The Internal Revenue Code:

Unequal Treatment Between Large and Small Firms

A Study By:
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Executive Summary

In this report, the Prosperity Institute explores America's tax regime [the Internal Revenue Code (Code)] with the object of examining which of its provisions directly and unfairly disadvantage small firms — or their owners — compared with large firms. The purpose of this report is to identify sections of the Code which discriminate against small businesses and to propose revisions that would establish true parity between small businesses and their larger counterparts.

The report finds that the Code is replete with provisions that either expressly discriminate (*de jure discrimination*) or have the economic effect of discriminating (*de facto discrimination*) against small firms in both intended and unintended ways.

This discrimination is of several basic origins:

1. Distributional, "nondiscrimination" rules for employee benefit plans.
2. The favoring of the corporate form of entity.
3. Tax treatment of certain "fringe benefits."
4. Tax preferences for programs that require large fixed costs.
5. Accounting rules.
6. Compliance costs.

I. Distribution of Employee Benefits

Of the above categories, the most egregious problems likely lay in the nondiscrimination rules governing the distribution of various employee benefit plans. First, the Code imposes several layers of requirements intended, ironically, to ensure tax-leveraged employee benefits are equitably distributed. A common problem is that these rules are so complex in practice that small firms face considerably higher compliance costs per employee than large firms face when seeking to exploit these benefits. Such costs are generally fixed; larger firms enjoy greater economies of scale than small firms; and, larger firms have an easier time passing these costs along to consumers.

Second, these distributional rules present a gauntlet so treacherous that small employers who wish to offer tax-leveraged plans expose themselves to considerable legal and financial risks.

Third, the nondiscrimination rules make the benefits of such plans worth less to the owners of a small company since the provisions sometimes prevent owners or top managers from enjoying the benefits they are being encouraged to extend to others.

These distribution rules have a minimal impact on large firms, but a major impact on small firms. Collectively, they frustrate tax policy objectives by

discouraging promotion of employer-sponsored plans. Instead of equitably distributing tax benefits, these rules have foster inequities between the treatment of small employers and employees and that of large firm employers and employees.

There are many examples of the types of tax-leveraged plans affected by these requirements. The ones cited in this report include:

- Qualified pension, profit-sharing and stock bonus plans.
- Group life insurance plans.
- Exclusions for amounts received under health plans and self-insured health plans.
- "Cafeteria plans" (also referred to as a "flexible benefit plans" where employees may choose their own "menu" of benefits).
- Educational assistance programs.
- Employee stock options.
- Dependent Care Assistance Programs.
- Adoption Assistance Programs.
- Employee achievement awards.
- Stock redemptions in family businesses.

To take a specific example of the dysfunctional operation of these requirements, if an employer were to sponsor a group life insurance plan, at least 85 percent of plan participants must be other than "key employees" within the meaning of Code § 416(i)(1)(A). Code § 79 – which authorizes this tax-leveraged benefit – could more bluntly have stated that "small firms are highly discouraged from providing life insurance to their employees until they have at least 10 employees." Should there be any doubt as to why an employee of a small firm is far less likely to be offered an employer-sponsored life insurance?

Laws that disproportionately injure small firms in an attempt to enforce equitable distribution of benefits rest on a dubious foundation. Denying small business owners the ability to participate in benefit schemes or increasing their cost to do so does not encourage the extension of such benefits to workers. Small firm employers denied the advantages of participating in tax leveraged benefits are probably earning less than executives with similar managerial responsibilities (and power to influence business decision-making) in larger firms who can take full advantage of the tax-leveraged benefits. The real losers are the employees of small firms who are much less likely to be provided benefits because of laws ostensibly meant to protect them.

The very idea that a small firm manager could take advantage of the tax benefits more than an employee has made it easier for policymakers to deny small firms the ability to enjoy particular fringe benefits. By discouraging small firm participation, the tax expenditure costs of these special tax breaks are more easily

managed. Concern over intracompany inequity has eclipsed the view that the efforts to ameliorate that effect often create a greater inequity.

II. Preference for Corporate Entity

Discrimination also results from provisions that favor the corporate form of entity – the most common choice of entity form for large firms and the least common choice for small firms. Some provisions single out sole-proprietorships (the self-employed) for the most unfavorable treatment. For example, the Treasury has imposed a sort of "souped-up" payroll tax regime on the self-employed by eliminating any distinction between payroll and earnings from capital and entrepreneurial risk for the owners and operators of these firms. Whether or not a taxpayer should be subjected to Self-Employment Contribution Act taxes (SECA taxes) on their net earnings from self-employment should depend upon whether or not the taxpayer's remuneration was in nature of compensation for services or investment returns from a capital asset.[1] Congress has also singled out sole-proprietorships for limiting deductibility of health insurance costs. Only in the year 2003 and thereafter will all such costs be deductible. Corporations also enjoy a larger deduction for charitable contributions of inventory property.

III. Tax Treatment of Fringe Benefits

Third, discrimination results from the treatment of certain "not-so-fringe" fringe benefits. These benefits can provide considerable advantage to a firm and its employees since they essentially permit deductions to the firm and exclusions from the taxable compensation of the employee. The eligibility rules favor large firms.

