Carried Interest for the Common Man

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outraged reactions to FATCA among private parties and government officials seem to be shifting to acquiescence by the FFIs, and at least some government officials view FATCA as an opportunity to strengthen their own offshore enforcement.

Carried Interest for The Common Man

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In this article, Winchester explains how the tax rules permit a self-employed individual to limit the tax on his earnings. He also assesses the merits of a proposal to address the situation.

This article was presented on January 17 at a symposium in Malibu, Calif., sponsored by Pepperdine University School of Law and Tax Analysts. Twenty of the nation’s leading tax academics, practitioners, and journalists gathered to discuss the prospects for tax reform as it is affected by two crises facing Washington: dangerously misaligned spending and tax policies, resulting in a crippling $17.4 trillion national debt; and the IRS’s alleged targeting of conservative political organizations. A video recording of the symposium is available at http://new.livestream.com/pepperdinesol/taxreform.

In recent years, the public has become increasingly aware of the compensation arrangement known as carried interest, which permits private equity fund managers to pay tax at obscenely low rates on obscenely high earnings for their work.\(^1\) The publicity has led Congress to consider no fewer than eight separate pieces of legislation since 2007 to increase the tax on carried interest.\(^2\) Much of the energy behind this movement seems to be grounded in a concern that the current tax system allows the superrich to gain an advantage that is unavailable to anyone else. However, that is not entirely accurate. For years, huge numbers of ordinary self-employed people have been able to limit the tax on their earnings when they conduct their business through a formal business entity instead of

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as sole proprietors. These business structures produce the same objectionable results as a carried interest arrangement.\(^5\) They just happen to be used by the common man.

This article will explain how the tax rules permit a self-employed individual to limit the tax on his earnings. It will also assess the merits of a pending proposal to address the inequities.

A. Taxation of the Self-Employed Individual

There are several legal forms through which a self-employed individual can conduct a business. These include the sole proprietorship, various forms of the partnership, the limited liability company, and the corporation. The individual’s total tax obligation in each case will vary in part by the way the business is classified for tax purposes. Each state law business form has a default tax classification. However, in almost all instances, the business can opt out of its default tax classification. The following section describes the options that are available for each state law business form.

1. Business forms and tax classifications. Any individual who does not conduct his business through a formal business entity is a sole proprietor under state law. A sole proprietorship is disregarded as a separate business entity for federal income tax purposes, and the activities of the business are reflected on the owner’s individual income tax return.\(^4\)

If an individual (or group of individuals) incorporates a business under a state statute, the business is classified as a C corporation for tax purposes by default.\(^5\) As a separate and distinct taxing entity, the company will pay the corporate tax on its profits, while the owners (the shareholders) will pay tax on any after-tax earnings that they receive as a dividend.\(^6\) However, if the business satisfies specific eligibility requirements, it can elect to be an S corporation.\(^7\) In that case, the company would be treated as an extension of its owners and would pay no tax on its profits.\(^8\) Instead, the shareholders would be taxed on their share of those profits, whether they receive any or not.\(^9\)

If a single individual conducts the business through an LLC, the company will be disregarded by default, causing the structure to be treated as a mere extension of its owner, like a sole proprietorship.\(^10\) However, the company can elect to be classified as a C corporation, causing the company and the owner to be treated as separate and distinct taxpaying units and triggering the two layers of tax on business profits.\(^11\) Moreover, the business has the additional option to be classified as an S corporation for tax purposes, assuming it meets the eligibility requirements.\(^12\)

If two or more individuals form an LLC to conduct the business, the company is treated as a partnership by default.\(^13\) Like an S corporation, a partnership is not subject to tax on its business profits. Instead, each partner is taxed on his share of the profits, whether paid out or not.\(^14\) However, the business can elect to be treated as a C corporation for tax purposes.\(^15\) It also has the option to be treated an S corporation, assuming it meets the eligibility requirements.\(^16\)

If two or more individuals conduct a business without forming a corporation or an LLC, they will constitute a partnership under state law.\(^17\) That entity constitutes a partnership for tax purposes.\(^18\) However, the business can elect to be treated as a C corporation.\(^19\) It also has the option to be treated as an S corporation, assuming it is eligible to do so.

