self-employment tax purposes does not

H.R. REP. NO. 8-702, at 85 (1977). Thus, it appears that general partners remain subject to employment tax on guaranteed payments received both for services performed and for the use of capital.

67. I.R.C. § 1402(a)(13) (West 2009).

68. However, there are proposed regulations which would consider the degree to which a limited partner participates in the operations of the partnership. Prop. Treas. Reg. § 1.1402(a)-2(h)(2), 62 Fed. Reg. 1702 (Jan. 13, 1997). Congress acted in 1997 to prohibit the Internal Revenue Service from finalizing these regulations. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788.

69. REVISED UNIFORM PARTNERSHIP ACT § 303(a) (1997).

70. One might expect that amounts received by a partner in exchange for the performance of services would count as wages from employment for FICA purposes. However, the legislative history indicates that Congress expected that it would not be appropriate to treat the partnership as a separate taxpaying unit (as opposed to an extension of the partner) in certain situations. See H.R. REP. NO. 2543, at 59 (1954). In addition, the Internal Revenue Service long ago concluded that it is inappropriate to treat a partnership as an employer of one of its members. Rev. Rul. 69-184, 1969-1 C.B. 256. As a result, payments that are considered to be made by the partnership to a partner who is not acting in his capacity as a partner will not count as wages that are subject to the FICA tax. Instead, the amounts are treated as self-employment income to the partner. *Id.*

71. Prop. Treas. Reg. § 1.1402(a)-2(h)(3), 62 Fed. Reg. 1702 (Jan. 13, 1997).

produce any clear answers. That is because state limited liability company statutes do not draw distinctions between members like the employment tax does.

One could assert a reasoned basis for treating a limited liability company member as equivalent to either a general partner or a limited partner for employment tax purposes. For example, it would seem appropriate to treat a member as equivalent to a general partner since all members are in a position to participate in the operations of the company.⁷² On the other hand, one could argue that the limited partnership rules should apply on the grounds that a member enjoys limited liability from the debts and obligations of the business, the hallmark of a limited partner's status as such.⁷³

Understandably, the absence of a clear rule has been an invitation for some to contend that a member must comply with the rules that apply to limited partners since doing so works to their advantage.⁷⁴ Taking that position minimizes the member's employment tax liability because the member's net earnings from self-employment would consist solely of amounts received from the company in exchange for services the member performed for the company; no part of the member's allocation of business profits would be included in the employment tax base. No sole proprietor enjoys such latitude to limit their employment tax liability.

Given the employment tax savings that could be realized by a self-employed person who operates through a business form other than a sole proprietorship, one might reasonably question why anyone would choose to do business as a sole proprietor. There are several reasons why this might be the case. First, some business forms may simply not be available. For instance, if a person does not have a business partner, the partnership form is simply not an option.⁷⁵ The S corporation form is only available to a business that satisfies a number of eligibility requirements relating to the shareholders and the type of business conducted by the firm.⁷⁶ Another reason may be that business owners

72. UNIFORM LIMITED LIABILITY COMPANY ACT § 301(a), (c) (1996). The employment tax was drafted to apply different rules to general and limited partners because at the time this distinction was drawn, a limited partner ran the risk of losing her limited liability if the partner participated in the management of the partnership's business. State laws have since evolved to where they now permit limited partners to participate in management without jeopardizing their limited liability for the debts and obligations of the business. *See* JOINT COMM. ON TAXATION, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION 277-87 (2001).

73. *See id.* § 303.

74. *See, e.g.,* Burgess J.W. Raby & William L. Raby, *New Incentive for Avoiding SE and FICA Tax*, 81 TAX NOTES 1389, 1389-90 (1998).

75. By definition, a partnership arises only when at least two persons carry on a business for profit. REVISED UNIFORM PARTNERSHIP ACT, *supra* note 69, § 202(a); Treas. Reg. § 301.7701-2(c)(1) (as amended in 2008).

