Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations

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MEMORANDUM FOR DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations (Audit # 200430022)

This report presents the results of our review of the Internal Revenue Service's (IRS) administration of self-employment tax laws. The overall objective of this review was to determine whether the existing tax laws, tax regulations, and IRS policies and practices ensure fairness in the administration of self-employment tax laws for similarly situated taxpayers.

In summary, inequities exist between the employment tax liabilities of sole proprietors and the employment tax liabilities of the owners of single-owner S corporations.[1] The employment tax methodology applied to S corporations does not properly address the facts and circumstances related to the predominant ownership structure of today's S corporations.[2] This condition is largely the result of Revenue Ruling[3] 59-221[4] issued

[1] In 1958, the Congress established Subchapter S of the Internal Revenue Code (I.R.C.) that enabled small businesses, including sole proprietorships, to form corporations owned by 10 or fewer shareholders. Electing this form of business organization, commonly referred to as an S corporation, exempts the profits from corporate taxation and allows the profits to "pass through" to the shareholders who are then responsible for individual income taxes on the profits.
[2] This report addresses issues similar to those discussed in the Joint Committee on Taxation (JCT) report *Options to Improve Tax Compliance and Reform Tax Expenditures* JCS-02-05 (January 27, 2005). Despite similarities in conclusions and recommendations, this report was developed independently without knowledge of the JCT study.
[3] A Revenue Ruling represents the IRS' official interpretation of the I.R.C. as it applies to a particular set of facts. Revenue Rulings are intended to promote the uniform application of the tax laws and assist taxpayers in attaining maximum voluntary compliance.
[4] 1959-1 C. B. 225; Rev. Rul. 59-221 (January 1959).

by the IRS in 1959 because the 1958 statute that established S corporations in tax law[5] was silent on the employment tax treatment of the corporate profits.

When the Revenue Ruling was issued, no S corporation tax returns had yet been filed, so the IRS based its ruling on assumptions regarding the ownership structure of S corporations. Apparently assuming that a majority of S corporations would involve multiple shareholders, the IRS concluded only shareholders actively operating the business should be subject to employment taxes and only on amounts received for their services. In a multishareholder environment, it would have been reasonable to assume that the salary of the business operator would be set by a consensus of shareholders at a level reflecting the market value of the operator's services.

What apparently was not anticipated was that most S corporations would eventually consist of sole proprietors who chose to incorporate without expanding ownership to include additional shareholders. In Tax Year (TY) 2000, 78.9 percent of all S corporations were either fully owned by a single shareholder (69.4 percent) or more than 50 percent owned by a single shareholder[6] (9.5 percent). Also apparently unanticipated was the fact that, when there is only one shareholder controlling and operating an S corporation, the determination of a salary is unilateral, highly subjective, and influenced by the knowledge that a higher salary will result in higher employment taxes and therefore lower profits.

One of the criteria for judging a tax system is whether similarly situated taxpayers are treated the same. Given equal amounts of income subject to employment taxes, owners of single-shareholder S corporations and sole proprietors are similarly situated for employment tax purposes. However, a fundamental and significant inequity is created between sole proprietors and owners of single-shareholder S corporations by the manner in which taxable income is determined, since sole proprietors pay employment taxes as a percent of all profits, while owners of single-shareholder S corporations pay employment taxes on only the portion of profits they unilaterally select as their salaries.

The 1959 Revenue Ruling that created this inequity has had three major detrimental effects on the tax system. First, the S corporation form of ownership has become a multibillion dollar employment tax shelter[7] for single-owner businesses. In 1959, the maximum potential loss of employment tax revenue from allowing owners of single-shareholder S corporations to select their own salaries would have been only $8.3 million ($49.1 million in Calendar Year 2000 dollars). In TY 2000, the cost was $5.7 billion due to historical increases in employment tax rates and the ability of nearly 80 percent of S corporation owners to minimize their employment taxes by minimizing their salaries.

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[5] Pub. L. No. 85-866, 72 Stat. 1650 (1958).
[6] Majority ownership provides such shareholders with the ability to make unilateral decisions, such as setting officer salaries.
[7] A tax shelter is the way of organizing a business to reduce or eliminate taxes.

Second, Revenue Ruling 59-221, in effect, places the burden on the IRS to prove that the salary chosen by the owner of a single-shareholder S corporation is not "reasonable" (i.e., commensurate with the services the shareholder provided to the S corporation). Dealing with this issue on a case-by-case basis puts a severe strain on the limited resources of the IRS. In TY 2000 alone, 36,000 single-shareholder S corporations with profits of $100,000 or more passed through total profits of $13.2 billion to their sole owners without paying any employment taxes. The cost of the IRS resources needed to effectively combat such a large problem on a case-by-case basis would be prohibitive.

Third, trends point to continued erosion of the employment tax base and related reductions in Social Security and Medicare revenues that employment taxes produce. The number of single-shareholder S corporations (as reported on U.S. Income Tax Return for an S Corporation (Form 1120S)) grew from 1,030,716 in TY 1994 to 1,684,861 in TY 2001, a 63.5 percent growth rate. Single-shareholder S corporations accounted for 26.4 percent of the combined profits of sole proprietorships and single-shareholder S corporations in TY 1994 and 36.1 percent in TY 2001. As single-owner business profits shift to the S corporation structure, the amount of salaries selected are steadily declining as a percent of corporate profits. Owners of single-shareholder S corporations paid themselves salaries subject to employment taxes that equaled only 47.1 percent of their profits in TY 1994, which fell to just 41.5 percent by TY 2001. In contrast, unincorporated sole proprietors pay self-employment taxes on all of their profits.[8]

To eliminate the employment tax shelter for most S corporations, increase Social Security and Medicare employment tax revenues by $30.8 billion and $30.2 billion respectively between Calendar Years 2006 and 2010, provide for equitable employment tax treatment of taxpayers, and reduce the burden on IRS examination resources, we recommended the IRS Commissioner inform the Assistant Secretary of the Treasury for Tax Policy of the detrimental effects discussed in this report of Revenue Ruling 59-221 that was apparently issued under the historically inaccurate assumption that most S corporations would involve multiple shareholders. The IRS Commissioner should consult with Treasury regarding whether the detrimental effects of Revenue Ruling 59-221 should be reversed through the issuance of new regulations or through the drafting of new legislation, either of which should subject all ordinary operating gains of an S corporation that accrue to a shareholder (including the shareholder's spouse and dependent children) holding more than 50 percent of the stock in the S corporation to employment taxes.

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[8] For purposes of determining employment taxes, the profits of sole proprietorships are calculated as gross income minus expenses and an amount equal to the employer's share of Federal Insurance Contributions Act (FICA) taxes. S corporations also deduct the employer's share of FICA taxes from their income for determining profits.

Management's Response: The Commissioner, Small Business/Self-Employed (SB/SE) Division, disagreed with the report recommendations but agreed there were problems related to compensation paid to S corporation officers and that differences exist between the employment tax liabilities of sole proprietorships and single-shareholder S corporations. The Commissioner, SB/SE Division, did not agree that IRS Revenue Ruling 59-221 was the cause of these problems. In discussions and in management's response, the IRS has expressed its belief that, since it was based upon corporate employment taxation statutes and regulations in effect prior to the creation of S corporations, Revenue Ruling 59-221 confirms that Self-Employment Contributions Act (SECA) taxes do not apply to S corporation shareholders. The IRS believes legislative rather than regulatory changes could help reduce the problems they experience in relation to the employment taxes of single-shareholder S corporations and believes any such legislation should also address possible similar inequities in other types of business structures. However, the IRS also stated that simplifying the assessment of employment taxes, as we recommended, would not be consistent with the underlying principles of employment tax statutes in connection with the performance of services.

Because the Commissioner, SB/SE Division, does not agree the source of the problem was Revenue Ruling 59-221 and believes it is important to consider the problem in the context of other business entities, the Commissioner, SB/SE Division, did not agree with the specific recommendations in this report or with the related outcome measures. Regarding the outcome measures, the Commissioner, SB/SE Division, expressed concerns that the outcome measures did not take into account that some taxpayers may react to the implementation of our recommendations by converting S corporations to other business structures. Concern was also expressed that our outcome measures did not reflect the impact of additional employment taxes that may be paid by owners of single-shareholder S corporations having multiple sources of income subject to employment taxes. Management's complete response to the draft report is included as Appendix V.

Office of Audit Comment: We disagree with the IRS position that Revenue Ruling 59-221 *confirmed* rather than established that SECA taxes should not apply to single-shareholder S corporations, and we continue to believe the current employment tax inequities are the result of the Revenue Ruling. The historical file for this Revenue Ruling shows the Revenue Ruling was prompted by a 1958 question from a taxpayer regarding whether or not self-employment taxes (applicable to sole proprietors) would apply to the profits of the newly-created S corporations. Rather than addressing the case of a sole proprietor choosing to become a single-shareholder S corporation, the IRS response discussed a multi-shareholder S corporation and concluded that self-employment taxes should not apply to the profits of such S corporations. The IRS applied the concepts supporting this decision to all S corporations, regardless of the number of shareholders, when it issued Revenue Ruling 59-221 in 1959.

We are encouraged the IRS recognizes that changes in tax law may be advisable as it relates to the compensation of owners of single-shareholder S corporations. While we support the IRS desire to eliminate through such legislation similar employment tax inequities in other business structures, identifying and quantifying such possible additional inequities were beyond the scope of this review. In addition, we do not believe correction of the current inequities discussed in the report should be delayed while a search for possible additional inequities is conducted. Nor do we believe current inequities should continue out of apprehension that an unquantifiable number of taxpayers may change their business structures to pursue new strategies to avoid employment taxes.

In response to IRS concerns related to the possible impact of taxpayers having multiple sources of employment-taxable income, we have reduced our original 5-year estimate of total additional employment tax revenues to $61 billion. See Appendix IV for additional information. In addition, we have added notes (a) through (c) to Recommendation 2 on page 18 to clarify our position on various uncertainties expressed in IRS management's response.