Because the tax rules apply in different ways to each tax classification of a business entity, the freedom to opt out of a default tax classification gives the self-employed individual the power to manage and control his tax exposure in ways that a sole proprietor (and any individual who works for someone else) cannot. The next sections describe the full range of taxes that can apply to the income of a self-employed individual under the various business structures available to him.

2. Potential federal taxes on the self-employed. The specific federal income taxes that would apply to the earnings of a self-employed person will depend on the tax classification of the business and a variety of other factors. The following sections

\(^5\)Reg. section 301.7701-3(b)(1)(ii).
\(^6\)Reg. section 301.7701-3(b)(1).
\(^7\)Reg. section 301.7701-3(b)(1)(i).
\(^8\)Reg. section 301.7701-3(b)(1)(i).
\(^9\)Reg. section 301.7701-3(b)(1)(i).
\(^10\)Reg. section 301.7701-3(b)(1)(i).
\(^11\)Reg. section 301.7701-3(b)(1)(i).
\(^12\)Reg. section 301.7701-3(b)(1)(i).
\(^13\)Reg. section 301.7701-3(b)(1)(i).
\(^14\)Reg. section 301.7701-3(b)(1)(i).
\(^15\)Reg. section 301.7701-3(b)(1)(i).
\(^16\)Reg. section 301.7701-3(b)(1)(i).
\(^17\)Revised Uniform Partnership Act, section 202(a) (1997).
\(^18\)Reg. section 301.7701-3(b)(1)(i).
\(^19\)Reg. section 301.7701-3(b)(1)(i).
describe the pertinent features of the various tax rules that might come into play.

a. Personal income tax. The personal income tax is imposed under a schedule of seven marginal rates: 10, 15, 25, 28, 33, 35, and 39.6 percent. The amount of income subject to each marginal rate depends on the individual’s filing status. The items that are subject to tax include earnings from work and earnings from a business. The latter category includes amounts earned as a sole proprietor and business earnings allocated to the individual by a partnership or S corporation. In computing business income, an individual is allowed to deduct half of any self-employment taxes he has to pay. In most cases, corporate dividends are taxed at rates that do not exceed 20 percent.

b. Corporate income tax. The corporate income tax is imposed under a schedule of four marginal rates: 15, 25, 34, and 35 percent. It is imposed on the income derived by any business classified as a C corporation for federal tax purposes. The base of the tax includes all income derived by the business except specific items of exempt income. Deductible expenses will reduce the company’s taxable income. Deductible expenses include reasonable compensation paid to employees and any employment tax that the company has to pay.

c. Medicare surtax on unearned income. Starting in 2013, a self-employed individual is subject to a new Medicare surtax on unearned income. The tax applies only when the individual’s modified adjusted gross income exceeds a specified threshold. For a married couple filing a joint return, the threshold is $250,000; for an unmarried individual, it is $200,000. When the tax applies, it is based on the lower of two amounts. The first is the taxpayer’s net investment income for the year; the second is the portion of the taxpayer’s modified AGI that exceeds the statutory threshold. The term “net investment income” includes corporate dividends. It also includes the taxpayer’s allocation of business income from a partnership or S corporation in those cases in which the taxpayer did not materially participate in the business. The term does not include any income that is subject to an employment tax. As described below, those taxes include a component that substitutes for the Medicare surtax on unearned income.

d. FICA taxes. The tax imposed by the Federal Insurance Contribution Act (FICA) has two components. The first is the Old Age, Survivors, and Disability Insurance component. It is a 12.4 percent levy on amounts that constitute wages from employment. Half of the tax is deducted from the employee’s compensation, while the employer pays the other half. Earmarked to finance Social Security benefits, this component of the FICA tax does not apply to earnings above a so-called contribution and benefit base. That base is adjusted each year and is set at $117,000 for 2014.