IV. Tax Preferences that Require Large Fix Costs

Fourth, there are provisions that benefit firms large enough to justify the capital outlays to which they relate. For instance, if a small employer were to pick up an employee's lunch tab every day of the year, that amount would be taxable to the employee as compensation. However, employees are entitled to exclude an amount that equals the value of the meal when eaten at an employer's cafeteria. Only the value of meals eaten at the company store so-to-speak, instead of across the street at the restaurant owned by the small entrepreneur, is excludible.

The same preferences are available for on-site athletic facilities, and the principle applies to a broad range of business operations.

[1] Congress has drawn this distinction in the case of C and S corporations, limited partnerships, limited liability companies, and limited liability partnerships – every other form of entity – besides sole-proprietorships and general partnerships. An owner of an S Corporation, for example, can distinguish between her salary and dividends since the company's earnings potential depends more on simply the value of the labor she provides.

V. Accounting Preferences

Fifth, there are certain accounting advantages larger firms enjoy, most notably the ability to select a tax year other than your partners. There also enjoy more lenient requirements for extending filing deadlines.

VI. Compliance Costs

Finally, no discussion of the disparity of treatment would be complete without noting the disproportionate burden of the costs of compliance. Small firms pay significantly higher overall compliance costs per employee than large firms.

Throughout the report, we recommend actions to remedy the specific cases of discrimination. We believe that steps should be taken now to eliminate existing disparities. Only in this way can the Code be made more equitable, can economic distortions that hurt free market competition be eliminated, can workers in small and large firms be treated fairly, and can the policies originally underlying enactment of the tax benefits be fulfilled.

In addition to these specific changes, we also propose a more systemic solution that would ensure potential problems are acknowledged and confronted before they become law. We recommend that the Joint Committee on Taxation staff prepare as part of their analysis of proposed tax legislation an equity assessment. In undertaking such an assessment, the staff could – in addition to providing a revenue estimate and a description of the legislation – show the distribution of the tax expenditure by employee by size of firm and certify whether the proposal would have a differential impact on small firms.

Whether it is the Joint Committee on Taxation staff, the Congressional Research Service, the General Accounting Office or the Office of Tax Analysis at the U.S. Department of Treasury, some organization should be tasked with periodically reviewing existing provisions to determine their use by size of firm. Furthermore, these entities could assist policymakers in examining proposed tax changes to ensure small firms can utilize the tax expenditures to the same degree as large firms. Each new change legislated into the Code, should be carefully scrutinized to ensure these inequities are not perpetuated.

About the Researchers

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For six years ending in 1990, Mr. Burton served as Manager of the Tax Policy Center for the U.S. Chamber of Commerce, where he led businesses in campaigns to reform tax laws. For example, he was one of the principal small business lobbyists involved in passage of the Taxpayer Bill of Rights. In 1986, he was integrally involved in urging reform of the entire tax structure; and most recently was instrumental in authoring H.R. 2525, the FairTax national sales tax plan. Mr. Burton has also testified before Congress, regularly appears on television and radio programs and has written on tax policy matters in publications, from the Wall Street Journal to the Washington Times. While at the Chamber, Mr. Burton edited the Journal of Economic Growth, which promoted market-based solutions to the variegated problems of development in the Third World, including privatization. Mr. Burton was also Vice President, Finance and General Counsel for New England Machinery, Inc., a Bradenton, Florida-based multinational manufacturer of packaging equipment and testing.

Foreword

At the dawning of the 20th century, U.S. federal taxes accounted for just 3 percent of the Nation's gross domestic product (GDP). The entire set of tax statutes and supporting regulations filled a few hundred pages. The entire tax return of President Theodore Roosevelt was two pages long.

This was soon to change.

As a number of prescient Members of Congress had forewarned in 1913 during debate over passage of the first income tax, the income tax was but a seed planted in fertile soil.

In the ensuing years, the fledgling income tax was nurtured by a productive partnership between tax-writers and lobbyists. Together they jointly defined what taxable income is, and what would qualify for deductions, expensing, credit or deferral. The tax policymaking process emerged as the cherished legislative tool for granting economic favors – far more popular than the more direct, visible, and accountable method of allocating specific taxpayer benefits through appropriations. Through the annual accretion of new tax bills – bills to raise revenue, bills to cut taxes, simplification bills, base broadening bills, stimulus bills, and bills for fairness sake – the American tax system grew into the dense, intertwined thicket of laws known as the Internal Revenue Code ("Code" or "IRC").

If one were to review the policy papers, the legislative iterations, the floor statements, and the public and private debates, one would find that most provisions in the Code had compelling justification at the time they were enacted. Many tax sections were hailed as a victories by their sponsors, and in the abstract had value, if merely political value. However, over the years, layer-upon-layer of tax laws was added. Once planted in the Code, tax breaks proved resilient as new constituencies developed new arguments for their perpetuation and enlargement.

Today federal taxes account for 21 percent of the GDP, and the federal tax rules span 45,662 pages.[2] The regulations consist of interminable sentences of very small type that, when strung together, occupy five volumes of translucently thin paper. The growth in words alone has been exponential. Since the mid-1980s alone there have been 7,000 federal tax code changes and a 74 percent increase in the pages of tax rules, not to mention Revenue Rulings, IR Memoranda, Private Letter Rulings, IR News Releases, Revenue Procedures, and the many other forms of pronouncements to supplement the Code sections and regulations. The IRS now employs more than 100,000 personnel, and Americans spend more than $200 billion complying with the law. Almost every year, another tax bill is enacted. Some years, the Congress enacts two tax bills.

