Effects of Pass-through Entities on Tax Collections

New Entities, New Challenges
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FTA Research Conference 2003

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Why should I be concerned?

- Pass-through generally pays one level of tax
- Generates lower tax revenues from the same activity conducted at the corporate level
  - Corporate level tax has been removed
- Is this a trend towards lower tax collections?

What will we examine?

- Claim that SOI data can show us the revenue loss of entity choice
  - Comparing corporate to pass-through entities
- Question of tax neutrality
  - Does entity choice distort business decision making?
  - Will there be a “level playing field”?
Does the data support this claim?

- S-Corporation net income less deficit
  - Between 1997 and 2000, 29.7% growth
- LLCs included in partnership SOI data (1065 data)
  - Increase in LLC filings 105.9% since 1997 from 349,054 to 718,704
  - Increase in net income (less deficit) 178.9% since 1997 from $17.1 B to $47.7 B

Does the SOI data show losses?

- Combined increase in reported pass-through income of $145.6 B from 1997 to 2000
- Form 1120-S net income increased from $153.7 B to $198.5 B ($44.8 B)
- Form 1040 shows reported income rose from $168.3 B to $212.9 B, or $44.6 B
- Form 1065 rose from $168.2 B to $269.0 B
- Gap of $101 B – paid to other shareholders?
How can we support our claim?

- SOI data are inconclusive on base reduction
- Examine the beneficial advantages of pass-through entities at the federal level
- Examine federal marginal effective tax rates
- 35 states have lower statutory personal income rates than corporation tax rates
  - 7 states are the same but 9 states have rates that are difficult to compare

Why file as a partnership?

- Set up largely for ownership and regulatory issues, not tax planning strategies
- Avoids double taxation
- Avoids minimum taxes
Why file as an S-corporation?

- Avoids double taxation on income
- Avoids minimum taxes
- Ways to reduce or avoid other taxes
  - Accumulated earnings and personal holding
  - Self-employment for non-corporations
- Since 1997, can have up to 75 shareholders
  - Includes estates, qualified trusts, and charities

Are there additional benefits of S-corporations?

- Benefit of allowing corporate deductions and individual deductions
- Can use initial losses against personal income (with sufficient basis)
- For those making more than $100,000, tax rates are lower than corporate rates
  - Under $75,000: Elect corporation then change
Why choose the Limited Liability Company?

• Limited liability
• Single layer of tax
• Avoids restrictions of S-corporations
• Elect to distribute income without regard to shareholder interest
• Open to foreigners, corporations, and/or estates and trusts

What does legal choice cost?

• Trade or business activity net income difference of $141.7 B reported from the entity level to the individual level
• At 27% METR for C-Corp & 22% for PIT
• Losing entity tax revenue of $20 - $25 B
  – 27% of taxable income (75%) from net income
  – States recover with franchise taxes, K-1 fees
• $7 B in tax savings due to preferential rates
Is there tax neutrality?

- Know there are economic qualities of pass-through entities
- Identify recent distortions in decision making due to qualities of pass-through
- Discuss the immediate future of the pass-through tax system

What do we want to encourage?

- Economic thought indicates that pass-through entities are a better approach than corporate level taxation
  – Two levels of taxation are unfair
- Services on the rise, manufacturers decline
  – Pass-through entity chosen over corporation
- Do pass-through entities resolve the question of retained earnings?
What distorts business decisions?

• 1/3rd of “high net-worth individuals” have nearly $6 trillion in assets offshore
• Pass-through entities are open for abuse
  – Not permanent - meant to form and disperse
  – Less legal basis than a corporation
• Personal residence, equipment and leasing, and charity trusts formed by abusive pass-through entities

What does the IRS report?

• 740,000 total taxpayers involved
  – 505,000 in abusive offshore schemes
• $20 to $40 B lost by offshore tax evasion
• $5 B in domestic shelters and under reported income
• Every 5th dollar not reported on partnership form (2001 IRS Commissioner Rossotti)
What do these cases look like?

- Grand Cayman banker pleads guilty to tax shelter abuse
  - Exposed 2,000 clients who hid income
  - 20 state investigations worth $300 M
- Anderson’s Ark & Associates
  - Over $100 M in false deductions claimed
- 1,206 taxpayers claimed $30 B in false deductions using trusts and bank cards

What is the cost of tax sheltering?

- IRS costs vary from $3 B to $45 B or more
- Official scorekeeping estimates of compliance revenue are at the lowest end of the IRS range
- IRS small study: 6-15% of flow-through income not reported in 2001
- MTC: $30 B to federal, $8-12 B to states
  - COST: MTC methodology is flawed
What is in the pipeline?

- Changes to Schedule E of federal 1040
- IRS to scan and track Schedule K-1 data
- S-corporation changes: 150 shareholders?
- Corporation taxes, dividends, and the streamlining of tax systems

How does this affect my State?

- States could expect increased tax collections
  - How much? When?
- Voluntary efforts appear to work, but generally collect pennies on the dollar
- Are there serious and reasonable measures to tax business activity?
  - JCT: Serious reform would be comprehensive
What conclusions can be drawn?

• Pass-through revenue is not 100% recoverable
  – Loss of entity level taxes and preferential rates
• Tax sheltering has changed the federal approach to auditing pass-through entities
• Efforts are being made to streamline and revise business activity taxation at the federal and state levels

What are your sources?

• Internal Revenue Service
• Joint Committee on Taxation
  – Legislative scoring and H.R. testimony
• General Accounting Office
  – GAO report on tax abuse (GAO-02-0733)
  – GAO report on independent contractors (2001-30-132)
• U.S. Department of Justice press releases
Do you have proof?

- Office of Tax Policy, NYC Dept of Finance
  - “Limited Liability Company Project Summary”
- Merrill Lynch & Gemini Consulting
- [www.taxprophet.com](http://www.taxprophet.com)
  - Tax attorney Robert L. Sommers