While we still believe our recommendations are worthwhile, we do not intend to elevate our disagreement concerning them to the Department of the Treasury for resolution.

Copies of this report are also being sent to IRS managers affected by the report. Please contact me at (202) 622-6510 if you have questions or Philip Shropshire, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (215) 516-2341.

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Background

The Federal Insurance Contributions Act (FICA)[1] and the Self-Employment Contributions Act (SECA)[2] require the payment of employment taxes to the Federal Government that fund both the Social Security (i.e., old age, survivor, and disability insurance or OASDI) and Medicare (i.e., hospital insurance or HI) trust funds. The OASDI portion of both FICA and SECA taxes is 12.4 percent of taxable wages or self-employment income, up to a maximum earnings limit that is sometimes adjusted by statute. For Tax Year (TY) 2000, this limit was $76,200; it has increased to $90,000 for TY 2005. The HI portion of both FICA and SECA taxes is 2.9 percent of total taxable income.

Employers withhold FICA taxes from the wages of employees, with matching amounts paid by the employers. Employees do not pay FICA taxes on the amount paid by their employers on their behalf. Sole proprietors (i.e., individuals who own unincorporated businesses) must pay SECA taxes[3] on profits from the operation of their businesses. The SECA tax law treats all profits (except for an amount equal to the employer portion of FICA) as if they were wages, and the proprietor pays the equivalent of both the employer and employee portions of FICA on the profits.

In 1958, the Congress established Subchapter S of the Internal Revenue Code (I.R.C.)[4] that enabled small businesses, including sole proprietorships, to form corporations owned by 10 or fewer shareholders.[5] Electing this form of business organization, commonly referred to as

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[1] 26 U.S.C. Chapter 21 (2004).
[2] 26 U.S.C. § 1401 (2004).
[3] Individuals are generally subject to SECA taxes if they have net earnings from self-employment (excluding church employee income) of $400 or more. Net earnings from self-employment generally means the net income earned by any self-employed person from a trade or business and any individual's distributive share of partnership net income or loss attributable to the partnership's trade or business.
[4] 26 U.S.C. Chapter 1, Subchapter S (2004).
[5] In TY 2000, S corporations were permitted to have up to 75 shareholders. A husband and wife are considered one shareholder for purposes of determining the number of shareholders in an S corporation. Generally, S corporation shareholders are individuals, but certain trusts, estates, charities, and qualified retirement plans may also be S corporation shareholders.

an S corporation, exempts the profits from corporate taxation and allows the profits to "pass through" to the shareholders who are then responsible for individual income taxes on the profits received. Shareholders who actively operate the business are subject to employment taxes on compensation received for their services.

Sole proprietorships and S corporations were, respectively, the first and second most prevalent types of business organizations in TY 2000. For TY 2000, there were approximately 17.9 million sole proprietorships that reported approximately $245 billion in profits from business operations. Also for TY 2000, approximately 2.9 million S corporations reported approximately $200 billion in profits from business operations.

To perform the audit, we analyzed TY 2000 data collected by the Internal Revenue Service (IRS) Statistics of Income (SOI) function regarding S corporations and compared ownership information reported by S corporations to information on the IRS Individual Returns Transaction File[6] for TY 2000. TY 2000 was the most current year for which specific data was available from multiple sources at the time audit planning commenced. We did not attempt to identify partnerships and corporations other than S corporations that may be solely-owned or majority-owned by a single individual. Data analysis was conducted in our Cincinnati office. We did not visit any IRS offices to perform the audit. The audit was performed in accordance with *Government Auditing Standards* during the period July 2004 through February 2005. We did not test management controls since they were not significant to our audit objectives. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

[6] An IRS file containing data transcribed from each tax return, as well as computer-generated information used to verify the accuracy of the transcribed data.

Billions of Dollars in Self-Employment Taxes Are Being Avoided Each Year As Sole Proprietors Increasingly Choose to Incorporate

The employment tax methodology applied to S corporations does not properly address the facts and circumstances related to the predominant ownership structure of today's S corporations.[7] This condition is largely the result of Revenue Ruling[8] 59-221[9] issued by the IRS in 1959 because the 1958 statute establishing S corporations in tax law[10] was silent on the employment tax treatment of S corporation profits.

When the Revenue Ruling was issued, no S corporation tax returns had yet been filed, so the IRS based its ruling on assumptions regarding the ownership structure of S corporations. Since the law allowed up to 10 shareholders in an S corporation, the IRS apparently assumed that a majority of S corporations would involve multiple shareholders when it concluded only shareholders actively operating the business should be subject to employment taxes and only on amounts received for their services. In a multishareholder environment, it would have been reasonable to assume the salary of the business operator would be set by a consensus of shareholders at a level reflecting the market value of the operator's services.

What apparently was not anticipated was that most S corporations would eventually consist of sole proprietors who chose to incorporate without expanding ownership to include other shareholders. In TY 2000, 78.9 percent of all S corporations were either fully owned by a single shareholder (69.4 percent) or more than 50 percent owned[11]

[7] This Treasury Inspector General for Tax Administration conclusion, as well as others throughout the report, address issues similar to those discussed in the Joint Committee on Taxation (JCT) Report *Options to Improve Tax Compliance and Reform Tax Expenditures* JCS-02-05 (January 27, 2005). Despite similarities in conclusions and recommendations, this report was developed independently and without prior knowledge of the JCT study.
[8] A Revenue Ruling represents the IRS' official interpretation of the I.R.C. as it applies to a particular set of facts. Revenue Rulings are intended to promote the uniform application of the tax laws and assist taxpayers in attaining maximum voluntary compliance.
[9] 1959-1 C. B. 225; Rev. Rul. 59-221 (January 1959).
[10] Pub. L. No. 85-866, 72 Stat. 1650 (1958).
[11] Majority ownership provides such shareholders with the ability to make unilateral decisions, such as setting officer salaries.

by a single shareholder (9.5 percent).[12] Also apparently unanticipated was the fact that, when there is only one shareholder controlling and operating an S corporation, the determination of a salary is unilateral, highly subjective, and influenced by the knowledge that a higher salary will result in higher employment taxes and therefore lower profits.

One of the criteria for judging a tax system is whether similarly situated taxpayers are treated the same.[13] Given equal amounts of income subject to employment taxes, owners of single-shareholder S corporations and sole proprietors are similarly situated for employment tax purposes.[14] However, a fundamental and significant inequity is created between sole proprietors and owners of single-shareholder S corporations by the manner in which taxable income is determined. Sole proprietors pay employment taxes as a percent of all profits, while owners of single-shareholder S corporations pay employment taxes on only the portion of profits they unilaterally select as their salaries.

The 1959 Revenue Ruling that, due to unanticipated predominance of single-shareholder S corporation ownership structures, created the inequity between sole proprietors and single-shareholder S corporations has had three major detrimental effects on the tax system:

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[12] These statistics reflect the impact of spousal ownership. A husband and wife are considered one shareholder for purposes of determining the number of shareholders in an S corporation.

[13] JCT report *Description and Analysis of Proposals to Replace the Federal Income Tax* JCS-18-95 (June 5, 1995).

[14] Both types of taxpayers are subject to OASDI taxes of 12.4 percent on taxable income that does not exceed the annual earnings limit. This limit increases each year with increases in the national average wage index. For TY 2000, the limit was $76,200. In TY 2005, the limit is $90,000. Both types of taxpayers are subject to HI taxes of 2.9 percent on total taxable income. Both types of taxpayers deduct one-half of their employment taxes from their incomes for determining their individual income tax liabilities on their business profits. A sole proprietor deducts the employment taxes from the total income reported on U.S. Individual Income Tax Return (Form 1040). The owner of an S corporation deducts the employment taxes from the income reported on U.S. Income Tax Return for an S Corporation (Form 1120S), thereby reducing the pass-through income that must be reported on the Form 1040.

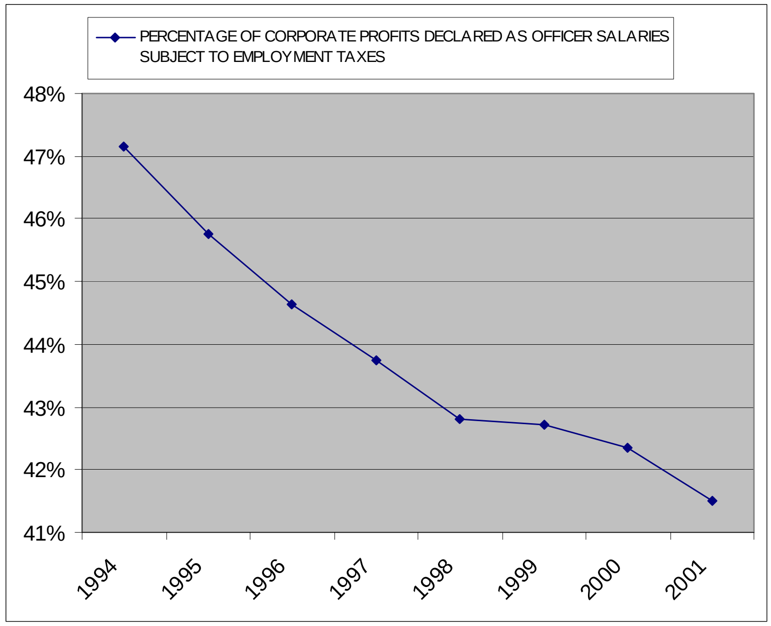
1) The S corporation form of ownership has become a multibillion dollar employment tax shelter[15] for single-owner businesses ($5.7 billion in TY 2000 alone).
2) Officer compensation issues have become a drain on limited IRS examination resources.
3) Trends point to continued erosion of the employment tax base and resulting reductions in Social Security and Medicare revenues.

