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THE SLEEPING DOG HAS BEEN KICKED

Lately, I have been writing quite a bit about the fact Congress' "well" of "easy" revenue increases to offset tax and spending policy changes has been running dry. Regular readers of the Weekly know that we know of a couple of sleeping dogs revenue increases with a direct impact on small business and we do not talk about them often for fear of drawing attention to them.

One of them made its public debut in this Congress last week. It has not been formally introduced as an offset. To continue to mix metaphors, the "trial balloon" has been floated. The issue is reclassifying some of the income received by principal S Corporation shareholders from their business as wages.

An S Corporation is a corporation that does not pay an entity-level tax such as the corporate income tax. Instead, the profits (or loss) are passed on to the shareholders, who must account for them separately on their individual income tax returns. This occurs even if the S Corporation retains its earnings, rather than distributing them to shareholders.

S Corporation shareholders can receive various "types" of income from their businesses including wages, distributions of the income, rents, royalties, loan repayments and so forth, and the tax consequences may be different for different types of income.

There is a belief that S Corporation shareholders avoid characterizing the income as "wages" since that would require the payment of employment taxes (or self-employment tax) on the amounts in addition to the income taxes.

In 2002, the Treasury Inspector General for Tax Administration (TIGTA) reported that the Internal Revenue Service (IRS) needed more effective means of identifying taxpayers who are not properly reporting Subchapter S Corporation officer compensation. The report looked at the incentive to underpay salaries and wages in order to avoid paying FICA and Medicare taxes.

According to TIGTA, in Tax Year 2000, 69.4 percent of all S Corporations were fully owned by a single shareholder, while another 9.5 percent had a single shareholder who owned more than 50 percent of the shares. As a result, nearly 80 percent of S Corporations had a single shareholder deciding what to pay him or herself. The report discovered that S Corporations reported an average of $5,300 in wages on their 1120-S Forms, while reporting an average of $349,323 in distribution on their schedules M-2.

In 2005, the Senate Finance Committee held a hearing to discuss the solvency of Social Security. Two of the witnesses who were invited largely talked about the issue in regards to the tax gap; that is, they spoke on how Social Security and Medicare were being short-changed due to loopholes in the tax code.

George K. Yin, the Chief of Staff of the Joint Committee on Taxation (JCT), spoke about the recommendations the JCT made in its report on the tax gap released earlier that year. J. Russell George, the Inspector General of TIGTA also testified. His testimony coincided with a report issued by his office the same day, regarding the taxation of S Corporations.

The report asserts that the current system of taxing S Corporations presents a significant loophole that allows single-shareholders to avoid certain taxes. As an example, TIGTA demonstrated that in 2000, the owners of 36,000 single-shareholder corporations received no salaries from their corporations, even though the operating profits exceeded $100,000, resulting in unpaid employment taxes of $13.2 billion. As a result, the report concluded that the IRS, by not attending to this issue, leaves a significant amount of tax revenue uncollected.

The bottom line is that the two agencies generally believed all net income from S Corporations that are more than 50 percent owned by a single shareholder should be subject to payroll taxes (or self employment tax as the case may be). The distributions would be subject to the employment taxes (or self-employment taxes), whether or not these earnings are distributed to the owners of the firm. Exceptions would be allowed for certain rental income, dividends and interest, certain gains, and other items. In the case of a service business, all of the shareholder's net income from the S Corporation is treated as net earnings from self-employment. In a personal service S Corporation substantially all of its activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

The underlying debate is how shareholders of an S Corporation should determine what portion of their income should be characterized as wages and what portion should be characterized as profit. Historically, the IRS and the courts have struggled with how to determine "reasonable compensation" for owner-employees.

According to the IRS audit manual, the IRS uses such factors as: "nature of duties, background and experience, knowledge of the business, size of the business, individual's contribution to profit making, time devoted, economic conditions in general, and locally, character and amount of responsibility, time of year compensation is determined, whether alleged compensation is in reality, in whole or in part, payment for a business or assets acquired, the amount paid by similar size businesses in the same area to equally qualified employees for similar services, etc."

However, over the years, the courts have also weighed in on the subject of reasonable compensation. In cases involving S Corporation payments to a shareholder-employee, courts have re-characterized a portion of the distributions as wages when the individual performing a service does not include any of the income as wages.

Courts have applied a multi-factor test to determine reasonable compensation. Most notably, they have considered whether an individual's compensation was comparable to compensation paid at similar firms. Going further, the Seventh Circuit adopted an "independent investor" analysis, which asks whether an inactive, independent investor would be willing to compensate the employee as he was compensated. The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.

The changes suggested by TIGTA and JCT essentially take out any guesswork in determining reasonable compensation by assuming that all of the income should be considered wages, reduced by certain excluded items. By applying payroll taxes to all income, the government would levy a substantial tax increase on many small and family-owned businesses.

At this point, as noted, we in the trial balloon stage. We do know that in the last Congress, then Chairman of the Ways and Means Committee, Charles Rangel, (D-NY), introduced an Alternative Minimum Tax reform bill and it had a reasonable compensation revenue offset in it. The proposal would have required a shareholder of an S Corporation that primarily provides services to include all distributions, regardless of the nature of the distribution (with some very narrow exceptions) as income for the purposes of calculating self-employment taxes. The bill did not define "services." We will have to see what is proposed this time.