76. *See* I.R.C. § 1361(b)(1), (2) (West 2009).

may simply be unaware of the full range of options and the tradeoffs associated with each one. Moreover, a business owner who wants to understand his options must either consult a tax professional for advice or attempt to educate himself about the tax rules that apply to each business form. There may also be situations in which the business is simply not substantial enough to justify the investment of time or money to identify the optimal business form for tax purposes. One can also not rule out those cases in which non-tax considerations, or non-employment tax considerations, outweigh any employment tax cost that might be associated with operating as a sole proprietor. It is hard to discount the utter simplicity of the sole proprietorship. The owner does not have to do anything other than engage in the business by himself.

III. THE GAP IN THE TAX GAP

The government estimated that the net federal tax gap was \$290 billion in 2001.⁷⁷ The employment tax gap accounted for \$59 billion of that total.⁷⁸ Only the income tax gap accounted for a greater share of the total. The \$59 billion employment tax gap consisted of two components: \$54 billion of tax that was underreported, and \$5 billion of tax that was reported but not paid.⁷⁹ The \$54 billion in underreported employment tax consisted of \$39 billion of underreported self-employment tax, \$14 billion of underreported FICA tax, and \$1 billion of unemployment tax.⁸⁰

When it estimated the tax gap, the government took into account the aggregate amount of true tax liability imposed by law that was not paid voluntarily and on time.⁸¹ Because a self-employed person is not legally required to operate as a sole proprietor, the savings achieved by operating through a different business entity were not taken into account when computing the tax gap. Moreover, there is substantial evidence that any abusive practices undertaken by firms and their controlling employee-owners are far from fully reflected in the official tally of the federal employment tax gap.

The IRS does not specify whether the abusive practices discussed in this Article were taken into account when it computed the \$53 billion of underreported FICA and SECA tax. Indeed, it is inherently difficult to estimate how much bigger the employment tax gap would be if the government took into account the nonuniform methods for computing the employment tax base of self-employed individuals who operate through a business entity. However, two

77. INTERNAL REVENUE SERV., *supra* note 1, at 11 fig.3.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.* at 6.

government economists have attempted to estimate the difference between the amount of income that is reported for employment tax purposes and the amount of income that should be attributable to an owner's labor. Those figures can provide at least a rough idea of the magnitude of the problem. According to their computations, profitable firms collectively understated their employment tax base by almost \$105 billion each year during the 2000 through 2004 period.⁸² That would translate into \$16 billion in unreported and unpaid revenue if the entire amount was subject to federal employment tax.⁸³

As big as that number is, there are good reasons to believe that the situation has been getting worse over time. The two government economists estimated that profitable S corporations accounted for nearly \$75 billion of the \$105 billion in untaxed labor income derived from profitable firms in their study. S corporations have accounted for a growing share of all corporate returns, reaching 65% in 2005.⁸⁴ Moreover, it is widely believed that sole proprietors convert their businesses to S corporations at least in part to avoid having to pay the self-employment tax on the entire amount of profits derived by the business.⁸⁵ There is already a cottage industry built around advising small businesses to save on employment taxes by forming S corporations.⁸⁶ So, unless historical

82. Bull & Burnham, *supra* note 4, at 418 tbl.10. The estimate is expressed in 2002 dollars and is based on a sample of returns from the 2000 to 2004 period. This figure understates the amount of income that would be subject to employment tax if the rules for sole proprietors applied uniformly across all firms. This is because the authors attempted to isolate the portion of a firm's income that is attributable to labor and the portion that is attribution to capital. Their estimate of the understated employment tax base assumes that the tax would apply solely to the portion of business income attributable to the owner's labor. The employment tax, however, does not apply solely to that portion of a sole proprietor's income that is attributable to the owner's labor. Rather, the tax applies to all the income derived by the business operated by a sole proprietor, other than certain items of income derived from passive sources. I.R.C. § 1402(a) (West 2009).

