proposed. "There is no question that these international tax proposals will increase taxes on U.S. multinationals, thereby increasing costs and preventing companies from hiring more workers," he said. "And of course it will add further complexity to an already complex tax code."

Stransky said that if Obama were serious about corporate tax reform, he would first seek to boost U.S. companies' competitiveness by reducing the overall corporate tax rate, which is 5 percentage points higher than that of the country's nearest competitor and 10 points above most of its rivals. "In addition, if the administration really wanted to create jobs, the president would have introduced a repatriation holiday to allow multinationals to bring back to the U.S. at a reduced tax rate some of their estimated $1 trillion in foreign earnings," he said.

Implementing a repatriation tax holiday would generate new revenue for the U.S. government and help create jobs, although permanently lowering the corporate tax rate would have a greater and more lasting effect, Stransky said.

Kenneth J. Kies of the Federal Policy Group said no one would dispute that the tax code puts U.S. multinationals at a disadvantage when competing with foreign companies and that serious reform is needed. "However, these proposals would increase taxes on U.S. multinationals by $112 billion," he said. "It's not surprising none of these proposals have been enacted, even when the Democrats controlled Congress." Kies added, "If you like the fact that U.S. companies are already at a competitive disadvantage, then you'll love these proposals." ■

ECONOMIC ANALYSIS

The Small Business Love-Hate Relationship With Corporate Tax

By Martin A. Sullivan — martysullivan@comcast.net

A small business can easily avoid double tax and retain all-important liability protection either by incorporating under state law and adopting subchapter S status for federal tax purposes or by forming a limited liability company under state law and filing as a partnership. So shouldn't every right-thinking small business owner avoid the double tax on corporate profits?

Apparently not. According to a new study from economists at the Treasury Department, more than 1.6 million small businesses are subchapter C corporations (Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce, and Richard Prisinzano, "Methodology to Identify Small Businesses and Their Owners," Office of Tax Analysis, Technical Paper 4, Aug. 2011, *Doc 2011-17260*, *2011 TNT 154-18*).

Despite the corporate tax's bad reputation, there are good tax reasons for small businesses to subject themselves to double tax under subchapter C. After summarizing the available data on small C corporations, this article calculates the tax benefits of subchapter C status for a typical small business. Graduated corporate rates, the low rate on corporate dividends, and an exemption from payroll taxes combine to make subchapter C the most advantageous choice for a lot of small business profits. If a business owner can afford to leave profits inside the corporation, the resulting deferral of individual tax only makes subchapter C more attractive.

Focus on Small Business

The new study from Treasury economists provides a wealth of data on small business. As you might expect, the bulk of the analysis focuses on passthrough businesses — sole proprietorships, partnerships (including LLCs), and S corporations. But C corporations are very much a part of the small business landscape. According to Treasury calculations, C corporations accounted for 23 percent of small business total receipts.

Table 1 summarizes the Treasury study's findings on C corporations. In 2007 there were 1.86 million subchapter C returns (Form 1120) filed. Of those, the study classified 1.64 million as filed by real businesses. (To be a business for purposes of the study, a corporation had to have at least $5,000 of deductions and other similar minimum measures of business activity.) Of those 1.64 million businesses, 1.56 million were classified as small businesses. (Small businesses had total receipts, or total income, of less than $10 million.) Of those 1.56 million, 864,000 were classified as employers. (Employers had wage and salary deductions in excess of $10,000.)

Table 1. Subchapter C Corporations, 2007	
Category of Subchapter C Corporation	Number of Returns (thousands)
All filers	1,865
Nonbusiness	227
Business	1,638
Small business	1,563
Other	75
Small business (by employer status):	
Employer	864
Non-employer	699
Small business (by total receipts):	
Less than $100,000	442
$100,001-$500,000	535
$500,001-$1 million	220
$1 million-$10 million	366
Source: *Doc 2011-17260*, *2011 TNT 154-18*.	

Graduated Corporate Rates

Why are so many small businesses volunteering to be subject to the corporate tax? Part of the answer is that the first $50,000 of corporate income is taxed at a 15 percent rate and the next $25,000 at a 25 percent rate. The official rate schedule is shown in Table 2.

Table 2. Tax Rates on Corporate Income	
Taxable Income	Tax Rate on That Slice of Income
$0-$50,000	15%
$50,001-$75,000	25%
$75,001-$100,000	34%
$100,001-$335,000	39%
$335,001-$10,000,000	34%
$10,000,001-$15,000,000	35%
$15,000,001-$18,333,333	38%
More than $18,333,333	35%
Source: Internal Revenue Code, section 11.	