The IRS Revenue Ruling inadvertently created a multibillion dollar employment tax shelter

The 1959 Revenue Ruling appears to influence the salary-setting decisions by the owners of single-shareholder S corporations. As shown in Figure 1, the salaries declared by the owners of S corporations have been steadily declining over the years. Owners of single-shareholder S corporations paid themselves salaries subject to employment taxes that equaled only 47.1 percent of their profits in TY 1994, which fell to just 41.5 percent by TY 2001. In contrast, unincorporated sole proprietors pay employment taxes on all of their profits.[16]

[15] A tax shelter is the way of organizing a business to reduce or eliminate taxes.
[16] For purposes of determining employment taxes, the profits of sole proprietorships are calculated as gross income minus expenses and an amount equal to the employer's share of FICA taxes. S corporations also deduct the employer's share of FICA taxes from their income for determining profits.

Figure 1: Officer Salaries Declared by Single-Shareholder S Corporations As a Percentage of Operating Profits (TYs 1994 – 2001)[17]

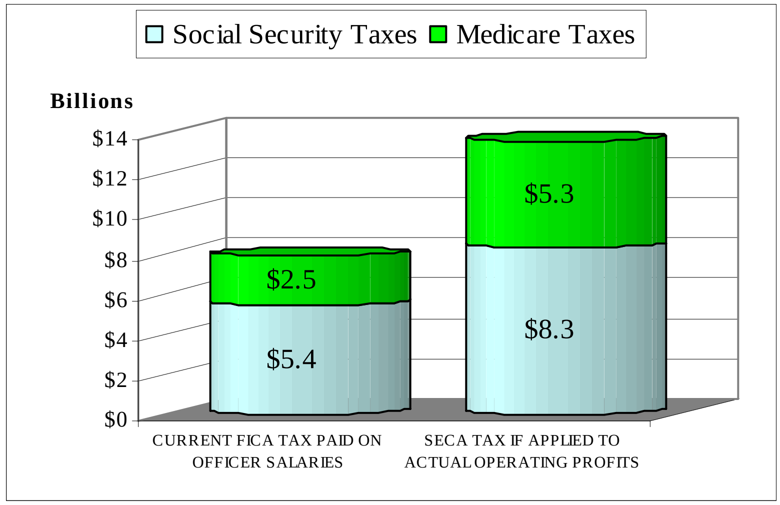


Source: IRS SOI function data.

The ability to independently set salary levels also extends to S corporation shareholders who own more than one-half of the corporation's stock, which in effect allows them the ability to make unilateral decisions, such as setting officer salaries. The ability of a single shareholder of an S corporation to set officer salaries has a significant effect on employment tax receipts. As shown in Figure 2, the amount of employment taxes paid in TY 2000 by single-shareholder S corporations was $5.7 billion less than the SECA taxes that would have been paid if the taxpayers were unincorporated sole proprietors.

[17] Includes only those S corporations that filed returns reflecting one shareholder for the corporation. Officer compensation reported on the returns is expressed as a percentage of the total of officer compensation and positive net income from the operations of the single-owner S corporations.

Figure 2: Actual FICA Taxation vs. Theoretical SECA Taxation of S Corporations (TY 2000)[18]



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of IRS Master File[19] *data.*

In 1959, the IRS ruling appeared to have limited impact. Just 71,140 S corporations existed in TY 1959 and, of these, only 46,037 reported profits. Since the maximum amount of self-employment tax per individual was just $180 in 1959, the maximum potential loss of self-employment tax revenue in 1959 would have been only $8.3 million ($49.1 million in Calendar Year (CY) 2000 dollars).[20]

However, the 1959 ruling does not reflect conditions in today's business and tax environments. A number of factors have combined to significantly increase the employment tax consequences of the IRS decision.

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[18] Represents the FICA taxes applicable to officer compensation paid, allocated according to the percentage of ownership for those shareholders owning more than 50 percent of the shares of the S corporations. We computed the SECA taxes based upon the total of officer compensation plus the amount of positive net income from the operation of the business, allocated based upon the percentage of ownership. See Appendix IV for additional information.

[19] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

[20] Assumes that all of the S corporations had only one shareholder and no salaries were paid to shareholders.

- The SECA tax rate on earnings at or below the maximum limit was four times higher for TY 2000 than it was for TY 1959.
- The maximum earnings limit for TY 2000 was 16 times higher than it was for TY 1959.
- The Medicare tax (which did not exist in 1959) was assessed on unlimited earnings in TY 2000.
- The number of S corporations that existed in TY 2000 was 40 times higher than that in TY 1959.
- In TY 2000, approximately 54.6 percent of all S corporations reported to the IRS that they were owned by a single shareholder.
- In reality, 78.9 percent of all S corporations were either fully owned by a single shareholder (69.4 percent) or majority owned by a single shareholder (9.5 percent) for TY 2000 when spousal ownership was taken into account.[21]

Thus, historical increases in employment tax rates and the ability of nearly 80 percent of S corporation owners to minimize their employment taxes by minimizing their salaries combined to transform the original $8.3 million maximum potential self-employment tax revenue cost into an estimated $5.7 billion revenue cost in TY 2000.

<u>The IRS has limited resources for combating abuses</u>

On a mass scale, it is extremely difficult for the IRS to alleviate the serious problem of self-employment tax avoidance by S corporations. Revenue Ruling 59-221, in effect, places the burden on the IRS to prove that officer compensation was not "reasonable" (i.e., commensurate with the services the shareholder provided to the S corporation). Therefore, the IRS must examine the

[21] A husband and wife are considered one shareholder for purposes of determining the number of shareholders in an S corporation. To determine actual S corporation ownership, we relied upon data from Shareholder's Share of Income, Credits, Deductions, etc. (Schedule K-1) of Form 1120S provided by the IRS SOI function and compared those data to spousal information on Form 1040 tax returns filed for TY 2000.

S corporation returns and supporting business records to make reasonable compensation determinations.

As shown in Figure 3, however, the IRS is able to examine only a small fraction of the S corporation returns that are filed each year. Between Fiscal Years (FY) 1996 and 2003, the examination coverage rates for S corporation returns ranged from a high of 1.04 percent to a low of 0.30 percent in the most recent year.

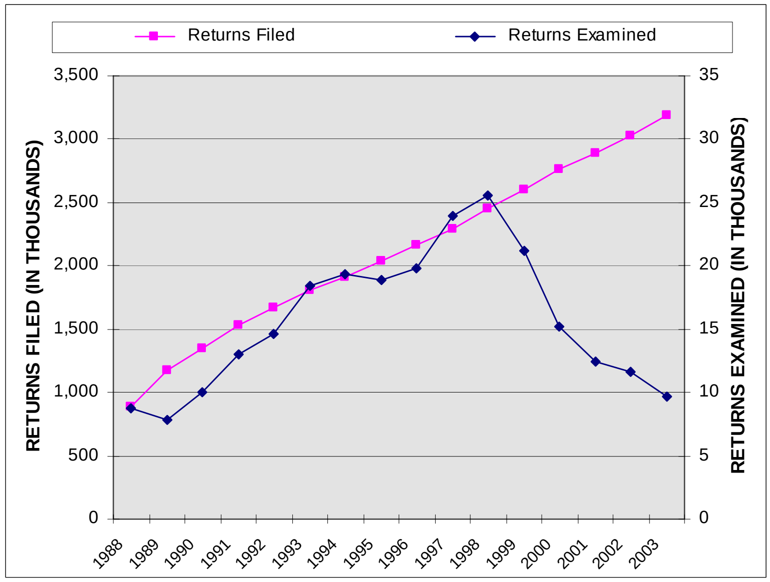
Figure 3: Examination Rates for S Corporation Returns (FYs 1996 – 2003)

Fiscal Year	Returns Examined	Coverage Rate
1996	19,490	0.92%
1997	23,898	1.04%
1998	25,522	1.04%
1999	21,169	0.81%
2000	15,200	0.55%
2001	12,437	0.43%
2002	11,646	0.39%
2003	9,695	0.30%

Source: TIGTA analysis of IRS data.

In addition, Figure 4 shows the IRS examination coverage of S corporation returns in the past 5 years has been insufficient to keep pace with the steady growth in the number of returns filed.

Figure 4: Examination Coverage of S Corporation Returns (FYs 1988 – 2003)

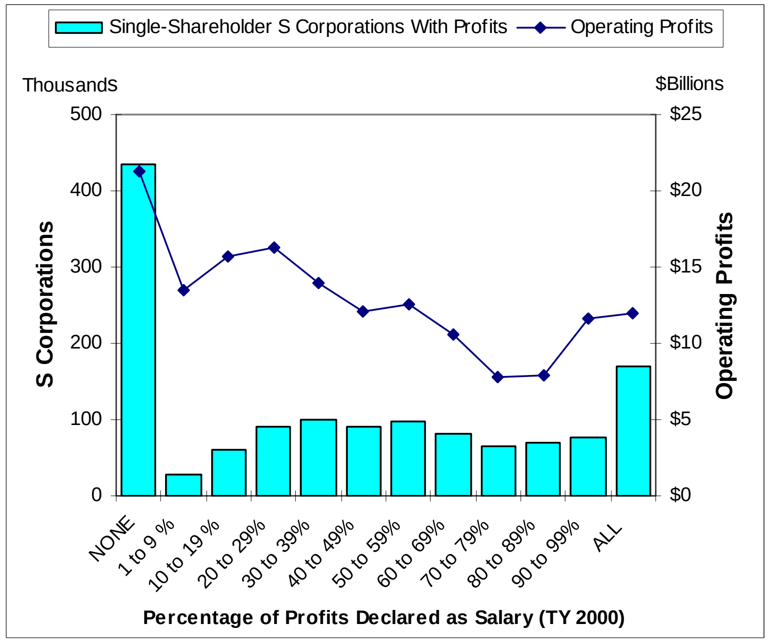


Source: IRS Data Books – Table 11.