[2] CCH, Inc., Standard Federal Tax Reporter, 2001, http://www.cch.com.

When asked to reflect upon the relative merits of the tax system, some consider it benign or, in the case of tax advisors and preferred industries, lucrative. The apathetic are resigned to the view it is a reflection of a complicated economy; the cynical believe it is an outstanding example of what physicists call Brownian motion.[3] But the vast majority of the American people find it simply unfair, wasteful and costly. In their reflective moments, tax professionals, even former IRS Commissioners and Chairmen of the Ways and Means Committee are among the most vociferous critics.

While many problems with the tax system are worthy of discussion, one of the worst is that its growth, complexity and size has created many distortions intended and unintended. There are inequities across industries (the pharmaceutical industry, for example, enjoys most of the Research and Experimentation (R&E) tax credit); by one's choice of the form of entity though which to conduct business (partnerships versus corporations); or by the choice to operate a business as a tax-exempt or taxpaying firm (nonprofit hospitals versus for-profit hospitals). Finally, there are distortions caused simply by the size of firm.[4]

The Code is replete with provisions which discriminate against small firms. By discouraging small firm participation in tax benefits, these distortions are not only unfair, but inefficient. The tax-incentives provided for employer-sponsored pension, health and long term care coverage illustrate the problem. It is widely known by health policy experts, for example, that small firm employees are less likely to have health insurance; however, studies have shown that when they have the resources, small firm employers are as likely to offer health insurance as an employee benefit as large firm managers. Rather than making health coverage desirable and cheaper for small employers, tax laws impose huge compliance costs and effectively punish the owner-operator if he extends coverage to himself. Consequently, most of the uninsured employees are found in small firms, whereas the distribution of tax benefits for the working insured are in larger firms. Large company managers, in contrast, can take unfettered advantage of the tax incentives.

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[3] Brownian motion is a physics term that describes random movement of microscopic particles suspended in liquids or gases. While they may be moving in many different directions, the net effect is zero.

[4] Some distortions are "horizontal" in nature; that is, they treat similarly situated businesses differently. Others are "vertical" in nature; because they affect firms based on their size and not their industry. Still, others are a mixture of both vertical and horizontal inequity, what we might term "diagonal' inequity. The consequences of vertical distortions for individuals are sometimes intended by policymakers in order to introduce accelerated progressivity. For example, corporate income tax rates increase as a function of corporate income. While we may doubt the wisdom of this policy, there is little doubt that accelerated progressivity inequities are intended. The consequences of other vertical inequities are clearly not intended but are merely byproducts of distinctions drawn for other purposes. Often it is these latter vertical inequities that impose higher costs or deny advantages to firms that are smaller.

This study has a limited purpose. It merely seeks to list advantages and to describe them. We hope this leads to a better understanding of how laws have sometimes been crafted to exclude small firms. Beyond this, we propose specific recommendations for each disparity cited. It is our hope that the policymakers will strive to rectify these problems, which are begging for attention.[5]

However, we also propose a more systemic and long-term solution that would ensure the problems of these inequities are examined and corrected, and avoided in the future. Some organization of government should be tasked with undertaking periodic reviews of existing provisions to determine their use by size of firm. The same entity should scrutinize new proposals to ensure these inequities are not perpetuated.

A Note About the Limits of This Analysis

There are at least two tests we could apply to examine potential disparities in the effects of our tax laws. We might apply a *de jure* test, where we look at the way the language of the law is parsed to determine if it expressly discriminates against small firms. A Code section might pass the *de jure* test if it simply stated, 'firms with fewer than 50 employees cannot take this deduction.'

Another way of testing potential disparities would be to look to the effect of the law. A *de facto* test would measure the practical impact of a provision which on its face does not discriminate. Many discriminatory provisions are not explicit, but they adopt sophisticated formulae which have the real world effect of discouraging small firm participation in the tax benefit.

To take an obscure example a *de facto* disparity, we can look to IRC regulation §1.132-6(e)(1), which excludes from an employee's compensation the value provided by his or her employer who electronically files the employee's income tax return. This exemption doesn't seem to be bad policy. It has roots in administrative efficiency. [6] What firm wouldn't see the wisdom of providing a tax-leveraged benefit at minimal cost? What employee wouldn't want someone to complete their tax returns for them for free? For many employees, it would be as if the firm was giving them three days of paid and stress free vacation.

However, it is an undeniable fact that tax compliance costs are fixed, and a large firm's per unit tax compliance costs are lower than a small firm's. Hence, the costs to the large firm to prepare employees' tax returns are much less per employee than the cost to a small firm. An employee weighing the benefits of working for a large or small employer is indifferent as to which firm provides the benefit. As a result, large firms can use the complexity of the tax Code, and a tax-leveraged inducement to attract and retain personnel. In a small way, the Code exacerbated already regressive compliance costs by subsidizing large firms who already have a leg up when it comes to absorbing government costs. This economic advantage results not from the natural tendency of the market to determine the most efficient provider of goods and services, but the unnatural input of government imposed costs, such as the costs of administering the tax Code. This is an example of a *de facto* disparity, even though both large and small firms are legally eligible to take advantage of the subsidy. [7]

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[4]The rationale of this change – if one were cynical – is to further distance most taxpayers not only from the recognition of the true taxes they pay, but from the pain of civil responsibility in filing them. One step further than withholding, individuals who never see the taxes withheld from their income, and who do not have to file, won't complain when taxes are raised, especially on others. Some European countries mandate that employers do their employee's taxes for them.