The second component of the FICA tax is the hospital insurance component. It is a 2.9 percent levy on an individual’s wages from employment. As with the OASDI component, half of this tax is deducted from the employee’s compensation, while the employer pays the other half. Earmarked to finance the Medicare program, this tax applies to all wages from employment; there is no earnings limit. Also, effective after 2012, married couples who receive wages exceeding $250,000 and unmarried individuals who receive wages exceeding $200,000 must pay a 0.9 percent Medicare surtax on earned income above those respective thresholds, resulting in a total tax of 3.8 percent on those amounts. This surtax is a substitute for the Medicare surtax imposed on unearned income.

A self-employed individual is subject to FICA taxes when he receives wages or other cash compensation from a business conducted through either a C corporation or an S corporation. In both cases, only the payments made to the owner as compensation will be subject to the FICA tax. This will be true even if other amounts derived by the business for the employee-shareholder represent earnings from his labor.

e. Self-employment taxes. The Self-Employment Tax Act (SECA) operates as the FICA counterpart.

21Section 164(f).
22Section 16(b). However, if the recipient has not held the stock for at least 61 days, the dividend is taxed no differently than the other items of ordinary income.
23Section 11(b). The statute imposes an additional surtax that can cause the marginal rate to rise as high as 39 percent at some income levels. ld. (flush language).
24Section 162(a).
25Section 162(a).
26Section 1411(b).
27Section 1411(a)(1).
28Section 1411(c)(1)(A)(i).
29Section 1411(c)(1)(A)(ii) and (c)(2)(A). Special rules apply for a business engaged in trading financial instruments. Section 1411(c)(2)(B).
30Section 1411(c)(6) (expressly excluding income that is subject to the Self-Employment Tax Act (SECA)); section 1402(b)(1) (excluding from the SECA tax base any income subject to FICA).
31Sections 3101(a) and 3111(a).
32Sections 3102(a) and 3111(a).
33Section 3121(a)(1).
34Social Security Administration release on benefit increase for 2014 (Oct. 30, 2013).
35Sections 3101(b)(1) and 3111(b)(6).
36Sections 3101(b)(2).
for a self-employed individual who conducts a business as a sole proprietor or through a business entity that is classified as a partnership for tax purposes. Like the FICA tax, the SECA tax has two components. The first is a 12.4 percent tax earmarked to finance Social Security benefits. The second component is a 2.9 percent hospital insurance tax earmarked to fund Medicare. As of 2013, married couples with more than $250,000 in self-employment income and individuals with more than $200,000 in self-employment income have had to pay an additional 0.9 percent Medicare surtax on their self-employment income above those thresholds. This surtax substitutes for the Medicare surtax on unearned income.

The components of the SECA tax apply to an individual’s “income from self-employment,” a term that excludes any amounts derived by an individual through a C corporation or an S corporation, including wages, dividends, and an individual’s pro rata share of S corporation earnings. For the OASDI component of the tax, the tax base is limited to the same earnings and benefit base that applies for FICA purposes. Moreover, the SECA and FICA statutes are designed so that the OASDI component of the taxes will never apply to more than the contribution and benefit base in effect for any year. The Medicare surtax under FICA and SECA is also coordinated to operate seamlessly.

Importantly, the SECA tax base does not include the distributive share of partnership income for someone who is a limited partner. That individual is subject to SECA tax only on the guaranteed payments he receives for performing services for the partnership. The statute does not define the term “limited partner.” When Congress adopted the exclusion in 1977, the term referred to individuals who, under state law, could not take an active role in the business if they wished to preserve their limited liability. Thus, the term was a suitable proxy for a passive investor. Over time, however, limited partners have been allowed to actively participate in the business. Further, the LLC, which did not exist before 1997 and is treated as a partnership for tax purposes, does not use the term “limited partner” to identify any of its members. Moreover, all members of an LLC can both actively participate in the business and enjoy the benefits of limited liability.

Recognizing the need to clarify the meaning of the term “limited partner,” Treasury proposed regulations in 1997 that used a functional test to measure an individual’s participation in the business. Under those regulations, an individual is presumed to be a limited partner unless he (1) has unlimited personal liability for partnership debts, (2) has authority to contract for the partnership, or (3) participated in the partnership’s business for more than 500 hours during the year. However, the regulations would deny the limited partner exclusion to any partner in some service partnerships. Treasury never finalized those regulations because Congress stepped in and imposed a one-year moratorium on the rulemaking process for them.