Above $75,000 of corporate income, marginal tax rates are in the thirties. But as shown in the figure on p. 1325, the average tax rate (that is, total tax as a percentage of total profit) stays below 25 percent up to about $130,000 in profits and below 30 percent up to about $180,000. It is the expected average tax rate that is relevant when a business owner is deciding between subchapter C or passthrough status.

Table 3 gives us two glimpses of how many small C corporations take advantage of low graduated rates. In Panel A of the table, C corporations are classified by asset size. Corporations with between $1 and $500,000 of assets had $7 billion of taxable income and corporate tax (before credits) of $1.4 billion. Their average tax rate was 19.9 percent. Corporations with between $500,000 and $1 million of assets had an average tax rate of 24.5 percent.

Because it allows us to distinguish between taxpayers and non-taxpayers, Panel B provides a better vantage point on corporate tax paid by small business. In 2007 there were 463,000 C corporations that paid some tax but less than $10,000. These corporations on average had taxable profits of $15,300 and a tax rate of 16.3 percent. There were 45,000 C corporations that paid between $10,000 and $20,000 of corporate tax. These corporations on average had taxable profits of $86,700 and a tax rate of 22.9 percent. So there you have it — a good half-million businesses paying corporate tax at rates in the high teens or the low twenties.

Although the corporate tax rate is low for small profits, it is still a second level of tax. To make subchapter C attractive to small business, there must be individual tax advantages for corporate income vis-à-vis passthrough income. There are two: the 15 percent rate on corporate dividends and the ability to defer individual tax on undistributed corporate earnings.

When considering choice of entity, a business owner must decide whether business earnings will be paid out as compensation or dividends.

When considering choice of entity, a business owner must decide whether business earnings will be paid out as compensation or dividends — and if they are paid out in dividends, if those dividends will be deferred. Then for each type of entity, the owner must calculate the effects of individual tax, payroll tax, and corporate tax. Table 4 does the math on the options for a business owner who has $50,000 of business earnings and has other sources of income that put him in the 35 percent bracket. (The calculations in Figure 4 draw heavily on the excellent article by Richard Winchester, ''Working for Free: It Ought to Be Against the (Tax) Law,'' 76 *Mississippi Law Journal* 227 (2006).)

Sole proprietors and general partners must pay payroll tax on business earnings — and so must limited partners and subchapter S shareholders for

Table 3. Tax Rates on Subchapter C Corporations in 2007

A. Subchapter C Corporations Classified by Asset Size

Asset Size	Returns	Income Subject to Tax (billions)	Tax Before Credits (billions)	Average Receipts (thousands)	Average Income Subject to Tax (thousands)	Average Tax Before Credits (thousands)	Tax Rate (before credits)
Total	1,865,464	$1,248.3	$433.5	$11,788	$669.2	$232.4	34.7%
Zero assets	301,352	$26.3	$8.9	$1,331	$87.2	$29.6	34.0%
With assets:							
$1-$500,000	1,170,738	$8.2	$1.6	$556	$7.0	$1.4	19.9%
$500,000-$1 million	144,642	$4.3	$1.1	$1,782	$29.7	$7.3	24.5%
$1 million-$5 million	172,099	$15.6	$4.7	$4,505	$90.5	$27.5	30.3%
$5 million-$10 million	28,778	$10.0	$3.4	$13,355	$347.8	$116.8	33.6%
$10 million-$25 million	20,168	$16.6	$5.7	$25,122	$825.6	$280.8	34.0%
$25 million-$50 million	8,440	$13.1	$4.5	$45,719	$1,556.8	$532.8	34.2%
$50 million-$100 million	5,897	$16.6	$5.7	$71,489	$2,818.6	$966.9	34.3%
More than $100 million	13,354	$1,137.5	$397.9	$1,363,381	$85,181.4	$29,798.0	35.0%