[5] We would add that even under the de jure test, the statutes are merely one source of disparity. We could also look to the regulations, revenue rulings, technical advise

Having said all that, we must draw limits. We chose to focus on the most blatant examples of disparity, rather than obscure disparities.[8] In a word, we have exercised judgment in determining which provisions go on the list.

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memoranda and court decisions that can also draw a *de jure* distinction. To elaborate, assume the large employer is H&R Block. H&R Block would be entitled to deduct as an ordinary and necessary business expense, and the employees would be entitled to exclude, several millions of dollars of free tax advice provided by their employer. An employee of a small firm, and even the owner, might have to use the same services of H&R Block. When they do, however, they must pay for it with their after-tax income. They may be able to deduct their personal return costs but only after the payment of payroll taxes and only after they meet the 2 percent miscellaneous itemized deduction floor. If the employee does not itemize, as fully three-quarters of Americans do not, he gets no advantage. The practical effect is that large firms take the lion's share of the tax subsidy, for something that is more efficient for them to do anyway.

America's Tax Regime:
Exploring Unequal Treatment Between Large and Small Firms

A Study Commissioned by the National Small Business Association

I. Distributional Concerns that Discriminate

A. Employee Benefit Plans (Pension and Profit-Sharing Plans)

1. Problem

Qualified pension, profit-sharing and stock bonus plans offer substantial tax benefits to sponsor-employers and their employees. The employer gets an immediate deduction for contributions under the plan.[9] Additionally, earnings of funds held in the plan are exempt from taxation.[10] The employee isn't taxed until fund amounts are distributed (usually after retirement).[11] Qualifying "lump-sum" distributions for those born before 1936 are treated favorably.[12] Tax is deferred on qualifying distributions of appreciated employer stock until the stock is sold.[13] Finally, amounts transferred into a direct trustee-to-trustee transfer are excluded from income and eligible rollover distributions can be rolled over tax-free to eligible retirement plans.[14]

With the dubious future of social security solvency, the tax benefits serve an indispensable social purpose. For employees, pension benefits offer hope for a better life upon retirement. For all Americans, private pension coverage helps remove the burdens on our beleaguered social safety net.

The forms of pension plans are variegated. A "qualified profit-sharing plan" has a definite, predetermined formula for allocating contributions made under the plan among the participants, and for distributing the funds accumulated after the participant attains a stated age or upon the occurrence of some event. A "thrift plan" is in the nature of a profit-sharing plan and provides for the contribution by the participants of a specified percentage of their salaries. The employee contribution is then matched by the employer, either dollar-for-dollar, or in some other specified manner. A "qualified pension plan" provides systematically for the payment of definite, determinable benefits to employees. Retirement benefits are generally measured by such factors as years of service and compensation received. Under an "annuity plan," tax sheltered retirement annuities are bought directly from the insurance company.[15] Through "401(k) plans," otherwise known as CODAs (cash or deferred arrangements), employees are allowed to choose between an employer contribution into a qualified trust for the employee or cash. A qualified trust can be a "profit-sharing plan," a "stock bonus plan," certain "money purchase plans" or a "rural cooperative defined contribution pension plan."[16]

"Qualified pension plans" are divided into either "defined contribution plans" or "defined benefit plans." The former provides individual accounts for participants and a benefit based on those amounts. The latter is a pension plan other than a defined

[9] Code § 404.
[10] Code § 501(a).
[11] Code § 402.
[12] Code § 402(d),
[13] Code § 402(e)(4).
[14] Code § 402(e)(6) and (c)(1).
[15] Code § 403(a)(1).
[16] An employee may elect to defer no more than $10,500, indexed for inflation. (Code § 401(k); 402(g)(1)).

contribution plan (generally a plan that provides for the payments of definite, determinable benefits to the employee over a period of years after retirement).

No matter which plan or combination of plans is chosen, each is subject to nondiscrimination rules. The plan must not discriminate in favor of "highly compensated" employees with respect to benefits.[17] A "highly compensated" employee for this purpose is defined in Code § 414(q) to mean a 5 percent owner at any time during the determination year or preceding year, or who, having received more than $85,000 in income (indexed since the year 2000), was also in the "top paid group" of employees (top 20 percent). Contributions must also not discriminate in favor of "highly compensated employees."[18] To comply, a plan must be nondiscriminatory in amount, and ancillary benefits and other rights and features must be made available to employees in a nondiscriminatory manner.

Each plan is also subject to specific coverage and eligibility requirements. Every qualified plan other than a government plan must meet special tests designed to ensure adequate coverage of rank and file employees. The plan must, on at least one day in each quarter of its tax year, either (1) benefit '70 percent of the employees who aren't highly compensated', (2) benefit 'a percentage of non-highly compensated employees that is at least 70 percent of highly compensated benefiting', or (3) meet a test under which the 'average benefit for the non-highly compensated is at least 70 percent of the average benefit for the highly compensated'.[19] This "average benefit test" also requires that the plan benefit employees under a nondiscriminatory classification.[20]

Coverage requirements generally demand plan benefits be evaluated to determine employee coverage on each day of the plan year. The problem with this approach is that small firm employee pools are volatile, sometimes seasonal, and can shift dramatically over the course of the year. The smaller the sample pool, the more statistically dynamic it will be. The more coverage will deviate throughout the year. Recent legislation eased this requirement somewhat by allowing for a representative snapshot to be taken in the course of a year, and for the firm coverage to be tested relative to that sample, but the problem persists.