Making reasonable compensation determinations is a complex and somewhat subjective endeavor that can result in litigation for the IRS. Since the IRS is forced to address the issue of reasonable officer compensation on a case-by-case basis, there are evidently many owners of S corporations who have determined the employment tax savings available from minimizing salaries is worth the risk of an IRS examination.

As shown in Figure 5, owners of single-shareholder S corporations vary widely in the amount of risk they wish to assume. As shown in the far left column, many are willing to set their salaries at $0 to maximize their employment tax savings.

Figure 5: Variations in Salaries Selected by Owners of Single-Shareholder S Corporations (TY 2000)[22]

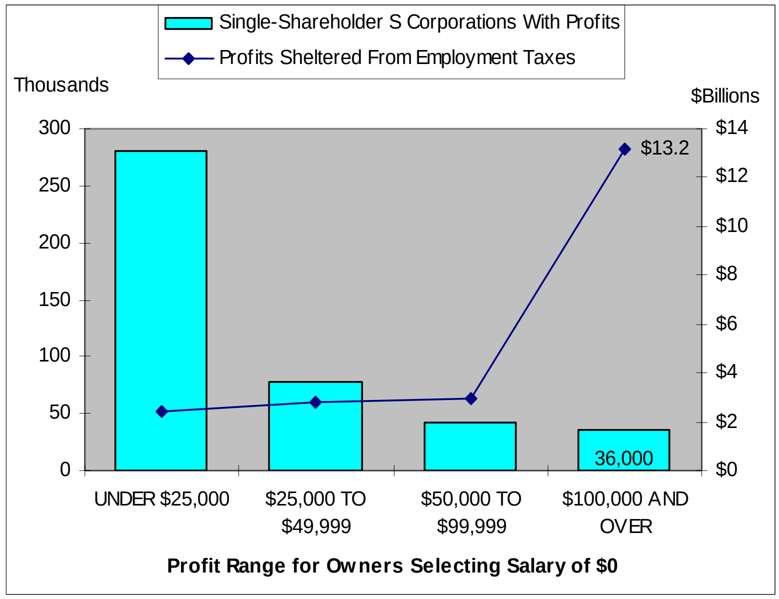


Source: TIGTA analysis of IRS Master File Data. These data reflect the impact of S corporation spousal ownership but not majority ownership.

Significant amounts of business profits frequently accrue to the owners of single-shareholder S corporations who choose to pay themselves no salaries and, therefore, pay no employment taxes. As shown in Figure 6, approximately 36,000 single-shareholder S corporations with profits of $100,000 or more in TY 2000 passed through total profits of $13.2 billion to their owners without paying any employment taxes.

[22] The profits of the single-shareholder S corporations consist of operating net income as reflected on corporate returns filed plus officer compensation. Officer compensation is included to ensure comparability with sole proprietorships for which similar payments are not deductible for computing net income from operations. Amounts for S corporations are for only those corporations filing returns claiming only one shareholder.

Figure 6: Operating Profits of S Corporations That Paid No Salaries to the Sole Owners (TY 2000)[23]



Source: TIGTA analysis of IRS Master File Data. These data reflect the impact of S corporation spousal ownership but not majority ownership.

Court records show the IRS can enforce reasonable compensation determinations through costly litigation. For example, in a recent tax court case,[24] a veterinarian who was the sole shareholder in his S corporation had received 3 years of profits from the business totaling nearly $419,000 while declaring no salary for himself, despite the fact the S corporation's sole source of income was from the services he provided. The court agreed with the IRS that the taxpayer's profits should be subject to employment taxes.

While such successes are helpful, there were 36,000 similar situations (see Figure 6) in TY 2000 alone in which the owners of single-shareholder S corporations took no salaries from the businesses while having over $100,000 in income.

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[23] Figure 6 is composed of those companies represented by the left-most column of Figure 5. The same footnote applies to Figure 6. Profits exempted from employment taxes represent the positive net income from the operation of the single-owner S corporations, as reported on corporate tax returns filed.
[24] *Veterinary Surgical Consultants, P.C. v. Commissioner, 117 T.C. 141 (2001).*

The cost of the IRS resources needed to effectively combat such a large problem on a case-by-case basis would be prohibitive.

If the S corporation owners who now have the ability to set their own salaries were instead subject to employment taxes on their profits, as are unincorporated sole proprietors, we estimate that Social Security and Medicare tax revenues would increase by $30.8 billion and $30.2 billion, respectively, during the 5-year period from CYs 2006 to 2010. This change would also allow the IRS to devote scarce compliance resources to examination priorities other than reasonable compensation determinations. See Appendix IV for additional information.

<u>Trends indicate continued erosion of the employment tax base</u>

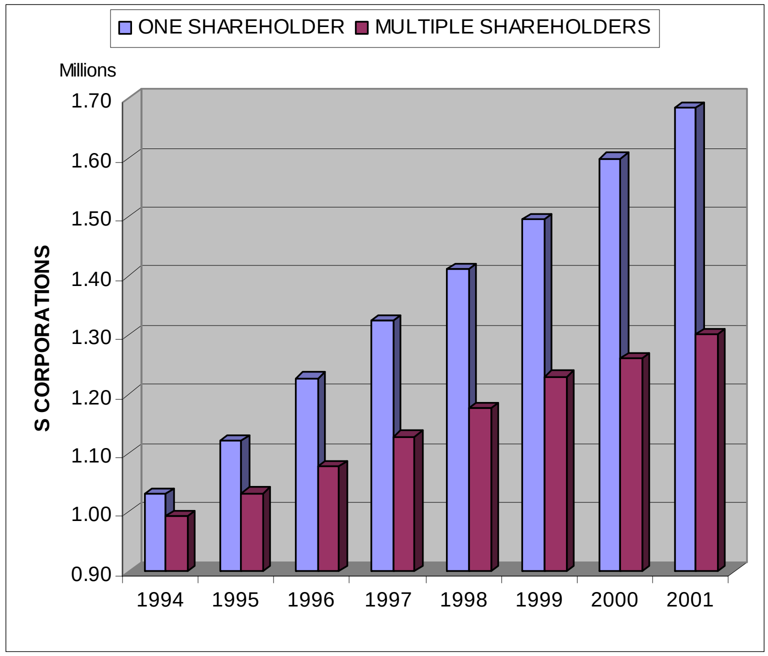
The number of single-shareholder S corporations (as reported on U.S. Income Tax Returns for an S Corporation (Form 1120S)) grew from 1,030,716 in TY 1994 to 1,684,861 in TY 2001, a growth rate of 63.5 percent. While there may be other reasons for small businesses to choose the S corporation form of organization, the opportunity to choose how much to pay for employment taxes must certainly be a consideration.

In fact, advising small businesses to shelter earnings from self-employment taxes through the formation of S corporations has become a cottage industry. A search of the Internet yields multiple sites that offer advice, assistance, and encouragement to sole proprietors to convince them to become S corporations. The sole proprietors are advised they can save thousands of dollars a year in employment taxes simply by incorporating. It is also possible on the Internet to gauge the size of the savings using computer-generated savings amounts based on the user's entries for anticipated profits and chosen salary levels. Not surprisingly, the lower the salary chosen, the higher the savings become, reaching maximum savings at a salary level of $0.

Figure 7 shows the growth in the numbers of single-shareholder and multiple-shareholder S corporations as reported to the IRS on S corporation returns. Although

Figure 7 shows that there are far more single-shareholder S corporations than multiple-shareholder S corporations, our analysis of taxpayer data revealed that the imbalance is significantly more pronounced than is shown in Figure 7.

Figure 7: Growth in Single-Owner and Multiple-Owner S Corporations (TYs 1994 - 2001)[25]



Source: IRS SOI function. These data do not reflect the impact of S corporation spousal or majority ownership.

Approximately 54.6 percent of all S corporations reported that they were owned by a single shareholder in TY 2000. However, this does not reflect the fact that tax law[26] treats a husband and wife as 1 shareholder or the fact that ownership of more than 50 percent of a corporation's stock by a single shareholder gives that shareholder control of business decisions, including the amount of business profits that will be paid to that individual as a salary.

By accounting for these factors, we determined that, in TY 2000, 78.9 percent of all S corporations are either owned by a single shareholder (69.4 percent) or majority owned by a single shareholder (9.5 percent).

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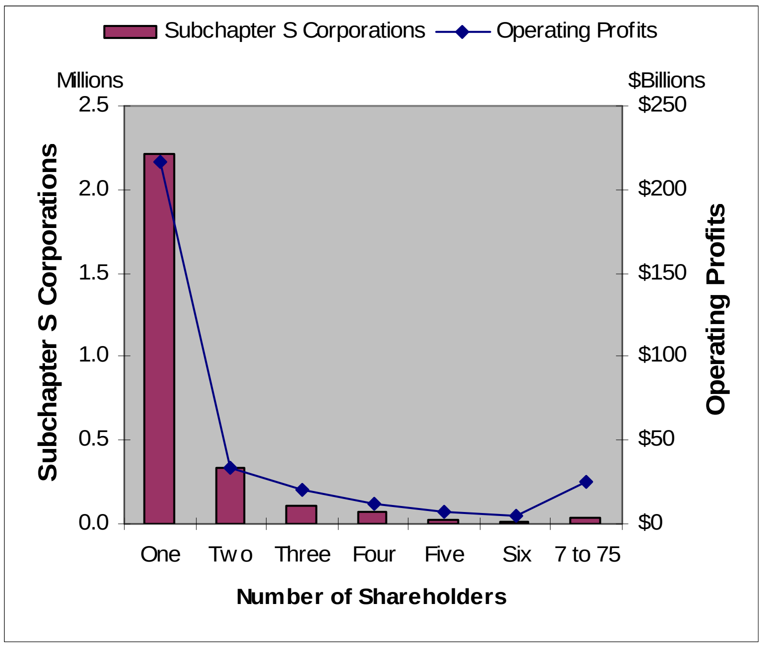
[25] Analysis reflects the number of shareholders shown on Forms 1120S.
[26] 26 U.S.C § 1361(c)(1) (2004).