Even though the moratorium is no longer in place, Treasury has done nothing to restart the rulemaking process, and the status of the proposed regulations remains far from clear. On one hand, a nonbinding resolution passed in conjunction with the moratorium expresses the view that the agency “exceeded its regulatory authority” and that only Congress “should determine the tax law governing self-employment income for limited partners.” Yet, some experts refer to the proposed regulations as the “most definitive guidance available.” Indeed, the IRS itself treats any proposed regulations as substantial authority that can be relied on to avoid accuracy-related penalties. Whatever value the regulations may have had was cast in doubt in 2013 when the Tax Court had to determine the scope of the limited partner exclusion. The court found that it had to interpret the term “limited

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36Section 1401(b).
37Section 1401(b)(2)(A).
38Section 1401(a) and (b).
39See Social Security Administration release, supra note 33.
40By operating in this way, the rules ensure that anyone whose income includes both wages from employment and income from self-employment will never be at a disadvantage to someone who does not have income from both sources.
41Section 1401(b)(2)(B).
42Section 1401(a)(13).
43Id.
44See Revised Uniform Limited Partnership Act, section 303 (1976).
partner” because the IRS never finalized any regulations defining the scope of the term. Moreover, instead of relying on state law labels, the court’s analysis took into account the partner’s level of participation in the business. There is simply no clear way to determine whether an individual qualifies as a limited partner for SECA purposes.

f. Unemployment tax. The Federal Unemployment Tax Act (FUTA) requires an employer to pay a 6 percent excise tax on up to $7,000 of wages paid during the year to any employee. The term “employee” refers to the same individuals who are subject to the FICA tax. Further, the amounts subject to the FUTA tax (that is, the employee’s wages) are identical to the amounts subject to the FICA tax. In other words, the FUTA tax applies to amounts received by an individual as wages from a C corporation or an S corporation. As with FICA, the individual’s share of any other profits of the business will not be subject to the FUTA tax even if those amounts could be considered the product of the employee-owner’s labor.

B. A Carried Interest by Another Name

If a self-employed individual conducts his business as a sole proprietor, he will be subject to the personal income tax on all the earnings from the business, other than some items of passive income. Also, he will be subject to all components of the SECA tax, including the Medicare surtax in the event his income exceeds the statutory threshold. There is no way a sole proprietor can limit or control that liability. Using this as a baseline, the following sections describe how a self-employed individual can limit his tax liability when he operates through a business entity. Exhibit I summarizes this analysis in tabular form.

1. C corporations. The results for a C corporation depend on whether the individual chooses to withdraw any earnings from the business and, if so, whether the payment takes the form of a dividend or wages.

If the business pays its earnings out in the form of wages, the tax picture is not very appealing. As an initial matter, there would be no corporate income tax because the salary expense would offset the company’s income, leaving nothing to be taxed. However, the earnings would be subject to taxes that could exceed those that would apply to a sole proprietor. There would be the personal income tax and the FICA tax that would substitute for the sole proprietor’s SECA tax. The FUTA tax would also be in play.

It is possible to access the earnings at a low tax cost in some cases if the corporation pays them out as a dividend. That would eliminate the FICA tax and any potential FUTA tax. However, the earnings would be subject to the corporate income tax and the tax on dividends at rates up to 20 percent. The Medicare surtax would still be an issue for individuals whose incomes exceed the statutory threshold. The corporation’s tax bracket and the individual’s tax bracket will determine the extent to which this technique produces any tax savings.

Significant tax savings could also be achieved if the corporation simply retains all the earnings and pays nothing to the employee-owner. In that instance, the business’s earnings will be subject solely to the corporate income tax at rates ranging from 15 to 39 percent. None of the other taxes described above would apply. This could offer the greatest savings in cases in which the corporation is in a low tax bracket and the individual is in a high tax bracket. But the employee-owner would not have access to the earnings.