A so-called "top heavy plan" must meet special additional requirements in the areas of minimum vesting and minimum benefits or contributions for other than "key employees."[21] For any plan year in which the plan is top-heavy, an employee's right to accrued benefits must be 100 percent vested after three years of service, or at the employer's option, 20 percent vested after two years of service as well as 20 percent in each of the following years.[22] A plan is considered top-heavy if the sum of the present

[17] Code § 401(a).
[18] Code § 401(a)(4).
[19] Code § 410(b)(1),
[20] Code § 410(b)(2).
[21] Codes § 416(a). However, note that SIMPLE retirement's plans aren't subject to the top-heavy rules. (Code § 416(g)(4)(G).
[22] Code § 416(b). There are numerous other requirements. For instance, a defined benefit plan must provide a minimum annual requirement benefit that is not integrated with Social Security for non-key employees that is equal to the lesser of: (1) 2 percent of the participant's average compensation for years in the testing period multiplied by his years of service, or (2) 20 percent of his average compensation for the participant in the years in the testing period. In a defined contribution plan (where the

value of the accrued benefits for "key employees" is more than 60 percent of the sum of the benefit value of accrued benefits to all employees.[23]

Additionally, there are so-called minimum funding requirements that apply to defined benefit and money purchase plans. Such plans must maintain a "minimum funding standard account" to which credits and charges (including interest) are made, and satisfy a "minimum funding standard" each plan year.[24]

Finally, there are separate rules that apply exclusively to either defined benefit plans or defined contribution plans. A defined benefit plan, other than a government plan, isn't qualified unless, on each day of the plan year, the plan benefits at least the lesser of (a) 50 employees of the employer, or (b) the greatest of 40 percent of employees or 2 employees (or 1 employee if there is only 1 employee plus the owner).[25]

What all these rules mean is that large firms need not provide as widely or evenly distributed coverage as small firms. For example, when a firm has more than 125 employees, they need to cover only 50 employees (40 percent of 125). According to the rules, this is the same for a firm with twice that number of employees or four times that number and so on. A firm with 500 employees that covers only 50 employees has a coverage rate of 10 percent. However, if a firm has only two employees, it must cover them both. Full coverage of all employees or a larger percentage means that a defined benefit based on the average work pool compensation will yield a lower benefit to managers and owners. For instance, if a 500-person firm can skew its benefit toward the higher compensation levels of the 10 percent of employees, they will enjoy a relative advantage.

A cash or deferred arrangement (CODA) must meet special nondiscrimination rules that require the plan to satisfy one of two "actual deferral percentage tests," so "highly compensated" employees cannot elect to defer a disproportionately high amount of their salary.[26] A plan is treated as meeting these requirements if it is a savings incentive match plan (SIMPLE) that meets special matching or nonelective requirements (see below). An alternative nondiscrimination safe-harbor based on employer matching or nonelective conditions also is available.[27]

There are several problems with the nondiscrimination rules. One problem is that the nondiscrimination rules are so complex that small firms end up paying considerably more per employee to establish, administer and monitor such plans than large firms due to economies of scale. Second, a breach of the complex rules is so costly that those who wish to offer them expose themselves to considerable risks. Breach is more

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contribution is defined but the benefit can fluctuate), the employer must contribute for each non-key employee not less than 3 percent of that employee's compensation. But the percentage doesn't have to exceed the percentage at which contributions are made or requirement to be made for the "key employee" with the highest contribution percentage.

[23] Reg. § 1.416-1 and 1.416-2T-1(C).

[24] Code § 416(c)(2).

[25] Code § 401(a)(26)(A). There is some relief, however. Instead of meeting the test on each day of the plan year, compliance on a single representative "snapshot" day during the year is sufficient. Reg. § 1.401(a)(26-7(b)).

[26] Code § 401(k)(3)(A).

[27] Code § 401(k)(12).

likely when firms are more volatile, as are small firms. Third, the nondiscrimination rules make the benefits of such plans worth less to the owners of
the company because the benefits must be more skewed towards employees the smaller the firm becomes.

Defined benefit plans are the method by which small employers traditionally recaptured some of their investment in the firm by allowing employees (who benefit from the business) to fund the employer's defined benefits. This is particularly attractive for small employers whose business, as stated above, is essentially their illiquid retirement plan. However, defined benefit plans are especially costly, and this cost has contributed to their declining use. At the same time, defined benefit plans are the type of plan that could be most valuable to small employers. Small business owners often need to build firms over many years and reinvest proceeds of growth in operating expenses and in developing the capital asset. During the building period they can contribute only modest amounts towards their own exit strategy. For small business owners to recapture some of the savings opportunities diverted to investment, they would be better off with a plan that benchmarks benefit based on years of service, rather than on contributions that are capped. In a sense, the employees, who are the future beneficiaries of the efforts of the founders, can help fund the retirement of the founder.