The \$105 billion figure does not take into account the profitable firms and sole proprietors who overstated the amount of firm income that should have been subject to employment tax. The authors estimated that such businesses collectively reported about \$91 billion of income that should not be subject to employment tax because it represents income from capital, not labor. Bull & Burnham, *supra* note 4, at 418 tbl.10. As a result, the authors estimated that the employment tax base of all profitable firms and sole proprietors is understated by \$14 billion (\$105 billion reduced by \$91 billion). *Id.*

Interestingly, the authors conclude that income from labor is even more grossly understated by unprofitable firms and sole proprietors. According to their estimates, such businesses collectively understated the employment tax base by over \$139 billion. *Id.* That translates into nearly \$21 billion in unrealized employment tax revenue if the entire amount were subject to the 12.4% OASDI tax and 2.9% hospital insurance tax.

83. The total consists of approximately \$13 billion in the 12.4% OASDI tax and \$3 billion in the 2.9% hospital insurance tax.

84. 1 NAT'L TAXPAYER ADVOCATE, *supra* note 58, at 304.

85. *Id.*; TREASURY INSPECTOR GEN. FOR TAX ADMIN. *supra* note 55, at 13.

86. TREASURY INSPECTOR GEN. FOR TAX ADMIN. *supra* note 55, at 13. There is no

trends reverse themselves, the gap in the employment tax gap is likely to get larger over time.

It is also doubtful that the official employment tax gap reflects the revenue loss resulting from the incentives created by the temporary dividend tax cut. As explained above, that short-term rule made it possible for a low-income C corporation to save tax dollars by substituting a dividend for compensation it would have paid a high-income controlling shareholder who worked for the firm.⁸⁷ However, there is no research showing the employment tax revenue loss resulting from that practice. Whatever it is, the mere existence of this tax reduction opportunity only further underscores the fact that the officially reported FICA tax gap substantially understates the true revenue loss to the government.

IV. WHAT CONGRESS CAN DO TO REDUCE THE GAP IN THE TAX GAP

The government's interest in reducing the tax gap is not served by a system that legitimizes tax reduction strategies that cannot be justified on any sound theory or philosophy. Unfortunately, the current employment tax system does precisely that. The non-tax differences in business form are unrelated to the different tax consequences associated with each one. To make matters worse, even if someone were unhappy with the tax rules that apply to a particular business form, in most cases she can secure a different set of tax consequences by simply electing a different tax classification for the business. A limited liability company probably provides the best illustration of this flexibility. By default, it will be either disregarded or treated as a partnership for federal income tax purposes, depending on whether it has one or more than one owner. However, the company can be classified as a C corporation at the election of the owner(s), or classified as an S corporation if an additional election is made.

The options available to the self-employed essentially represent a cost free invitation for them to reduce their employment tax liability by strategically choosing a business form and a tax classification for the business. Policymakers should be concerned whenever the tax law operates in a way that jeopardizes the integrity of the tax base. However, they should be especially concerned now about preserving the integrity of the employment tax base because any threat to it will only further undermine the viability of the Social Security and Medicare programs when their long term solvency is in question. The annual expenditures for the OASDI program are expected to exceed employment tax collections starting in 2017. At that time the social security trust fund will have to liquidate its assets to cover the shortfall until those assets are exhausted in

shortage of literature discussing ways to capitalize on this opportunity to minimize or eliminate employment taxes where they would otherwise apply. *E.g.*, James L. Wittenbach & Ken Milani, *FICA Factors for S Corporation Payments to Owner/Employees*, 75 PRAC. TAX STRATEGIES 338 (2005).

87. See *supra* notes 51-52 and accompanying text.

2041.⁸⁸ Under the circumstances, the sooner lawmakers close the employment tax gap, the better.