The two techniques for minimizing tax (retaining earnings and substituting dividends for wages) produce the greatest tax savings when the corporation is in a low tax bracket and the individual is in a high tax bracket. There is compelling evidence that almost all corporations are in the lowest corporate tax bracket (15 percent) and that almost all closely held corporations are owned by high-income individuals.

A corporation is taxed at 15 percent when its taxable income does not exceed $50,000. There are no definitive statistics on the prevalence of corporations with net incomes at or below that level. However, the number appears to be quite high based on the available evidence. The IRS conducts an annual survey of corporate income, which classifies a corporation by the size of its assets. According to data from the latest survey, most C corporations have both low assets and low incomes. Sixty percent of active corporations (other than S corporations) had no more than $500,000 in total assets and had an average net income just under $19,000. An additional 10 percent of active corporations had assets between $500,000 and $1 million.

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53Sections 3301 and 3306(b)(1).
54Section 3306(i).
55Rev. Rul. 73-361, 1973-2 C.B. 331. Both FICA and FUTA generally define wages to be “all remuneration for employment.” See sections 3121(a) and 3306(b) (defining the term “wages”).
56Section 11(b)(1)(A).
57IRS Publication 16, Statistics of Income, 2010 — Corporation Income Tax Returns, Table 13, at 123.
and average net income of just under $55,600. That amount is just $5,600 over the threshold at which all of a corporation’s income is taxed at 15 percent. Clearly, it would be more desirable to know what the median income is, not the average. However, even if you discount the figures to account for this, you are still left with an enormous number of corporations that represent real opportunities for tax avoidance. The incentive to use tax minimization techniques is greatest when a low-income corporation is owned by someone in a high tax bracket. There is no definitive evidence showing how frequently high-income individuals own low-income corporations. However, an IRS survey of personal wealth shows that the ownership of non-publicly traded corporations is extremely concentrated in the hands of the very wealthy.

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58Id.

59Individuals whose personal net worth exceeded $3.5 million account for 36.3 percent of wealthy individuals, but they owned 87.5 percent of the value of all stock in non-publicly-traded corporations owned by wealthy individuals. Individuals whose personal net worth exceeded $10 million accounted for roughly 8 percent of all wealthy individuals, but they owned 64.8 percent of all stock in non-publicly-traded corporations.
When a self-employed individual seeks to minimize tax by using a corporation either to retain earnings or to pay out the earnings as a dividend, the technique requires the corporation to understate the individual’s wages. Two government economists have estimated the strength of the incentive for a closely held corporation to do precisely that.60 Using data from 2000 to 2004, the economists estimated that there was a 100 percent incentive to understate wages when the company sustained a loss. When the corporation was in the 15 percent tax bracket, the incentive ranged from 26 to 32 percent during the three years preceding the tax cut on corporate dividends. It jumped to 37 percent for the first two years of the tax cut.61 The economists found no identifiable incentive to understate wages above the 15 percent corporate tax bracket. Thus, there appears to be valid reason to believe that self-employed individuals are frequently taking advantage of the opportunity to use a C corporation to avoid tax in ways that the sole proprietor cannot. These practices will become only more popular if lawmakers reach their stated goal of reducing the corporate income tax.62

Even when it does pay compensation to an employee-shareholder, a C corporation can be used to limit the tax on the earnings of a self-employed individual if the payment is timed with care. Because compensation in excess of the FICA contribution and benefit base is exempt from the OASDI component of the tax, employment taxes can be saved by compressing multiple years’ worth of compensation into a single year. Thus, if the owner received $180,000 in compensation in 2014, only $117,000 would be subject to the 12.4 percent OASDI tax. The rest would be exempt from that tax, even though it may relate to services performed during a year in which the corporation did not pay the owner a salary.

An LLC that is classified as a C corporation offers additional tax planning opportunities. Because shares in a state law corporation belong to designated classes, all owners of shares in a given class must share in any distribution paid to one class member; the corporation cannot single out an individual shareholder to receive a dividend. No such restriction applies to an LLC. This frees the company to single out one of its members to compensate in the form of a dividend.