The SIMPLE plans alluded to above are an example of Congress seeking to "help" small firms establish pension plans. These plans as noted are meant to make it easier for employers to meet these requirements. Employers with no more than 100 employees may set up a savings incentive match plan for employee (SIMPLE) and in the case of an "IRA-type" SIMPLE plan, the small firm need not meet the top-heavy rules or be tested under the nondiscrimination rules. Because they need not be tested, they're generally cheaper and easier to operate than other retirement options because they are preappoved. The plans are being marketed by a number of financial services firms.

However, SIMPLE plans make a key trade-off: they lower annual contribution limits (reduce the amount an employer can save) for ease of administration. Thus, with a SIMPLE plan an employer can't save nearly as much for retirement each year as with the other options.

The basic rules for SIMPLE plans are as follows. The employee may contribute only up to $7,000 annually in 2002 (adjusted annually).[28] Moreover, the employer must either match each participating employee's contribution up to 3 percent of the employee's pay or make an across-the-board 2 percent contribution for all eligible employees with at least $5,000 in annual compensation, regardless of whether they participate in the plan.[29] These are the only permitted contributions — the maximum contribution total for any employee (or yourself) would be $14,000 for 2002 ($13,000 for 2001). Employees vest immediately in all contributions made to their account, by themselves or the employer.

[28] Those who are age 50 or over in 2002, can contribute an additional $500 for the year.

[29] In the IRA form, employers can elect to limit the match to a minimum of 1 percent of all eligible employees' compensation, but this election can only be made in two out of every five year.

The problem for small employers with such plans is that a small employer typically doesn't have as many years as the employee to "save" for his or her retirement. What they have been doing all their lives is essentially plowing profits (which large firms' employees could use for their retirement) back into their business. In essence, therefore, small firm employers, instead of funding their own retirement, have been building a capital asset which will be enjoyed by future employees of the company. However, they are generally so busy doing that that they did not find the resources to save for their own retirement. They cannot catch up with the small contributions allowed under the SIMPLE system and may be left with an unfortunate decision: leverage the business with debt or sell it to fund their retirement.

If one doubts the real world effects of the complexities of pension rules on small firms, the data may help convince them. Recently, the Congressional Research Service issued a report entitled "Pension Coverage: Recent Trends and Current Policy Issues."[30] The report shows small business lagging in many areas of coverage. The report found that 83.3 percent of employees in firms with 100 or more employees had employers who sponsor a pension or retirement savings plan. This is contrasted to 58.1 percent of employees in companies with 25 to 99 employees have employers who sponsor such a plan. Worse, only 30.3 percent of employees in firms with fewer than 25 employees have employers who sponsor such a plan.[31] It is clear that the size of the company impacts retirement plan sponsorship.

They also looked at the relative percentages of employees participating in employer-sponsored plans when offered. According to the data, 88.2 percent of employees in firms with 100 or more employees that sponsor a pension or retirement savings plan participated in the plan. However, 85.5 percent of employees in companies with 25 to 99 employees which sponsor such a plan participated. And again, the trend holds - 84.8 percent of employees in firms with fewer than 25 employees whose employers sponsor such a plan participated.[32] In short, when small businesses sponsor retirement plans, the employees participate at just about the same levels as in larger companies. Thus, it is critical to encourage small business to provide plans and to remove obstacles that presently discourage them.

2. Solution

A common problem with employee benefit plan law is overly broad application of the nondiscrimination rules in their various iterations. Particularly, in applying "highly compensated" rules, "key employee" rules, or "control employee" rules, we err by setting up classifications of individuals based on ownership percentages, and then gauge the proper distribution of benefits under arbitrary rules applied to these

[30] Patrick J. Purcell, Analyst in Social Legislation. This report gives an excellent overview of the current coverage trends for retirement plans, though it is relying on data through 1997. Thus, in the small business area, it is not picking up any additional plan sponsorship and thus, coverage, due to the new SIMPLE plan and some of the real simplifications that have been accomplished in the last several retirement plan bills enacted by Congress.

[31] Table 3, Panel A, "Participation in Pension or Retirement Savings Plans by Size of Firm."

[32] Table 3, Panel B, entitled the " percentage of Employees in Firms that Sponsored a Plan who Participated in the Plan."

classifications. The percentage of stock ownership in a firm, or the combination of stock ownership and absolute or relative level of earnings, may all be indications that an individual has the managerial power to decide upon distribution of benefits. However, the problem to be addressed is the exercise of this power in a disproportionate manner, not the ability to exercise that power.

Contribution limits between SIMPLE and 401(k) plans should be harmonized. References to "key employees" should be eliminated, as should all references that distinguish between owners and employees. The individual's ownership in a firm should be irrelevant for purposes of determining the equitable distribution of benefits. Furthermore, all rules relating to distributional requirements should be harmonized, so that the same rules or variations of rules apply to each section of the Code where distribution is a concern. For instance, the Code might specify a number of safe harbors. Benefits or contributions might be acceptable if they are within a range of compensation, or if they are based on years of service to the company and compensation. What the regulations might do is to effectively publish as safe harbors a number of plans that meet the requirements of the nondiscrimination rules.