Any reform of the employment tax laws must be premised on the idea that a uniform rule should apply to any self-employed individual. The Internal Revenue Service twice proposed very limited measures to make the rules apply in a more uniform way.⁸⁹ Neither proposal attracted enough support to succeed.⁹⁰ In fact, the second proposal was met with enough political resistance that Congress was successfully lobbied to impose a moratorium on further rulemaking by the agency.⁹¹ In the interim, what was a bad situation has only gotten worse. At the same time, two other sets of proposed reforms have been advanced and greeted with positive receptions. Because any reform must be politically palatable in order to make a difference, it makes sense to examine the elements of these two plans and to build on their strengths.⁹²

The first proposal was offered by the Staff of the Joint Committee on Taxation (the “JCT Staff”).⁹³ It has the advantage of having been widely endorsed by certain elements of the practicing bar.⁹⁴ The second proposal was offered by the American Bar Association (the “ABA”) and the American Institute of Certified Public Accountants (the “AICPA”).⁹⁵ It was described as an “excellent approach” by a critic of the IRS regulations who represented a coalition of

88. THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE & SURVIVORS INSURANCE & FEDERAL DISABILITY INSURANCE TRUST FUNDS, 2008 ANNUAL REPORT 2 (2008).

89. See 59 Fed. Reg. 67253 (proposed Dec. 29, 1994) (to be codified at 26 C.F.R. pt. 1); 62 Fed. Reg. 1702 (proposed Jan. 13, 1997) (to be codified at 26 C.F.R. pt. 1). Both sets of rules define a limited partner for employment tax purposes.

90. The first set of proposed regulations was withdrawn and replaced with the second set of proposed rules after the agency received too many negative comments from the public.

91. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788.

92. A third proposal was advanced by the Treasury Inspector General for Tax Administration, who focused on eliminating the tax evasion opportunities posed by S corporations. See TREASURY INSPECTOR GEN. FOR TAX ADMIN., *supra* note 5, at 18-19 (requiring any 50% owner of an S corporation to count as net earnings from self employment his or her share of all the ordinary operating gains of the S corporation).

93. JOINT COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 99-104 (2005).

94. *E.g.*, TAX SECTION, N.Y. STATE BAR ASS'N, COMMENTS ON JCT RECOMMENDATION RELATING TO EMPLOYMENT AND SELF-EMPLOYMENT TAXES OF PARTNERS, LLC MEMBERS AND S CORPORATION SHAREHOLDERS (2005). However, the NYSBA believed the JCT Staff proposal defined the employment tax base too broadly. See also, David C. Culpepper et al., *Self-Employment Taxes and Passthrough Entities: Where Are We Now?*, 109 TAX NOTES 211 (2005) (endorsing the JCT Staff proposal with some reservations).

95. *ABA Tax Section Suggests Legislative Fix for LLC Self-Employment Tax*, 1999 TAX NOTES TODAY 133-23 (July 13, 1999). Although submitted by the ABA Tax Section, the transmittal letter states that the organization worked closely with the Tax Division of the AICPA to develop it. In addition, the proposal itself notes that it is identical to the position of the AICPA.

small businesses that lobbied Congress to impose the rulemaking moratorium on the agency.⁹⁶

A. JCT Staff Proposal

Under the JCT Staff proposal, the current rules that apply to general partners of a partnership would apply to any individual who owns an interest in an S corporation or any business classified as a partnership for tax purposes. Thus, all such persons would generally have to pay self-employment tax on the profits of the business allocated to them, even if such income is not actually paid out to them. These individuals would also have to pay self-employment tax on any compensation they receive for services rendered to the business. However, a special rule applies if the individual does not “materially participate” in the business. In such a case, the tax would apply only to the “reasonable compensation” that the individual receives.

