

Effects of Pass-through Entities on Tax Collections

New Entities, New Challenges

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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?

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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”?

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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

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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?

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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

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Why file as a partnership?

- Set up largely for ownership and regulatory issues, not tax planning strategies
- Avoids double taxation
- Avoids minimum taxes

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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

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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

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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

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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

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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

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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)

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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

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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

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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

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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

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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
 - “World Wealth Report” (2000)
- www.taxprophet.com
 - Tax attorney Robert L. Sommers