B. Section 79 -- Group Life Insurance Purchased for Employees

1. Problem

Code § 79 provides that up to $50,000 of group life insurance purchased by employers from the gross income of employees may be excluded from employee taxable income. This exclusion can be of considerable value to employees and employers. Each year, the exclusion is worth an amount equal to the employee's tax rate times the cost of the policy. However, if such a policy were in effect over the course of an employee's life, since the policy amount paid is the present discounted value of the future income stream (plus intermediation costs and risk adjusted) the value of the tax benefit is the employee's tax rate times $50,000.

Section 79(d) establishes a series of "non-discrimination" rules that effectively discourage any small employer from offering a life insurance plan. Among other things, § 79 requires that at least 85 percent of plan participants be other than "key employees" within the meaning of Code § 416(i)(1)(A). Section 416, in turn, contains a labyrinth complex enough to win the admiration of King Minos. The definition of a "key employee" under § 416(i)(1)(A) includes an employee who owns at least "5 percent … of the employer."

By way of example, let us assume that a business has two owners. With two owners, it would be impossible for the business to provide tax-free life insurance for its owners or its employees unless it had at least 14 employees.[33] If the business had one owner, then 7 employees would suffice under this rule.[34] Therefore, § 79 could just as easily, and possible a lot more clearly, state "small firms are severely discouraged from providing life insurance to their employees until they have at least 7 employees."

[33] 85 percent of 14 is 11.9, thus 12 employees and two owners comply with the rule.
[34] 85 percent of 7 is 7.65, thus 8 employees and one owner complies with the rule.

There is another rule provided under § 416(i)(1)(A)(iv)), which was added recently by Congress.[35] Under that rule, "a 1 percent owner of the employer having an annual compensation from the employer of more than $150,000" is a "key employee," even if the owner owned 1 percent of the company for only one day in the past four years.

The deleterious effect of this provision on highly paid large firm employees is softened somewhat, exacerbating the inequity. Section 416(i)(I)(A)(i) provides that the term "key employee" is an "officer having an annual compensation greater than 50 percent of the amount in effect under § 415(b)(1)(A)" (which concerns contributions in employee benefit plans)[36] but that no "more than 50 employees" or if lesser, "the greater of 3 or 10 percent of the employees", shall be treated as officers. As a result, the larger a firm is, the more highly paid employees in large firms can skew benefits towards themselves relative to smaller firm owners. Additionally, officers are not considered those who are subject to a collective bargaining agreement.

The economic effect of this provision discourages owners of small firms to extend life insurance to their employees and to themselves. The problem, of course, is that life insurance is often what is needed to prevent the liquidation of the firm upon the death of a significant owner.

2. Solution

The main problem with the life insurance benefit is that it differentiates between owners and non-owners. No distinction should be drawn. Employers would be more inclined to use these tax deferred tools to attract and retain employees if given an opportunity to set up plans for themselves.

C. Section 105 – Exclusions for Amounts Received Under Health Plans and Self-Insured Health Plans

1. Problem

Gross income does not include amounts an employee receives from his employer, directly or indirectly, as reimbursement for expenses for the medical care of himself, his spouse and his dependents. Under Code § 105, an employee can exclude from his gross income an employer's direct or indirect reimbursement (directly or through insurance) of his medical expenses or that of his spouse or dependents.[37] Amounts received under an accident or health plan for employees, as well as amounts received from a sickness and disability fund, are treated as amounts received through accident or health insurance. These amounts are excludible even when the sole-proprietor employer is the employee's spouse.

This section incorporates several discriminatory provisions called "prohibition[s] of discrimination" in the case of "self-insured medical reimbursement plans." "Self-

[35] See § 901 of P.L. 107-16. Section "(iv)," for instance, takes effective after January 1, 2002.

[36] That amount for 2001 is $140,000.

[37] Reimbursement is includible in the employee's income to the extent it exceeds medical expenses or its attribute to medical expense deductions he took in a previous year (Code § 105(b); Reg. §1.105-3).

insured plans" are plans of an employer to reimburse employees for medical care expenses for which reimbursement "is not provided under a policy of accident and health insurance" (i.e. it is provided directly). Under the rules prohibiting discrimination, the self-insured plan must neither discriminate in favor "highly compensated" employees as to eligibility nor provide benefits in a discriminatory manner to "highly compensated" employees.

"Discrimination," in turn, is defined as a plan that does not benefit 70 percent or more of employees or 80 percent or more of employees eligible to benefit if 70 percent or more are eligible to benefit.[38] A "highly compensated" person is defined to be one of the 5 highest paid officers, a shareholder who owns more than 10 percent of the stock value, or is one of the highest paid 25 percent of all employees. The application of this provision leads to unusual results. If there are only 3 employees, than under the 70 percent rule, all would need to be benefited; if there are 4 employees, 75 percent would need to be benefited; if there are 5 employees, 80 percent would need to be benefited, but once there are more than 7 employees, the firm need only benefit 70 percent.

In the event the plan is determined to be discriminatory, the "excess reimbursement" of "highly compensated" individuals is not excludable, which means that the reimbursement of the medical costs is included in the income of the owners. Determining the "excess reimbursement" is a multi-stage analysis, which considers both eligibility and actual provision of benefits. "Excess reimbursement" includes the amount of any reimbursement available as a result of a benefit being provided to "highly compensated" individuals as opposed to non-highly compensated individuals. Additionally, an "excess reimbursement" can include an amount equal to a fraction, the numerator of which is the total amount reimbursed to all participants who are "highly compensated," and the denominator of which is the total amount reimbursed to all employees under the plan for the plan year.