Figure 8 demonstrates the true predominance of single-shareholder S corporations in TY 2000, as well as the sizable portion of business income related to single-shareholder S corporations. The left-most column in Figure 8 shows the operating profits[27] and the volume of S corporations that were either solely owned or solely controlled by a single shareholder. The remaining columns show the S corporations with more diverse ownership.

Figure 8: Number of S Corporations and Operating Profits Stratified by Number of Shareholders (TY 2000)



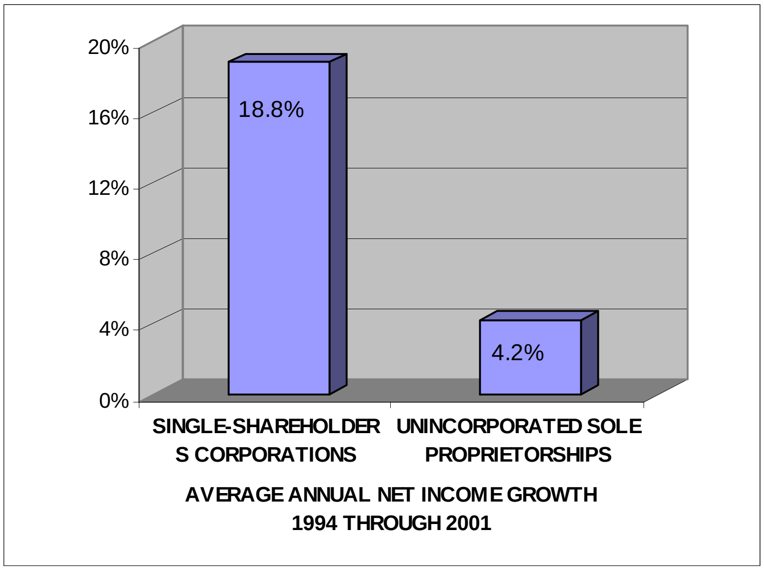
Source: TIGTA analysis of IRS SOI function and Individual Master File Data. These data reflect the impact of S corporation spousal and majority ownership.

The trend toward single-shareholder S corporations may account for the relatively slow growth of business profits that are subject to SECA taxes seen in Figure 9. The average annual growth in net income from the operation of

[27] For comparability to sole proprietorships, the operating profits shown represent the total positive net income from the operation of the businesses plus officer compensation paid (which is not a deductible item for determining the net income of a sole proprietorship). The total positive net income is from line 21 of Form 1120S.

single-shareholder S corporations[28] between TYs 1994 and 2001 was 18.8 percent. The average annual growth in net income from the operation of sole proprietorships was only 4.2 percent during the same period.

Figure 9: Average Annual Growth in Net Operating Income of S Corporations and Sole Proprietorships (TYs 1994 – 2001)

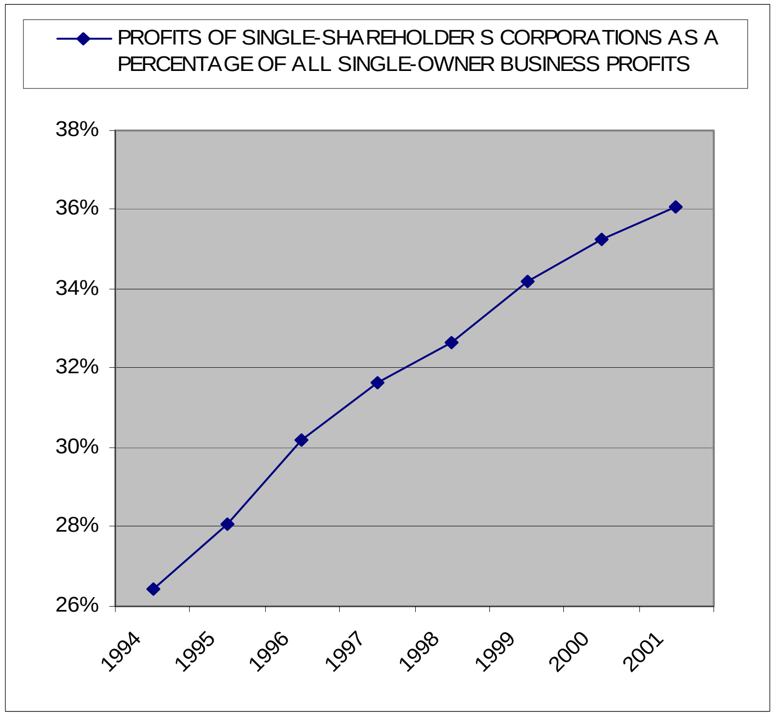


Source: IRS SOI function data. These data do not reflect the impact of S corporation spousal or majority ownership.

The continuing migration of sole proprietors to the S corporation structure diverts business profits away from the SECA tax base into S corporations where the amount of FICA taxes that will be generated is significantly less, due to the subjectivity of establishing reasonable officer compensation. Figure 10 shows that single-shareholder S corporations accounted for 26.4 percent of the combined profits of sole proprietorships and single-shareholder S corporations in TY 1994 and 36.1 percent in TY 2001, an increase of nearly 10 percentage points in just 8 years.

[28] Represents positive net income from business operations minus net deficits as reported on line 21 of Form 1120S. Amounts on line 21 are net of officer compensation which is not a deductible item in determining the net income of sole proprietorships.

Figure 10: Operating Profits of Incorporated and Unincorporated Single-Owner Businesses (TYs 1994 – 2001)[29]



Source: IRS SOI function data. These data do not reflect the impact of S corporation spousal or majority ownership.

Recommendations

To eliminate the employment tax shelter for most S corporations, increase self-employment tax revenues, provide for equitable employment tax treatment of taxpayers, and reduce the burden on IRS examination resources:

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[29] Represents the total positive net income from the operation of sole proprietorships plus the positive net income from the operation of single-shareholder S corporations. The net income for the single-shareholder S corporations includes officer compensation paid to ensure comparability with sole proprietorships for which similar payments are not deductible for computing net income. Amounts for S corporations are for only those corporations filing returns claiming only one shareholder. No adjustments have been made for spousal or majority ownership. Figure 10 excludes partnerships and corporations other than S corporations that may be solely-owned or majority-owned by a single individual.

1. The IRS Commissioner should inform the Assistant Secretary of the Treasury for Tax Policy of the detrimental effects discussed in this report of Revenue Ruling 59-221 that was apparently issued under the historically inaccurate assumption that most S corporations would involve multiple shareholders.

Management's Response: The Commissioner, Small Business/Self-Employed (SB/SE) Division, did not agree with this recommendation. The Commissioner, SB/SE Division, disagrees that Revenue Ruling 59-221 is the cause of the inequities reflected in the report. The issue is not with Revenue Ruling 59-221. In fact, the statutory and judicial laws that form the basis for Revenue Ruling 59-221 are still the law today. The Commissioner, SB/SE Division, stated, under current law for S corporations, the issue is how best to determine "reasonable compensation" for application of the FICA tax.

Office of Audit Comment: We continue to believe the current employment tax inequities are the result of the Revenue Ruling. The historical file for this Revenue Ruling shows the Revenue Ruling was prompted by a 1958 question from a taxpayer regarding whether or not self-employment taxes (applicable to sole proprietors) would apply to the profits of the newly-created S corporations. Rather than addressing the case of a sole proprietor choosing to become a single-shareholder S corporation, the IRS response discussed a multi-shareholder S corporation and concluded that self-employment taxes should not apply to the profits of such S corporations. The IRS applied the concepts supporting this decision to all S corporations, regardless of the number of shareholders, when it issued Revenue Ruling 59-221 in 1959.

2. The IRS Commissioner should consult with the Assistant Secretary of the Treasury for Tax Policy regarding whether the detrimental effects of Revenue Ruling 59-221 should be reversed through the issuance of new regulations or through the drafting of new legislation, either of which should subject all ordinary operating gains of an

S corporation that accrue to a shareholder (including the shareholder's spouse and dependent children) holding more than 50 percent of the stock in the S corporation to employment taxes.

a. SECA taxes should not apply to officer compensation (if any) on which FICA taxes are paid.

b. No employment taxes should apply to S corporations without operating gains.

c. No changes should be made to the current employment tax treatment of S corporation minority shareholders.

Management's Response: The Commissioner, SB/SE Division, does not agree with this recommendation. The Commissioner, SB/SE Division, stated new regulations would not affect the fundamental application of employment taxes to S corporations. A recommendation to discuss legislative changes to simply subject to employment tax "all ordinary operating gains of an S corporation that accrue to a shareholder" is not consistent with the principles underlying the employment tax statutes in connection with the performance of services. Nor does it properly recognize the administrative and taxpayer burdens that this legislation may cause or consider the application of employment taxes to other flow-through entities. However, the IRS will continue its outreach efforts to communicate all employment tax provisions as they pertain to each tax entity. As appropriate, the IRS will work with the Department of the Treasury in furtherance of legislation that would resolve the issues in the best interest of tax administration.

Because the Commissioner, SB/SE Division, does not agree with our premise that the source of the problem is the revenue ruling and believes it is important to consider the problem in the context of other business entities, the Commissioner, SE/SE Division, does not agree with the specific recommendations of this report and, therefore, cannot agree with the outcome measures. The Commissioner, SB/SE Division, also has concerns with our calculation of the outcome measures. The Commissioner, SB/SE Division, stated the calculation does not take into account that some taxpayers may react to implementation of the proposal by converting S corporations to another entity (such as a C corporation or a limited liability company). The Commissioner, SB/SE Division, also stated our report assumes the S corporation shareholder has no other self-employment income (or FICA tax wages) and does not account for an offset to self-employment taxes for any S corporation that will reflect an ordinary loss.