2. S corporations. The results for an S corporation will depend on whether the company pays the employee-owner for his work and whether that individual materially participates in the business. The earnings will be subject to the personal income tax in all cases. The only questions are whether the FICA and FUTA taxes will apply and whether the Medicare surtax on unearned income will come into play.

An S corporation will be no better than a sole proprietorship if the business pays the employee-owner for his work. In that instance, the salary will offset the business’s earnings and leave it with no taxable income to be allocated to the owner as a pro rata share. Instead, the wages will be taxed to the owner at his marginal rates. Further, the entire FICA tax will apply, including the Medicare surtax in the event the owner’s income exceeds the statutory threshold. This would produce a tax bill that is identical to the one faced by a sole proprietor. The tax bill will be higher if FUTA taxes must be paid on the wages.

The taxes on the earnings could be substantially reduced if the business did not pay the employee-owner for his work. The earnings would still be subject to the personal income tax because they would appear on the employee-owner’s tax return as a pro rata share. However, there would be no liability for the FICA or FUTA taxes. Moreover, even the Medicare surtax would not apply if the work performed by the employee-owner constituted material participation in the business. That is very likely when the employee-owner is merely a self-employed individual operating through the corporate form.

The S corporation represents a very real threat to the tax base. There is overwhelming evidence that S corporations grossly underpay employee-owners with alarming frequency. Fifty-six percent of S corporations had one shareholder in 2006, while another 28 percent had two shareholders.63 These closely held companies routinely pay nothing to their officers in the form of compensation. For single-shareholder S corporations, the rate was 58 percent in 2005, while the rate was 29 percent when the corporation had two shareholders.64 A separate


61This seems to validate the concern that the Bush-era dividend tax cut made it financially attractive for many closely held corporations to substitute a dividend for wages to an employee-shareholder. See Richard Winchester, “Working for Free: It Ought to Be Against the (Tax) Law,” 76 Miss. L.J. 227 (2006).


63National Taxpayer Advocate, “2007 Annual Report to Congress,” vol. 1 at 313, chart 1.20.7.

64Id. at 314, chart 1.20.8.
study from 2000 revealed a similar pattern. In that year, 78.9 percent of all S corporations were either fully owned by a single shareholder (69.5 percent) or majority-owned by one shareholder (9.5 percent). Moreover, when the corporation had only one owner, the average salary paid out to him or her equaled only 41.5 percent of company profits. These statistics make it easy to see how a single-shareholder S corporation has been used to achieve the same kind of tax benefits that a carried interest arrangement can.

3. Partnerships. The results for a partnership are a bit complex. They depend primarily on whether the individual qualifies as a limited partner. If so, the tax on the earnings derived by the business will depend on whether the limited partner is paid for his work. The outcome is also affected by whether the partner materially participates in the business.

A partnership structure will be most analogous to a sole proprietorship when the partner is a general partner who receives no wages. In that instance, the business’s earnings will be subject to the personal income tax because they will be allocated to the partner as a distributive share, which is also subject to each component of the SECA tax. The Medicare surtax on investment income would be irrelevant, as it would be for a sole proprietor.

The results do not materially change if the general partner receives wages for his work. The payment would effectively eliminate the business’s taxable income, leaving nothing to be taxed to the partners as distributive shares under the personal income tax. However, both the personal income tax and the SECA taxes would apply to the amounts paid out as wages. The Medicare surtax on investment income would continue to be irrelevant.

The analysis is no different for a limited partner whose share of the earnings is paid out as wages. Those wages would be subject to both the personal income tax and the full range of SECA taxes, but not the Medicare surtax on unearned income.

The tax on the business’s earnings will decline (compared with a sole proprietorship) when the partner is a limited partner who receives no wages. In that case, the personal income tax will apply to the individual’s share of the earnings, but SECA will not. The Medicare surtax on investment income will come into play if the partner does not materially participate in the business. Otherwise, it will be irrelevant. Although this arrangement offers tax savings, one must contend with the fact that the rules for distinguishing general partners from limited partners are far from clear. This is particularly true for LLC members. The absence of a clear rule has been an invitation for some to take positions that minimize their tax liability. This kind of flexibility is simply unavailable to a sole proprietor.