B. Subchapter C Corporations Classified by Amount of Corporate Tax

Amount of Corporate Tax	Returns	Income Subject to Tax (billions)	Tax Before Credits (billions)	Average Receipts (thousands)	Average Income Subject to Tax (thousands)	Average Tax Before Credits (thousands)	Tax Rate (before credits)
Total	1,865,232	$1,245.9	$432.6	n.a.	$667.9	$231.9	34.7%
No corporate tax	1,250,661	$22.5	$7.3	n.a.	$18.0	$5.9	32.5%
With corporate tax:							
$1-$10,000	463,453	$7.1	$1.2	n.a.	$15.3	$2.5	16.3%
$10,000-$20,000	44,828	$3.9	$0.9	n.a.	$86.7	$19.9	22.9%
$20,000-$75,000	50,190	$7.1	$2.0	n.a.	$140.8	$39.7	28.2%
$75,000-$250,000	28,208	$17.5	$6.0	n.a.	$621.7	$212.6	34.2%
$250,000-$500,000	10,248	$11.9	$4.0	n.a.	$1,156.9	$394.5	34.1%
$500,000-$1 million	6,326	$17.6	$6.0	n.a.	$2,774.9	$951.2	34.3%
$1 million-$10 million	8,682	$80.2	$27.7	n.a.	$9,242.1	$3,191.4	34.5%
More than $10 million	2,636	$1,078.1	$377.5	n.a.	$408,990.7	$143,209.2	35.0%

Source: IRS, Statistics of Income division. Data in Panel A are from the 2007 Corporate Source Book (http://www.irs.gov/taxstats/article/0,,id=165716,00.html) derived by subtracting Table 3 (S corporations) and Table 1 RIC and REIT data from Table 1 (all corporations). Panel B data are from Table 22, "Returns of Active Corporations, Other Than Forms 1120S, 1120-REIT, and 1120-RIC," of the 2007 Complete Corporate Report (http://www.irs.gov/taxstats/bustaxstats/article/0,,id=112834,00.html).

any compensation for services to the business. This adds $7,650 of tax, which is partially offset by the deduction of half that amount at the individual level. It is this extra payroll tax burden that is at the center of so many controversies as to whether LLC and subchapter S earnings are compensation or business profits.

The last three columns of Table 4 show the possibilities for a small C corporation. If a small business owner takes business earnings in the form of salary, he is even worse off than if salary were paid by a passthrough business. There may be no corporate income to take advantage of the deductible half of payroll tax (as assumed in Table 4), or if there are other corporate profits the payroll taxes would be deductible at the 15 percent corporate rate (instead of the 35 percent individual rate).

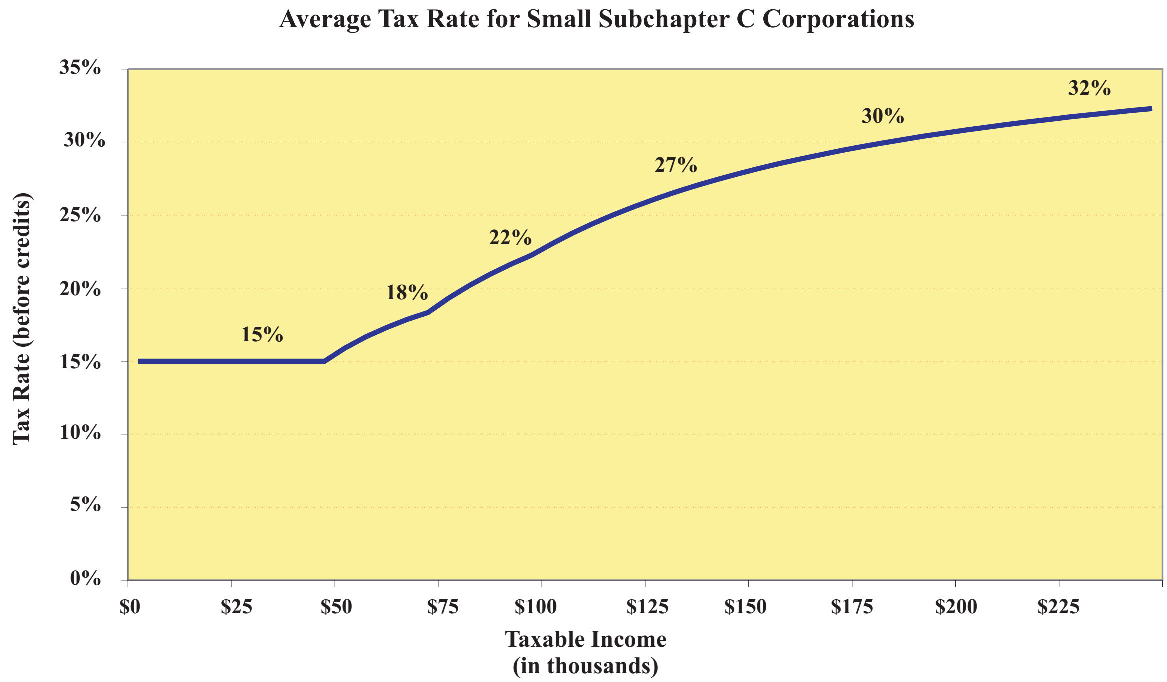
The much more relevant columns are the last two. A small corporation with $50,000 of earnings can pay a 15 percent corporate tax ($7,500) and then distribute after-tax earnings ($42,500) as dividends and pay 15 percent individual tax ($6,375). That's a