Office of Audit Comment: We disagree with the IRS assertion that Revenue Ruling 59-221 *confirmed* rather than established that SECA taxes should not apply to single-shareholder S corporations, and we continue to believe that the current employment tax inequities are the result of the Revenue Ruling. However, we are encouraged that the IRS plans to work with the Department of the Treasury in furtherance of legislation that would resolve the issues in the best interest of tax administration.

While we support the IRS desire to eliminate through such legislation similar employment tax inequities in other business structures, identifying and quantifying such possible additional inequities were beyond the scope of this review. In addition, we do not believe correction of the current inequities discussed in the report should be delayed while a search for possible additional inequities is conducted. Nor do we believe current inequities should continue out of apprehension that an unquantifiable number of taxpayers may change their business structures to pursue new strategies to avoid employment taxes.

In response to IRS concerns related to the possible impact of taxpayers having multiple sources of employment-taxable income, we have reduced our original 5-year estimate of additional employment tax revenues to $61 billion. See Appendix IV for additional information. In addition, we have added notes (a) through (c) to this recommendation to clarify our position on the uncertainties expressed in IRS management’s response.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the existing tax laws, tax regulations, and Internal Revenue Service (IRS) policies and practices ensure fairness in administering self-employment taxes to all similarly situated taxpayers.

To accomplish this objective, we:

I. Researched historical tax law changes regarding sole proprietors and S corporations and, where possible, identified the reasons for those changes.

II. Reviewed available IRS studies, reports, and general information regarding self-employment taxes and related compliance information, including tax court cases.

III. Identified and evaluated the characteristics of S corporations by analyzing databases that were developed by the IRS Statistics of Income (SOI) function for Tax Year (TY) 2000 U.S. Income Tax Return for an S Corporation (Form 1120S) and related Shareholder's Share of Income, Credits, Deductions, etc. (Schedule K-1). TY 2000 was the most current year for which specific data was available from multiple sources at the time audit planning commenced.

   A. To determine the presence of spousal ownership among the shareholders in S corporations, matched the Schedule K-1 data to the IRS Individual Returns Transaction File[1] for TY 2000 to identify the shareholders in the same S corporation that filed jointly or as married filing separately for TY 2000.

   B. Once the spousal ownership test was completed, identified all shareholders owning more than 50 percent of the stock in an S corporation (regardless of whether the stock was owned by 1 spouse or both).

IV. Evaluated historical trends regarding both nonfarm sole proprietorships and S corporations by analyzing statistics published by the SOI function from 1959 to 2001.

V. Researched Social Security Administration (SSA) records regarding the historical rates for Federal Insurance Contributions Act[2] and Self-Employment Contributions Act[3] tax rates as well as the annual contribution bases for the SSA's Old-Age, Survivors, and Disability Insurance .

VI. Researched Internet sites for applicable information and advice offered to the public regarding employment taxes.

[1] An IRS file containing data transcribed from each tax return as well as computer-generated information used to verify the accuracy of the transcribed data.
[2] 26 U.S.C. Chapter 21 (2004).
[3] 26 U.S.C. § 1401 (2004).

Appendix II

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Appendix III

Report Distribution List

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration for Calendar Years 2006 through 2010. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $30.8 billion in increased Social Security tax revenues from S corporation shareholders owning more than 50 percent of the stock in the corporations (see page 3).
- Increased Revenue – Potential; $30.2 billion in increased Medicare tax revenues from S corporation shareholders owning more than 50 percent of the stock in the corporations (see page 3).

Methodology Used to Measure the Reported Benefit:

To determine the number of solely owned and solely controlled (i.e., a single shareholder with more than 50 percent ownership) S corporations, we relied on the percentage of ownership information reflected on Shareholder's Share of Income, Credits, Deductions, etc. (Schedule K-1) that was developed by the Internal Revenue Service (IRS) Statistics of Income (SOI) function for Tax Year (TY) 2000 U.S. Income Tax Return for an S Corporation (Form 1120S). We enhanced this information by matching the Social Security Numbers (SSN)[1] from the Schedules K-1 to an extract from the Individual Master File[2] that contained the primary and secondary SSNs and the filing status from each individual income tax return filed for TY 2000. If both the primary and secondary SSNs matched one return and both SSNs matched the Schedules K-1 issued by the same S corporation, we totaled the percentage ownership from the Schedules K-1 and reduced the number of shareholders shown on the S corporation return by one.

After this analysis was complete, we identified all S corporations with more than 50 percent ownership as modified for spousal ownership. To determine the income received by these taxpayers from their S corporations, we multiplied the total operating profits of the S corporations by the percentage of ownership of the taxpayers. To determine the operating profits of the S corporations on a basis equivalent to Self-Employment Contributions Act

[1] The SSN is generally used as a taxpayer identification number that must be used on U.S. Individual Income Tax Return (Form 1040) and its related schedules.
[2] The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

(SECA)[3] tax treatment of sole proprietors, we added officer compensation to the net income (or deficit) from the operation of the trade or business. Although both Federal Insurance Contributions Act (FICA)[4] taxes and SECA taxes are virtually identical on this amount (as explained on page 3 of this report) and officer compensation is not a deductible amount for determining operating income for sole proprietors, the change was necessary for clarity of discussion and SECA tax computations and for comparability of S corporation profits and sole proprietorship profits. Both the unadjusted operating net income and the amount of officer compensation were obtained from the TY 2000 Form 1120S database developed by the IRS SOI function.

To determine the amount of FICA Social Security taxes currently paid by taxpayers owning more than 50 percent of an S corporation, we multiplied the taxpayer's percentage of ownership by the amount of officer compensation for the S corporation and then multiplied the result, limited to the TY 2000 Social Security income ceiling of $76,200, by 12.4 percent. Our computations assumed the taxpayer had no other income subject to Social Security taxes. To determine the amount of FICA Medicare taxes currently paid, we multiplied all of the taxpayer's officer compensation by 2.9 percent.

To determine the amount of SECA taxes that would be paid on the taxpayer's share of the operating profit from the S corporation, we applied the SECA tax rules to the total of operating net income plus officer compensation that exceeded zero. In the case of officer compensation that was partially or wholly in excess of available gains, we computed no SECA taxes on the portion of the officer compensation that exceeded the available gains. The operating profits were multiplied by 92.35 percent[5] to determine the taxable SECA base. To determine the amount of SECA taxes that would be assessed on the taxable SECA base, we multiplied the taxpayer's operating profits, limited to the TY 2000 Social Security income ceiling of $76,200, by 12.4 percent. Our computations assumed the taxpayer had no other Social Security-taxable income for the year, but the presence of such income would reduce both taxable FICA income and taxable SECA income and, thus, would not materially affect the difference between the FICA and SECA taxation computed by the Treasury Inspector General for Tax Administration (TIGTA). To determine the amount of SECA Medicare taxes that would be paid, we multiplied the taxable SECA base by 2.9 percent. To produce national statistics, the record weights[6] provided by the SOI function on all TY 2000 Form 1120S database items were applied to all taxpayer counts and amounts.

To determine the increase or decrease that would result from subjecting S corporations to SECA taxes, we compared the amount of FICA taxes currently paid on officer compensation to the amount of SECA taxes that would be assessed if they were applied, instead, to all operating

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[3] 26 U.S.C. § 1401 (2004).
[4] 26 U.S.C. Chapter 21 (2004).
[5] For purposes of determining employment taxes, the profits of sole proprietorships are reduced by an amount equal to an employer's share of FICA taxes (7.65 percent) before calculating SECA taxes on the remaining 92.35 percent.
[6] Record weights are values that indicate how many records similar to the sampled record would likely be found if all records were examined.

profits. To determine these future amounts, our computer programs totaled all applicable FICA and SECA amounts and we then expressed these amounts as a percentage of officer compensation (for FICA taxes) or operating profits (for SECA taxes). The future annual growth in officer compensation (7.70 percent) and operating profits (9.60 percent) were based upon average annual increases in those items from TYs 1999 through 2001 according to SOI function data published by the IRS. While the average annual growth in single-owner S corporation profits from TYs 1995 through 2001 was 12.77 percent, we used a more conservative average annual profit growth rate of 9.60 percent for TYs 1999 through 2001 for our analysis to more closely reflect recent economic conditions.