C. Improving on an Overdue Proposal

Lawmakers ought to be concerned if the law allows private equity fund managers to pay tax at rates that are lower than those that apply to anyone else for their labor. At the very least, the situation calls into question the tax system’s ability to produce equitable results. However, outcomes that are just as offensive frequently occur when self-employed individuals conduct business through a business entity. Yet, Congress does not seem very concerned.

Congress has known since at least 1997 that the rules for applying SECA to partnerships and LLCs needed to be updated. However, instead of addressing the defects, Congress did just the opposite and directed the IRS not to do so. Moreover, the few measures considered by Congress have been very narrowly tailored, focusing on shutting down the S corporation employment tax dodge. There has been no legislative attempt to clarify the definition of a limited partner or address the potential abuses available through a C corporation. All these problems could be solved if the employment tax rules defined the tax base consistently across all business forms.

In 2005 the Joint Committee on Taxation proposed a uniform rule for defining the employment tax base of most self-employed individuals. Under the JCT proposal, any owner of an entity taxed as a partnership or S corporation would be subject to SECA tax on the entire portion of business profits.
allocated to him. The tax would also apply to any compensation paid to that person for the performance of services. However, if the individual did not materially participate in the business, only the amounts paid as compensation would be subject to SECA. Some items of passive income would be exempt from the tax, but all the earnings derived from a service business would be subject to tax, including passive items.69

The JCT proposal is a substantial step in the right direction. It uses a sensible, uniform rule to define the tax base. It eliminates the ambiguities that now surround the taxation of LLC members and partners in partnerships. It eliminates the opportunity for an S corporation shareholder to simultaneously avoid the Medicare surtax on earned and unearned income. And it virtually eliminates the disparities between the taxation of sole proprietors and the taxation of self-employed individuals who operate through a business form other than a C corporation. However, the JCT proposal would offer a truly comprehensive and complete solution if the measure also applied to self-employed individuals who operate through a C corporation.

The rationale for limiting the scope of the JCT proposal is that it treats all flow-through entities the same for employment tax purposes. However, it seems clear that individuals have an equally troubling opportunity to dodge the employment tax when they use a C corporation to operate a business. In the early years of the income tax, individuals used the C corporation to dodge the personal income tax on investment income. Congress responded by adopting the personal holding company rules to eliminate the tax avoidance behavior that is possible when ownership of the business is sufficiently concentrated. The personal holding company rules come into play when five or fewer individuals own over half the corporation’s value during the second half of the year.70 Today, the dividend tax cut has opened the door for individuals to use a C corporation to dodge the employment tax when they work for a corporation that they also own and control. The legislative response should mirror the one adopted to address the use of a C corporation to dodge the personal income tax on investment income.

Congress should enact the JCT proposal and improve on it by requiring the measure to apply whenever the ownership of a corporation is concentrated as measured by the same “five or fewer” standard that triggers the personal holding company rules.71 In those cases, SECA taxes should apply to the shareholder’s share of the corporation’s taxable income and to any amounts paid to the owner as compensation for services. However, if the shareholder does not materially participate in the business, only amounts paid as compensation should be subject to SECA tax.

In its current form, the JCT proposal is expected to increase revenues by $129 billion over 10 years.72 If it is extended to cover closely held corporations, that figure could reach the $160 billion range.73 By comparison, only $17.4 billion of additional revenues is expected to be raised by taxing income from a carried interest as ordinary income.74 From a revenue standpoint alone, employment tax reform merits congressional attention.

Private equity fund managers may be easy to demonize. But if Congress is really interested in ensuring that everyone plays by the same set of rules, it should fix the defects in the employment tax system that are creating widespread disparities in the way self-employed individuals are taxed. The JCT proposal is a solid start. But it is incomplete and should be expanded to cover self-employed individuals who work for a corporation that they also own and control.

70Section 542(a)(2).