The material participation standard is already used elsewhere in the Internal Revenue Code. Under the passive activity loss provisions, an activity qualifies as a passive activity only if the taxpayer does not “materially participate” in it.⁹⁷ The Internal Revenue Service has issued a set of temporary regulations that contain a mechanical set of rules to determine whether the material participation test is satisfied by an individual.⁹⁸ By invoking the material participation standard in its employment tax proposal, the JCT Staff is invoking the mechanical tests in those regulations for purposes of the proposal.

The JCT Staff proposal retains the current limitation on the kinds of profits that are taxable to an owner under the self-employment tax. Thus, certain types of passive income like dividends and interest, certain gains, and other items that do not seem to qualify as income from labor would not be subject to tax. However, the proposal carves out an exception when the entity is in a service trade or business. In such situations, all of the profits allocated to an owner are treated as net earnings from self-employment.⁹⁹ There were two stated ratio-

96. Sheryl Stratton, *ABA/AICPA Have Legislative Fix for LLC Self-Employment Tax Problem*, 84 TAX NOTES 351, 353 (1999).

97. I.R.C. § 469(c)(1)(B) (West 2009). Certain losses and credit are disallowed on passive activities. *Id.* § 469(a)(1).

98. An individual materially participates in an activity if either (1) she participates in the activity for more than 500 hours during the year, (2) her participation constitutes substantially all of the participation in such activity of all individuals during the year, (3) her participation involves more than 100 hours during the year and is not less than the participation of any other individual, or (4) her aggregate participation in significant participation activities exceeds 500 hours for the year. Treas. Reg. § 1.469-5T(a)(1)-(4), (c) (as amended in 1996). In addition, there are two situations in which material participation of prior years constitutes material participation in the current year. *See Id.* § 1.469-5T(a)(5), (6) (as amended in 1996).

99. A service business is defined to be one whose activities involve the performance

nales for the approach suggested by the JCT Staff. The first was to treat similarly situated individuals similarly. The second was to limit the tax to amounts that constitute labor income.¹⁰⁰

B. ABA/AICPA Proposal

The proposal offered by the ABA and the AICPA confined itself to the manner in which the law applied to individuals who conduct business through an entity classified as a partnership for tax purposes. The proposal contained two key parts. First, it would apply a uniform rule to any equity owner in an entity taxed like a partnership. Thus, the rule would eliminate the artificial distinction between general and limited partners, and it would also eliminate the uncertainty about how limited liability company members would be treated. All of these individuals would be treated the same. Second, the proposal would require these individuals to count as net earnings from self employment their entire share of the profits of the business other than amounts representing a return on any capital the individual had invested in the business.

The proposal contained two ways to distinguish an individual's return on capital from the amounts subject to the self-employment tax. The first approach was to restrict the tax to the amount representing "reasonable compensation" for any services performed by the individual for the business. Under the second approach, a reasonable rate of return on capital would be computed by multiplying the individual's invested capital by 150% of the highest applicable federal rate.

The organizations justified their approach on the theory that only income attributable to the services rendered by the individual should be subject to the self-employment tax. Although the proposal did not address the case of sole proprietors, the organizations expressly noted that the idea should be extended to that class of self-employed individuals too. Such a measure would reduce the employment tax liability of sole proprietors, who currently include in the SECA tax base all the earnings derived by their business activities.

C. An Assessment and a Proposal

Both proposals share two worthwhile features in common. First, both articulate a clear rule that applies when a person is an employee-member of a limited liability company that is classified as a partnership for federal income tax

of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. This definition is similar to the one that appears in I.R.C. § 448(d)(2) (West 2009).

100. *Social Security: Achieving Sustainable Solvency: Hearing Before the S. Comm. on Finance*, 109th Cong. 4 (2005) (statement of George K. Yin, Chief of Staff, Joint Comm. on Taxation), available at <http://www.house.gov/jct/x-38-05.pdf>.

purposes. That is a problem that Congress should have corrected a long time ago. Second, both eliminate the artificial distinction that current rules draw between a general partner and a limited partner. There may have been a meaningful tax distinction between the two in the past. However, partnership law has evolved to the point where the distinction is now irrelevant for tax purposes.