(text continues on p. 1325)

Table 4. Total Tax on $50,000 of Small Business Earnings Under Various Scenarios

	Sole Proprietorship	Partnership			Subchapter S Corporation		Subchapter C Corporation		
		General Partner	Limited Partner						
			Salary	Distribution	Salary	Distribution	Salary	Distribution	Retained
Business earnings	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000
Payroll tax at 15.3%	**$7,650**	**$7,650**	**$7,650**	**$0**	**$7,650**	**$0**	**$7,650**	**$0**	**$0**
Corporate tax:									
Rate	0%	0%	0%	0%	0%	0%	15%	15%	15%
Corporate taxable profits	$0	$0	$0	$0	$0	$0	$0[a]	$50,000	$50,000
Corporate tax	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$0**	**$7,500**	**$7,500**
Individual tax:									
Less corporate tax	$0	$0	$0	$0	$0	$0	$7,500	$7,500	$7,500
Deductible payroll tax	$3,825	$3,825	$3,825	$0	$3,825	$0	$0	$0	$0
Individual taxable income	$46,175	$46,175	$46,175	$50,000	$46,175	$50,000	$42,500	$42,500	$42,500
Tax rate	35%	35%	35%	35%	35%	35%	35%	15%	10%[b]
Individual tax	**$16,161**	**$16,161**	**$16,161**	**$17,500**	**$16,161**	**$17,500**	**$14,875**	**$6,375**	**$4,250**
Sum of all taxes	**$23,811**	**$23,811**	**$23,811**	**$17,500**	**$23,811**	**$17,500**	**$30,025**	**$13,875**	**$11,750**
Overall tax rate	48%	48%	48%	35%	48%	35%	60%	28%	24%

[a]Assumes insufficient taxable profits to deduct employer share of payroll tax.
[b]This is an effective rate, assuming earnings are retained for eight years and the discount rate is 5 percent.



Source: Internal Revenue Code, section 11.

total tax of $13,875 for a total tax rate on earnings of 28 percent. That compares favorably with LLC distributions or subchapter S income taxed at 35 percent ($17,500). The annual tax savings of choosing C over S status is $3,625.

But wait, there's more. While many small business owners need cash for living expenses and cannot afford to keep earnings in the business, there are some owners — particularly those in high tax brackets with other sources of income — who can allow the corporation to retain earnings. This deferral of individual tax can be thought of as a reduction in the individual dividend rate, where the size of the rate reduction depends on the length of deferral. For purposes of illustration, the last column assumes an effective dividend rate on deferred distributions of 10 percent (consistent with eight years of deferral, assuming a 5 percent discount rate). Under these assumptions, the total tax burden is $11,750, yielding an overall rate of 24 percent. The subchapter C small business owner pays $5,750 less tax than his subchapter S counterpart.

Under the right conditions, a C corporation can be a nice little tax shelter for a small business. That helps explain why so many small businesses remain C corporations when they have the option of becoming LLCs or S corporations.

Other Considerations for C Corporations

Fringe benefits (C corporation advantage). In general, the tax advantages for employee benefits are more generous for C corporations than for passthrough entities. The most notable of these advantages is the ability to establish a medical reimbursement plan. Since 2003 the insurance premiums of the self-employed have been deductible. But those premiums are subject to the 15.3 percent payroll tax. Out-of-pocket medical expenses are deductible only when they exceed 7.5 percent of adjusted gross income. Section 105 allows a C corporation to set up a medical reimbursement plan in which all medical expenses for employee-owners (and their families) are deductible against both payroll and profit taxes without including those benefits in the employee-owner's taxable income. This option is not available to employee-owners of passthroughs.

