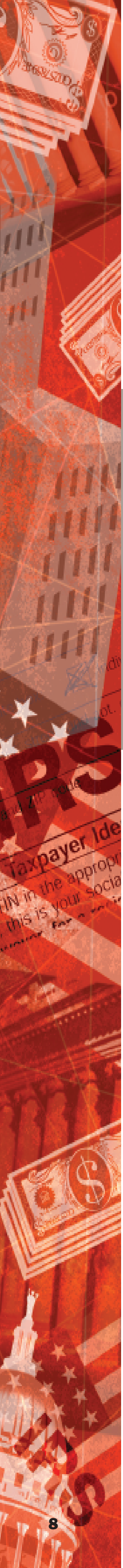

By Leonard G. Weld
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What Do You Mean They Don't Pay Taxes?

As the U.S. government looks at different strategies to reform corporate income tax, pass-through entities—which include various partnerships, S corporations, limited liability companies, and publicly traded partnerships—could face close scrutiny. Many of these entities don't pay income tax, with the gains or losses being passed on directly to the owners.

In a January 10, 2012, *Wall Street Journal* article titled "More Firms Enjoy Tax-Free Status," John McKinnon wrote about the rise in tax-free entities between 1986 and 2008 (the latest tax-year information released by the IRS). According to IRS statistics cited by McKinnon, the percentage of business entities that didn't pay taxes grew from 24% in 1986 to 69% in 2008. (These statistics don't include churches or other charitable organizations that pay no taxes because of IRC §501(c).)

These percentages could soon change. An unnamed Treasury official has been quoted as saying, "The Obama administration is interested in a plan that would tax pass-through entities with [annual] revenues of $50 million or more as corporations." White House spokeswoman Amy Brundage said the process is still unfolding and "no decisions have been made about the content of any specific reform proposal or the timing…" At the moment, the idea appears to involve reducing the federal corporate tax rate offset with a broadening of the tax base by taxing large pass-through entities. According to Chuck Marr at the Center for Budget and Policy Priorities, "The Administration proposes that consideration be given to establishing greater parity between the tax treatment of corporations and that of pass-through entities, in order to 'help improve equity, reduce distortions in how businesses organize themselves, and finance lower tax rates.'"

Here's a look at some of the different types of entities that don't pay taxes directly. If the government continues with its current thinking on corporate tax changes, these tax-free entities could be likely targets for reform.

Partnerships

Partnerships can be formed with slight variations. A general partnership involves two or more owners that share equal rights and responsibilities for management of a business, and any individual partner can bind the entire partnership to a legal obligation. Each individual partner assumes full responsibility for all of the business debts and obligations.

In a limited partnership (LP), the personal liability of each individual partner is restricted to the amount of his or her investment—but there must be at least one general partner who has full personal liability for the business debts and obligations. This general partner retains the right to control the business, while the limited partners don't participate in management decisions.

A partnership pays no taxes on the income it earns. A partnership files Form 1065, U.S. Return of Partnership Income, which discloses the business revenues, expenses, and net income from operations. Some items, called separately stated items, aren't used in the calculation of partnership income. They instead pass through to the partners directly. Common separately stated items include charitable contributions and capital gains or losses of the partnership. Operating income of the partnership is allocated to the partners, who pay tax on their own share of income and use their share of charitable contributions and capital gains or losses. Because the net income passes through the partnership untaxed, a partnership is known as a "pass-through" entity. Losses can also pass through to owners, and they can be used to offset wage or investment income.

S Corporation

An S corporation is a corporation that chooses to be taxed under the rules of Subchapter S of Chapter 1 of the Internal Revenue Code. These rules allow an S corporation to be taxed as a pass-through entity, like a partnership. The corporation calculates its taxable income, passes the income through to the shareholders, and the shareholders pay tax on the income. The S corporation files a Form 1120 S information tax return. An S corporation has the same rules as a partnership for separately stated items such as charitable contributions and capital gains or losses.

Like all corporations, an S corporation must have shareholder meetings, elect officers, and have a board of directors. The shareholders have limited liability and can't lose their personal assets even if the corporation can't pay its debts.

The S-corporation election was written into law in 1958 in order to make it easier to form small businesses. To limit S corporations to small start-up corporations, the legislation allowed only one class of stock, required the company to be a domestic corporation, and limited the number of stockholders to 35. The current limit is 100 shareholders. There are also restrictions as to who may own S corporation stock. Corporations, S corporations, and Limited Liability Companies aren't eligible to own S corporation stock. This prevents the easy avoidance of the shareholder limit.

In a normal corporation, losses stay within the corporation and don't benefit the shareholders. With an S corporation, just as in a partnership, the losses pass through to the shareholders and can offset their other income.

Limited Liability Company

Limited Liability Companies (LLCs) first appeared in the late 1970s. The IRS treats LLCs as partnerships for federal tax purposes. Therefore, an LLC is also a pass-through entity. If it has just one member, it can be taxed as a sole proprietorship. LLCs must be registered in a state, and different states have similar, but sometimes distinct, laws. An LLC is usually taxed at the state level.

Unlike corporations, LLCs have members instead of shareholders. A member's ownership is specified in the ownership agreement. Moreover, a corporation has an unlimited life whereas an LLC terminates at the death or bankruptcy of a member.

Publicly Traded Partnerships

Some partnerships began trading ownership interests on securities markets. The ability to raise capital and have easily traded ownership rights makes these partnerships seem like corporations. Consequently, in 1987 Congress legislated that all publicly traded partnerships (PTPs) will be taxed as corporations. IRC §7704 defines a PTP as any partnership if its ownership interests are traded on an established securities market or are readily tradable on a secondary market.

Yet Congress provided a significant exception to application of the corporate tax rules. If a PTP has 90% or more of the gross income in a taxable year classified as "qualifying income," the corporate tax rules don't apply and the PTP remains a pass-through entity for that year. Qualifying income includes interest, dividends, real property rents, and gains from the sale or other disposition of real property. In addition, qualifying income also includes income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or storage of any fuel.

Given this exception, it's no surprise that most PTPs are found in the mining, finance, real estate, and energy industries. Two of the largest private equity firms—Blackstone Group, LP and KKR & Co., LP (formerly Kohlberg Kravis Roberts)—became PTPs in 2011. One of the largest energy transportation companies, Kinder Morgan Energy Partners LP, has a market capitalization of more than $20 billion and an effective tax rate for 2011 of 3.48%, according to the S&P Stock Report.

A quick example illustrates why PTP classification is so helpful. If a corporation has $200 in pre-tax income, it pays the corporate tax rate of 35%, which leaves $130 ($200 – $70 tax) to be distributed as a dividend. The individual shareholder who receives the dividend pays tax at the special rate for qualifying dividends of 15%. That leaves a net of $110.50 ($130 – $19.50 tax) from the original $200 of income.

If a PTP passes through $200 of untaxed earnings, the only tax is at the owner level. Since these earnings weren't taxed at the PTP level, the earnings may be taxed at a rate as high as 35%, which is currently the highest marginal tax rate for individuals. That leaves a net of $130 ($200 – $70) from the $200 of income.

Potential Tax Revenue

Congress has provided pass-through treatment to partnerships and S corporations. Even PTPs have an exception that allows them to raise capital via securities markets and still maintain their pass-through status. It's hardly a surprise that when something is "tax free," you get more of it. Based on IRS figures, approximately 69% of business entities are pass-through entities, which means they are taxed at the owner level and the entity is "tax free." One easy way for Congress to raise additional revenue is to impose a modest tax on pass-through entities or to remove the "qualifying income" exception for PTPs. **SF**

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