Although both proposals can claim to have a measure of support from interested parties, the ABA/AICPA plan is weaker than the JCT Staff proposal in at least two respects. First, it applies in far fewer cases than does the JCT Staff proposal. The ABA/AICPA plan adopts a uniform rule that applies only to business entities that are classified as partnerships for federal income tax purposes. Although self-employed individuals operating through these entities account for a substantial share of the employment tax gap, it is far less than the share attributable to self-employed individuals who operate through corporate entities. The JCT Staff proposal at least includes S corporation shareholders within the scope of the rules it proposes.

The more troubling feature of the ABA/AICPA plan is that it uses the “reasonable compensation” standard as one way for a partner to determine her employment tax base. The reasonable compensation standard is largely responsible for the revenue that is lost when a self-employed individual operates through a corporate entity. Extending that standard to partners in partnerships would likely lead to an increase in the employment tax gap, not a reduction in it. A legislative measure will help reduce the size of the tax gap if it uses bright-line rules to draw distinctions and to measure tax liability. The JCT Staff proposal does not eliminate the use of the “reasonable compensation” standard. However, it comes into play in a very limited range of situations, minimizing the threat to the integrity of the employment tax base. In fact, the JCT Staff proposal is built around a general rule that requires a partner or S corporation shareholder to pay self-employment tax on her entire share of the profits of the business. As a result, the JCT approach comes very close to replicating the treatment of sole proprietors in the most important cases.¹⁰¹ There will be fewer opportunities to engage in artificial tax reduction strategies if the law contains fewer disparities in the way the employment taxes apply across all business forms.

However, the JCT Staff proposal suffers from the failure to apply its uniform rule to cases where a self-employed individual operates through a C corporation. This weakness is especially salient if the objective is to reduce opportunities for evasion of the employment tax. It is already apparent from past

101. The one principal difference is that, for individuals other than sole proprietors, the self-employment tax base excludes certain rental income, dividends and interest, certain gains and other items. However, as a practical matter, it may be that many of these items would never be reflected in a sole proprietor's business income. That would prevent it from being taken into account for self-employment tax purposes.

experience that there is a real incentive for a C corporation to undercompensate a controlling employee-shareholder for her services in a substantial number of cases, causing employment tax collections to fall short of what they would be if the individual was a sole proprietor. In fact, the revenue loss exceeds by as much as a factor of two what the government loses when S corporation shareholders substitute dividends for officer compensation. A C corporation will only become more attractive as a potential employment tax shelter if a tax reform package fails to cover it. A uniform rule that does not apply to all relevant situations will have a limited impact on reducing undesirable practices.

If the JCT Staff proposal did apply to C corporations, it would require any shareholder who “materially participates” in the business to pay self-employment tax on her share of the firm’s earnings and also on any amounts that the firm pays to her as compensation for her labor. That is likely to bring within the scope of the rule any shareholder in a publicly traded corporation that employs the shareholder on a full-time basis. Those are clearly not the kinds of individuals who are engaging in the types of practices that are jeopardizing the integrity of the employment tax base. To the contrary, if those individuals do not control the corporations that employ them, there is little reason to doubt that the compensation they receive for their services accurately represents their income from labor.

Instead, the kind of employment tax evasion that has been described in this Article is most likely to occur when the employee exercises control over the firm that employs her. Thus, any approach to address this situation should consider the extent to which such opportunities to exercise and exploit control exist.¹⁰² As a general proposition, such opportunities occur in the closely held corporation.¹⁰³ There are several ways to define a closely held corporation. In many instances a corporation is considered to be closely held for income tax purposes if the corporation satisfies the stock ownership test contained in the personal holding company rules.¹⁰⁴ Under that test, a corporation would be considered closely held if five or fewer individuals own more than 50% of the stock of the corporation during the last six months of the taxable year.¹⁰⁵

Whenever a corporation qualifies as a closely held corporation, then the rules of SECA should apply to determine the employment tax liability of any

102. Winchester, *supra* note 50.

103. See John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: “Hey the Stars Might Lie But the Numbers Never Do,”* 78 TEX. L. REV. 885 (2000) (describing how closely held corporations are often used to secure tax advantages that are not available to other business entities).