Treatment of losses (disadvantage). For businesses with losses, passthrough entities provide the advantage of allowing owners to deduct those losses on their individual returns. Losses of C corporations stay bottled up at the entity level. One provision of the law that reduces this disadvantage for small C corporations is section 1244. A corporation can issue up to $1 million of section 1244 stock. If that stock is sold at a loss, the losses are treated as ordinary business losses instead of tax-disadvantaged capital losses.

Personal service corporation (disadvantage). If a corporation is considered a personal service corporation (PSC), it cannot benefit from the graduated corporate rate structure. It pays a flat 35 percent tax on profits. A PSC is a corporation in which substantially all activities are personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. In addition, 95 percent of the stock is owned by employees, retirees, or their estates or heirs. With a little planning, avoiding PSC status is not difficult. For example, if the spouse of a small business owner owns 6 percent of the stock, and the spouse is not an employee of the business, the corporation is not a PSC.

Accumulated earnings tax (disadvantage). Deferral of small C corporation profits is limited by the accumulated earnings tax. It is an additional tax of 15 percent on accumulated taxable income in excess of $250,000 ($150,000 for PSCs) or in excess of an amount that meets the reasonable needs of the business.

Personal holding company tax (disadvantage). There are limits on the amount of investment income a small business owner can earn inside a C corporation in order to benefit from graduated corporate rates. A personal holding company is a C corporation with five or fewer individuals owning more than 50 percent of the corporation and with 60 percent or more of the profits from passive activities (personal holding company income). Personal holding companies are subject to an additional tax of 15 percent on any undistributed personal holding company income.

Policy Implications

If the top individual tax rates rise above 35 percent, as proposed by President Obama and as scheduled under current law to occur at the end of 2012, the benefits of subchapter C status vis-à-vis passthroughs will increase. On the other hand, if the 15 percent dividend rate increases, the advantage of C corporation status will be cut.

And what about corporate rates? The most talked-about component of tax reform is a reduction of the top corporate rate. Would this entail a commensurate reduction in all rates in the corporate rate schedule (shown in Table 1)? Or, as some have proposed, should the corporate graduated rate structure be eliminated? The latter option is better economics. It would end the sheltering described above and result in more even taxation of business income. But it suffers from the severe political disability of imposing a tax increase on small business to pay for a tax cut on large business.

Finally, even this cursory overview of small business taxation makes clear that small businesses deserve a simpler tax system. The complexity and uncertainty facing small business owners about their tax situation is enough to squeeze the dynamism out of anybody's entrepreneurial spirit. ■

Corporate Tax Reform Alone Isn't Enough, Supercommittee Says

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Members of the Joint Select Committee on Deficit Reduction said September 22 that corporate tax reform alone would not address the inefficiencies of the tax code, while Treasury Secretary Timothy Geithner said the administration has developed a detailed corporate tax reform plan.

Corporate tax reform would leave passthrough entities out of the equation, said House Ways and Means Committee Chair Dave Camp, R-Mich. With an increasing number of passthrough entities filing tax returns as individuals, a declining percentage of businesses pay taxes at the top two corporate rates.

Camp said that more than 47 percent of federal receipts come from individuals, while just 8 percent are from corporations. While revenue from individuals is increasing over time, revenue from businesses remains relatively flat, he said.

Senate Finance Committee Chair Max Baucus, D-Mont., said 50 percent of small business income is taxed at the top two rates but that only 3 percent of small businesses are subject to those rates. Baucus added that about half of that 3 percent are individuals who don't employ others.

The supercommittee is required under the Budget Control Act of 2011 (P.L. 112-25) to report out a plan by November 23 to reduce the deficit by $1.5 trillion over 10 years. President Obama and congressional leaders such as House Speaker John A. Boehner, R-Ohio, have been pushing the group to include comprehensive tax reform in its plan. (For prior coverage, see *Tax Notes*, Sept. 19, 2011, p. 1204.)

Geithner, speaking the same day at a forum hosted by *National Journal*, gave no indication of what is in the plan, but the White House included a tax reform proposal in its job creation and deficit reduction proposal presented to the supercommittee last week. (For related coverage, see p. 1317.)

Geithner said that although it would be impossible to finalize all the details of tax reform in the two months the supercommittee has to do its work, it is "not unrealistic" to set up an outline for reform through a reconciliation structure and leave the details to be worked out later.

Geithner said that along with spending on infrastructure and education, corporate tax reform is a key component to a sustained economic recovery.