Table 1: Employment Tax Revenue Losses Before SECA Taxes Can Be Applied to Single-Owner S Corporations

	TY 2000 ACTUAL DUE IN CY 2001	TY 2001 DUE IN CY 2002	TY 2002 DUE IN CY 2003	TY 2003 DUE IN CY 2004	TY 2004 DUE IN CY 2005	TY 2005 DUE IN CY 2006
A) Average Annual S Corporation Officer Compensation Growth (Actual TY 1999 Through TY 2001)	7.70%	7.70%	7.70%	7.70%	7.70%	7.70%
B) Officer Compensation of Single-shareholder S Corporations Through TY 2005 (CY 2006)	$ 84,725,792,926	$ 91,249,678,981	$ 98,275,904,263	$105,843,148,891	$113,993,071,356	$ 122,770,537,850
C) FICA Old Age, Survivor, and Disability Insurance (OASDI) Tax Liability as a Percentage of Profits (OASDI on Actual TY 2000 Officer Compensation)	6.43%	6.43%	6.43%	6.43%	6.43%	6.43%
D) FICA Hospital Insurance (HI) Tax Liability as a Percentage of Profits (Actual TY 2000)	2.90%	2.90%	2.90%	2.90%	2.90%	2.90%
E) FICA OASDI Revenue Anticipated (item B * item C)	$ 5,444,396,482	$ 5,863,615,011	$ 6,315,113,367	$ 6,801,377,096	$ 7,325,083,132	$ 7,889,114,534
F) FICA HI Revenue Anticipated (item B * item D)	$ 2,457,047,995	$ 2,646,240,690	$ 2,850,001,224	$ 3,069,451,318	$ 3,305,799,069	$ 3,560,345,598
G) Total FICA Revenue Anticipated (item E + item F)	$ 7,901,444,477	$ 8,509,855,701	$ 9,165,114,590	$ 9,870,828,414	$ 10,630,882,202	$ 11,449,460,131
H) Average Annual S Corporation Profit Growth (Actual TY 1999 Through TY 2001)	9.60%	9.60%	9.60%	9.60%	9.60%	9.60%
I) Profits of Single-Shareholder S Corporations Through TY 2005 (CY 2006)	$ 198,615,942,141	$ 217,683,072,587	$238,580,647,555	$261,484,389,720	$286,586,891,133	$ 314,099,232,682
J) SECA OASDI Revenue as a Percentage of Profits (SECA OASDI Applied to Actual TY 2000 Operating Profits, Including Officer Compensation)	4.18%	4.18%	4.18%	4.18%	4.18%	4.18%
K) SECA HI Revenue as a Percentage of Profits (SECA HI Applied to Actual TY 2000 Operating Profits, Including Officer Compensation)	2.68%	2.68%	2.68%	2.68%	2.68%	2.68%
L) SECA OASDI Revenue Anticipated (item J * item I)	$ 8,296,204,959	$ 9,092,640,635	$ 9,965,534,136	$ 10,922,225,413	$ 11,970,759,053	$ 13,119,951,922
M) SECA HI Revenue Anticipated (item K * item I)	$ 5,319,232,854	$ 5,829,879,208	$ 6,389,547,612	$ 7,002,944,183	$ 7,675,226,825	$ 8,412,048,600
N) Total SECA Revenue Anticipated (item L + item M)	$ 13,615,437,813	$ 14,922,519,843	$ 16,355,081,748	$ 17,925,169,596	$ 19,645,985,877	$ 21,532,000,522
O) OASDI Revenue Loss (item L minus item E)	$ 2,851,808,477	$ 3,229,025,624	$ 3,650,420,769	$ 4,120,848,317	$ 4,645,675,920	$ 5,230,837,388
P) HI Revenue Loss (item M minus item F)	$ 2,862,184,860	$ 3,183,638,518	$ 3,539,546,389	$ 3,933,492,865	$ 4,369,427,756	$ 4,851,703,002
Q) Total Employment Tax Loss (item O + item P)	$ 5,713,993,337	$ 6,412,664,142	$ 7,189,967,158	$ 8,054,341,182	$ 9,015,103,676	$ 10,082,540,390

Source: TIGTA analysis of IRS data. Minor differences may result from the rounding of multiplicands.

Table 2: Employment Tax Revenue Increases From Applying SECA Taxes to Single-Owner S Corporation Profits

	TY 2005 DUE IN CY 2006	TY 2006 DUE IN CY 2007	TY 2007 DUE IN CY 2008	TY 2008 DUE IN CY 2009	TY 2009 DUE IN CY 2010	TOTAL
AA) Average Annual S Corporation Officer Compensation Growth (Actual TY 1999 through TY 2001)	7.70%	7.70%	7.70%	7.70%	7.70%	N/A
AB) Officer Compensation of Single-Shareholder S Corporations Through TY 2005 (CY 2006)	$ 122,770,537,850	$ 132,223,869,265	$142,405,107,198	$153,370,300,452	$165,179,813,587	$ 715,949,628,353
AC) FICA OASDI Revenue as a Percentage of Profits (Actual TY 2000)	6.43%	6.43%	6.43%	6.43%	6.43%	N/A
AD) FICA HI Revenue as a Percentage of Profits (Actual TY 2000)	2.90%	2.90%	2.90%	2.90%	2.90%	N/A
AE) FICA OASDI Revenue Anticipated (item AC * item AB)	$ 7,889,114,534	$ 8,496,576,353	$ 9,150,812,732	$ 9,855,425,312	$ 10,614,293,061	$ 46,006,221,992
AF) FICA HI Revenue Anticipated (item AD * item AB)	$ 3,560,345,598	$ 3,834,492,209	$ 4,129,748,109	$ 4,447,738,713	$ 4,790,214,594	$ 20,762,539,222
AG) Total FICA Revenue Anticipated (item AE + item AF)	$ 11,449,460,131	$ 12,331,068,561	$ 13,280,560,841	$ 14,303,164,025	$ 15,404,507,655	$ 66,768,761,214
AH) Average Annual S Corporation Profit Growth (Actual TY 1999 Through TY 2001)	9.60%	9.60%	9.60%	9.60%	9.60%	N/A
AI) Profits of Single-Shareholder S Corporations Through TY 2005 (CY 2006)	$ 314,099,232,682	$ 344,252,759,020	$377,301,023,886	$413,521,922,179	$453,220,026,708	$ 1,902,394,964,474
AJ) SECA OASDI Tax as a Percentage of Profits (Actual TY 2000)	4.18%	4.18%	4.18%	4.18%	4.18%	N/A
AK) SECA HI Tax as a Percentage of Profits (Actual TY 2000)	2.68%	2.68%	2.68%	2.68%	2.68%	N/A
AL) SECA OASDI Tax Amount Anticipated (item AJ * item AI)	$ 13,119,951,922	$ 14,379,467,306	$ 15,759,896,167	$ 17,272,846,200	$ 18,931,039,435	$ 79,463,201,029
AM) SECA HI Tax Amount Anticipated (item AK * item AI)	$ 8,412,048,600	$ 9,219,605,266	$ 10,104,687,371	$ 11,074,737,359	$ 12,137,912,145	$ 50,948,990,741
AN) Total SECA Taxes Anticipated (item AL + item AM)	$ 21,532,000,522	$ 23,599,072,572	$ 25,864,583,539	$ 28,347,583,558	$ 31,068,951,580	$ 130,412,191,771
AO) OASDI Revenue Increase (item AL minus item AE)	$ 5,230,837,388	$ 5,882,890,953	$ 6,609,083,436	$ 7,417,420,887	$ 8,316,746,373	**$ 33,456,979,038**
AP) HI Revenue Increase (item AM minus Item AF)	$ 4,851,703,002	$ 5,385,113,057	$ 5,974,939,262	$ 6,626,998,646	$ 7,347,697,551	**$ 30,186,451,519**
AQ) Total Employment Tax Increase (item AO + item AP)	$ 10,082,540,390	$ 11,268,004,010	$ 12,584,022,698	$ 14,044,419,533	$ 15,664,443,925	**$ 63,643,430,557**

Source: TIGTA analysis of IRS data. Minor differences may result from the rounding of multiplicands.

To address concerns expressed by the IRS in response to this report regarding the impact of single-shareholder S corporation owners who may have employment-taxable income from multiple sources, we conducted further analysis. Such multiple sources of employment-taxable income would include multiple single-shareholder S corporations owned by one individual and wages received by the owner of a single-shareholder S corporation for services not related to the single-shareholder S corporation. Multiple-source employment-taxable income would not impact HI revenue which applies to all employment-taxable earnings. However, it could impact OASDI taxes that in TY 2000 were assessed on only the first $76,200 of such income. SOI records for TY 2000 indicate that 2 percent of single-shareholder S corporations are owned by taxpayers that own more than 1 single-shareholder S corporation. Information was not available regarding non-S corporation wage income for the owners of single-shareholder S corporations, so we relied on data regarding sole proprietors to gauge the impact of wage-related employment taxes on such income. The IRS Individual Return Master File records for TY 2000 indicates that 5.9 percent of sole proprietors at least partially reduced their self-employment taxes due to employment taxes paid on wages. To maximize the reduction in our 5-year revenue increases, we added these percentages and assumed that the OASDI increases would be completely eliminated for 7.9 percent of the owners of single-shareholder S corporations whose OASDI increases involved employment-taxable income from multiple sources. This reduced our original OASDI estimated increase to 92.1 percent (100 - 7.9) of the original $33,456,979,038, resulting in a revised estimate of $30,813,877,694 in OASDI increases.

<u>Implications of Officer Compensation Allocation</u>

The recipient of officer compensation from an S corporation is not identified on Forms 1120S or the Schedules K-1 attached to those returns. As a result, it was necessary to make assumptions regarding the amount of compensation (salary) paid to the sole owners or majority owners of the corporations. For our calculations, we distributed officer compensation according to the percentage of ownership shown on Schedules K-1 of Forms 1120S, as adjusted for spousal ownership. The FICA taxes were then computed on the amount of officer compensation and the SECA taxes were computed on the total profits available for distribution by the S corporation (consisting of officer compensation plus nonofficer-compensation profits). The difference between the FICA and SECA taxes was then calculated.

Implications for fully-owned S corporations: For S corporations owned by a single shareholder, we allocated all officer compensation to the shareholder. If, as an extreme example, all of the officer compensation was actually paid to someone other than the single shareholder, the amount of FICA taxes paid by the single shareholder would be reduced to $0, leaving the total amount of SECA taxes on the nonofficer compensation (business operating profits) as the total difference between the FICA tax of $0 and SECA taxes that would be applied to the business operating profits. In this case, the business profits of up to $76,200 (the Social Security taxable limit) that were not subject to Social Security taxes for SECA purposes (because they were above the Social Security Administration limit when officer compensation was added to operating profits) would now be subjected to SECA taxes of 12.4 percent, which would increase the difference between FICA taxes ($0 in this example) and SECA taxes.

Thus, our estimate of the amount of the increase in SECA taxes over FICA taxes may be understated if all officer compensation was not paid to the single shareholder of an S corporation, to the extent that decreasing the amount of officer compensation decreases the amounts we considered subject to FICA taxation and concurrently increases the amounts we should have considered subject to SECA taxation. Approximately 85 percent of the SECA tax increases we computed were related to single-shareholder S corporations. Allocating no officer compensation to the shareholders would add 44.9 percent to the tax increases we computed.