104. The personal holding company stock ownership test is incorporated in the at-risk rules. I.R.C. § 465 (West 2009). The test is also incorporated in the passive activity loss limitation rules. *Id.* § 469.

105. See *Id.* § 542(a)(2).

owner, as follows. First, the tax should apply to the shareholder's share of the corporation's taxable income for any given year and to any amounts paid to the owner as compensation for services rendered. A corporation already computes its taxable income each year. The employee-shareholder's share would simply be a function of her interest in the corporation as measured by stock owned. Thus, if the employee-shareholder owned 40% of the stock in a year that the corporation had \$160,000 in taxable income, \$64,000 of that amount would represent that individual's share of the corporation's earnings.¹⁰⁶ In addition, the self-employment tax would apply to any amounts actually paid to that individual as compensation. However, if the shareholder does not materially participate in the business, only amounts actually paid to him as reasonable compensation would be subject to the SECA tax. This approach would establish near complete parity in the way the rules operate, regardless of the legal entity through which an individual conducts a business.

The JCT Staff proposal applies two sets of rules to determine the extent to which the profits of the business are subject to employment tax. For all businesses other than a service business, the employment tax applies only to the investor's share of earnings other than certain passive income items that are already excluded from the definition of net earnings from self-employment. However, if the business is in a service business, no such adjustment is made.¹⁰⁷ The distinction between service and non-service business should apply with equal force when the business is conducted through a corporation.

The overall approach being proposed here is to apply SECA to any closely held C or S corporation and to any business that is classified as a partnership for federal income tax purposes. Each owner of such a business would have to pay employment tax on her share of the firm's profits and on any compensation that she actually receives. However, if the owner does not materially participate in the business, the tax would apply only to the reasonable compensation she receives for services performed for the business. The employment tax would not apply to the owner's share of a firm's profits derived from interest, dividends and other forms of passive income. However, this exclusion would not apply if the firm is in a service business.

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The nation's employment tax laws are supposed to operate as a tax on an

106. $\$160,000 \times 40\% = \$64,000$.

107. The JCT Staff proposal employs an existing definition of a service business. Under that definition, a service business is one in which substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. I.R.C. § 448(d)(2)(A) (West 2009).

individual's income from labor. The income derived from a person's labor does not change with the business form used or tax classification adopted for the business. It might only make it harder to isolate the share of business profits attributable to the labor in certain cases. Therefore, it makes little sense for the employment tax base to vary depending on the legal form or tax classification that an individual adopts for a business. However, that is exactly what happens now. To make matters worse, the loss in revenue resulting from this unwise statutory design is not taken into account when the government measures the difference between what it ought to collect in tax and what it does collect in tax. Clearly, that uncollected amount should count as part of the federal tax gap. Otherwise, we must be prepared to conclude that the employment tax collected from sole proprietors exceeds what they ought to pay.

It is in the government's interest to address this inequity and to restore the integrity of the employment tax base. And the sooner it does so, the better. The key is to adopt a uniform rule for computing the employment tax base for any self-employed individual, regardless of the business form used to conduct the business. In addition, bright-line rules should be favored over subjective standards whenever possible. The JCT Staff proposal represents a thoughtful step in the right direction and Congress should seriously consider its merits. However, Congress should be equally aware of its limitations. Most important, because the plan does not extend its uniform rule to self-employed individuals who operate through a C corporation, the impact of the plan will be far more limited than if it did. However, even in its current form, the JCT Staff proposal is better than what we have now.