Implications for majority-owned S corporations: For multiple-shareholder S corporations in which 1 shareholder owns more than 50 percent of the stock (and thus controls the S corporation's decision making), we allocated officer compensation to the majority shareholder by applying the shareholder’s percentage of ownership to the total amount of officer compensation paid by the S corporation. The results from allocating too much officer compensation to the majority shareholder would mirror those described for single-shareholder S corporations. That is, if we assigned too much officer compensation to the majority shareholder, it would cause the SECA tax increases we computed to be understated.

However, if more officer compensation was paid to the majority shareholder than we allocated, the difference between the FICA taxes and SECA taxes we computed may be overstated to the extent that increasing the amount of officer compensation increases the amounts we should have considered subject to FICA taxation and decreases the amounts we considered subject to SECA taxation. Approximately 15 percent of the SECA tax increases we computed were related to majority shareholders in multiple-shareholder S corporations. Allocating all officer compensation to the majority shareholders would reduce the SECA increases we computed for these taxpayers by 10.1 percent. Allocating no officer compensation to the majority shareholders would add 60.1 percent to the tax increases we computed.

In summary, if we underestimated the officer compensation attributable to sole owners or majority owners of S corporations, our estimates of the SECA tax increases could be overstated by as much as 1.5 percent. Conversely, if we overestimated the officer compensation attributable to the sole owners or majority owners, our estimates of the SECA tax increases could be understated by as much as 47.2 percent.

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

RECEIVED
MAY 0 4 2005

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

APR 29 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations (Audit #200430022)

We have reviewed your draft report and agree that there are compliance issues regarding the payment of sufficient wages to S corporation officers. We also agree that, statutorily, there are differences between the employment tax liabilities of sole proprietorships and single-shareholder S corporations.

However, we do not agree with your basic diagnosis of the cause of the compliance problems and, accordingly, we do not agree with your report or your resulting recommendations. Your report implies that all single-shareholder S corporations are employment tax shelters. We believe this implication is overstated.

Although most closely-held businesses report payment of a reasonable wage to their shareholders who perform services as employees of the corporation, properly establishing reasonable compensation for any shareholder actively operating a corporate business is a continuing challenge. To combat the concern that some S corporations may be underreporting their officer compensation, the IRS developed a Compliance Initiative Project (CIP) that uses filters to identify returns for audit that appear to have this issue. As the project progresses, we are refining these filters to improve our selection criteria.

In addition, we have made significant outreach efforts to ensure S corporations are aware of the requirement to treat reasonable compensation to S corporation officers as wages for employment tax purposes. When a taxpayer elects and receives approval for S corporation status, we mail a letter to the taxpayer regarding employment tax obligations. The issue of the payment of reasonable compensation to S corporation officers was also a point of discussion at the IRS Tax Forums last year. The IRS website (www.irs.gov) provides the public with information about this issue, devoting a page to Revenue Ruling 59-221 and the reasonable compensation issue. On another page of the IRS website, we provide information that distinguishes compensation to a corporate officer from shareholder loans or other payments made to officers. IRS

Publication 15, Employer's Tax Guide (Circular E), provides comprehensive information on employment tax issues and addresses officer compensation.

Determining reasonable compensation for any S corporation is a case-by-case facts-and-circumstances issue. Accordingly, we appreciate your recognition that resource limitations may hinder our ability to address our compliance concerns through enforcement and outreach activity, and your general view that changes in the underlying law may be advisable.

Under current law, business owners have different employment tax liabilities depending on the type of business entity (e.g. sole proprietorship, partnership, S corporation). An individual running a sole proprietorship owes Self-Employment Contributions Act (SECA) tax on his net income from the operation of a trade or business. A general partner in a partnership owes SECA tax on his distributive share of the partnership's income or loss. A limited partner in a partnership owes SECA tax on guaranteed payments received for services performed for the partnership. A shareholder officer in an S corporation owes Federal Insurance Contributions Act (FICA) tax on his compensation for services. The issue is how best to determine reasonable compensation for services for application of the FICA tax. Revenue Ruling 59-221 reflects the longstanding rule embedded in the Code and case law that a corporation and its shareholders are separate taxable entities. Thus, while Revenue Ruling 59-221 confirms that SECA tax does not apply to S corporation shareholders, the statutory and judicial laws that form the basis for Revenue Ruling 59-221 are still the law today. Accordingly, we disagree that revocation of the revenue ruling or promulgation of regulations would change the fundamental application of employment tax law to S corporations.

While we agree that our ability to address the compliance issue of whether an S corporation reports reasonable compensation may be furthered with appropriate legislation, the recommendation to subject to employment tax "all ordinary operating gains of an S corporation that accrue to a shareholder" is not consistent with the principles underlying the employment tax statutes. The intent of both SECA and FICA taxes is to fund the accrual of social security benefits earned generally in connection with the performance of services. Your recommendation requires no services to be performed for the S corporation by the shareholder to generate liability for self-employment tax.

Your report is also based on the premise that like entities should have similar treatment and it presumes S corporations are most like sole proprietorships that file Form 1040, Schedule C, Profit or Loss From Business. Your report does not discuss the fact that the current regime for self-employment taxes for S corporations does not match the self-employment tax rules for partnerships, although both are flow-through entities, which are usually managed by their owners. Your report also does not compare the treatment of S corporations and their shareholders to the treatment of limited liability companies (LLCs) and their members or business trusts and trustees/beneficiaries performing services for the trusts. Furthermore, the recommendation does not consider whether the employment tax treatment of S corporations can effectively be addressed without also addressing the employment tax treatment of these other flow-through entities. Your recommendations also do not consider the similarity between S corporations and C corporations.

By contrast, as referenced in your report, the Joint Committee on Taxation (JCT) has published a recent report, Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05) which recognizes the employment tax differences among the types of business entities and provides for a more appropriate remedy to the compliance issues we are facing. The JCT proposal takes into consideration partnerships and LLCs that were not addressed by your report and brings into play the concept of material participation (labor services versus capital profits). We believe a global approach to all flow-through entities would minimize disparate employment tax treatment between various entity types.

There are also administrative and taxpayer burdens that must be considered. Your recommendation suggests that certain S corporation shareholders will be required to pay both FICA tax on their wages as officers and SECA tax on their distributive shares. This proposal could create a perception of double taxation, and result in the individual being employed and self-employed with respect to the same services. Coordinating the FICA and SECA taxes under these circumstances would impose additional administrative and recordkeeping burdens on the S corporation and its shareholders, and complicate enforcement by the IRS. Through your use of the rules of attribution, the draft report did not address whether other minority shareholders would still be required to receive reasonable compensation from the S corporation subject to FICA tax since it would appear they would not be subject to SECA tax under your proposal.

Because we do not agree with your premise that the source of the problem is the revenue ruling and, as we believe it is important to consider the problem in the context of other business entities, we do not agree with the specific recommendations of this report. Therefore, we cannot agree with the outcome measures. We also have concerns with your calculation of the outcome measures. The calculation does not take into account that some taxpayers may react to implementation of the proposal by converting S corporations to another entity (such as a C corporation or a LLC). Your report also assumes the S corporation shareholder has no other self-employment income (or FICA tax wages) and does not account for an offset to self-employment taxes for any S corporation that will reflect an ordinary loss.

While most taxpayers try to be compliant, we will continue our initiatives to identify such employment tax issues for S corporations that do not reflect reasonable compensation.

We will continue our outreach efforts to communicate all employment tax provisions as they pertain to each tax entity. As appropriate, we will work with Treasury in furtherance of legislation that would resolve the issues.

Our comments to the recommendations are as follows:

RECOMMENDATION 1
The IRS Commissioner should inform the Assistant Secretary for Tax Policy of the detrimental effects discussed in this report of Revenue Ruling 59-221 that was issued under the historically inaccurate assumption that most S corporations would involve multiple shareholders.

CORRECTIVE ACTION
We do not agree with this recommendation for the reasons stated in our response. We disagree that Revenue Ruling 59-221 is the cause of the inequities reflected in your report. The issue is not with Revenue Ruling 59-221. In fact, the statutory and judicial laws that form the basis for Revenue Ruling 59-221 are still the law today. Under current law for S corporations, the issue is how best to determine "reasonable compensation" for application of the FICA tax.

Implementation Date
N/A

Responsible Official(s)
N/A

Corrective Action Monitoring Plan
N/A

RECOMMENDATION 2
The IRS Commissioner should consult with the Assistant Secretary for Tax Policy regarding whether the detrimental effects of Revenue Ruling 59-221 should be reversed through the issuance of new regulations or through drafting of new legislation, either of which should subject all ordinary operating gains of an S corporation that accrue to a shareholder (including the shareholder's spouse and dependent children) holding more than 50 percent of the stock in the S corporation to employment taxes.

CORRECTIVE ACTION
We do not agree with this recommendation for the reasons stated in our response. New regulations would not affect the fundamental application of employment taxes to S corporations. A recommendation to discuss legislative changes to simply subject to employment tax "all ordinary operating gains of an S corporation that accrue to a shareholder" is not consistent with the principles underlying the employment tax statutes

in connection with the performance of services. Nor does it properly recognize the administrative and taxpayer burdens that this legislation may cause or consider the application of employment taxes to other flow-through entities. However, as stated previously, the IRS will continue its outreach efforts to communicate all employment tax provisions as they pertain to each tax entity. As appropriate, we will work with Treasury in furtherance of legislation that would resolve the issues, in the best interest of tax administration.

Implementation Date
N/A

Responsible Official(s)
N/A

Corrective Action Monitoring Plan
N/A

If you have any questions, please call me at (202) 622-0600 or Steve Burgess, Director Examination, Small Business/Self-Employed Division, at (202) 283-6955.