Insurance premiums paid for partners (including Limited Liability Company (LLC) members, Limited Liability Partnerships (LLPs) partners, Limited Partnership partners, General Partnership partners and more-than-2-percent S Corporation shareholders (who are treated as partners)) are not excludible.[39] However, they are counted for purposes of determining the discriminatory nature of the plan.[40]

2. Solution

[38] Alternatively, a plan may be approved by the IRS. Employees who are subject to a collective bargaining agreement are again excluded from the count.

[39] S Corporations are corporations for which an "S election" is in effect. An "S election" allows the corporation to be treated as pass through entities under Chapter S of the Internal Revenue Code of 1986.

[40] The net effect of this provision is to increase the administrative costs, and thereby discourage small employers from offering self-insurance plans or providing health benefits. This is not a trivial matter, as research has determined that small employers are more likely to offer health insurance plans to their employees when they can afford them, but that the health insurance costs (exclusive of administrative fixed costs per employee) are much higher. Additionally, small firm owners are often older and have special needs which may require greater flexibility in the selection of coverage.

Require that the number of employees that must be benefited be rounded off to the lower whole number. For instance, a three employee firm would only have to benefit 2 employees to meet the 70 percent requirement. Second, eliminate the prohibition against owner employees from participating.

D. Section 125 – Cafeteria Plans

1. Problem

A "cafeteria plan," also referred to as a "flexible benefit plan," is a written plan under which employees may choose their own "menu" of benefits consisting of cash and qualified benefits. Provided for under Code § 125, cafeteria plans exclude from gross income amounts placed into the plan. The difference between cafeteria plans and other plans is the element of choice among a range of benefits. According to § 125, "no amount shall be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan."

A "qualified benefit" is any benefit that is excluded from income by a specific provision of the Code. Qualified benefits that may be offered include dependent care assistance programs,[41] group-term life insurance, coverage under an accident or health plan (i.e. health insurance), adoption assistance,[42] qualified cash or deferred arrangements, or vacation days.[43]

According to Internal Revenue Code Section 125(d), all participants in a cafeteria plan must be employees. The term "employees" is defined in Regulation Section 1.125-2 Q&A-4 as follows: "The term 'employees' includes present and former employees of the employer. All employees who are treated as employed by a single employer under subsections (b), (c), or (m) of section 414 are treated as employed by a single employer for purposes of section 125. The term "employees" does not, however, include self-employed individuals described in section 401(c) of the Code. Even though former employees generally are treated as employees, a cafeteria plan may not be established predominantly for the benefit of former employees of the employer."

While they were touted as a small business benefit, cafeteria plans ironically exclude most small business forms of entity. For example, self-employed individuals are prohibited from participating in a cafeteria plan and are defined under Section 401(c) as being sole proprietors and partners in a partnership, which means that limited partners, LLP partners and LLC members are excluded. In addition, Section 1372 treats the Subchapter S Corporation as a partnership for fringe benefit purposes. As a result, more than 2 percent shareholders in an S corporation are treated as partners in a

[41] Under Code § 129.

[42] Under code § 137 if it meets the requirements therein.

[43] Vacation days pay are excluded provided the plan precludes any participant from using or receiving cash for, in a later plan year, any vacation days remaining unused at the end of the year. Note: the following benefits aren't qualified benefits – (1) scholarships or fellowships under Code § 117, (2) educational assistance programs under Code § 127, (3) employer provided fringe benefits under Code § 132, (4) meals and lodging furnished for he employer's convenience under Code se. 119, and (5) employer contributions to a medical savings account under Code § 106(b).

partnership and therefore cannot participate in a cafeteria plan. A cafeteria plan could be disqualified if ineligible individuals are allowed to participate. This would result in taxation to all participants of at least their pretax cafeteria plan benefits. There also could be additional payroll taxes owed by the employer.[44]

Other requirements hurt small employers even if they qualify. The first relates to the ubiquitous "highly compensated" gauntlet employers must run. If the plan discriminates in favor of "highly compensated" participants – either as to eligibility to participate or as to contributions and benefits - the exclusion won't apply to that person. As usual, the definition of a "highly compensated" person has almost nothing to do with compensation. "Highly compensated" simply means that the person in question is an officer, a shareholder with five percent or more ownership, a spouse or dependent of an officer, or part owner. In essence, the person assumes risk in the company. The definition of "highly compensated" in Code § 125(e)(1) also tautologically includes "high compensated" participants - sort of as a vague catch-all in case a small business owner thought he or she were safely through the gauntlet. Whether or not the plan "discriminates" is not spelled out in the statute, except in the case of health benefits.[45]

It is also not spelled out in the Code regulations. Proposed regulation § 1.125-1Q-19 and A-19 tries to address the question of discrimination Vis a Vis cafeteria plans, but it does so tautologically. This guidance provides, "in order to be treated as nondiscriminatory for a plan year, a cafeteria plan must not discriminate in favor of highly compensated participants as to benefits and contributions for that plan year." This assessment, the proposed rulemaking provides, will be made on the basis of the "facts and circumstances" of each case.

In the case of "key employees" (as defined in § 416(i)(1)), the provision is much clearer. The exclusion does not apply if more than 25 percent of the total benefits provided to all employees are provided to "key employees." A "key employee" is defined as an employee who at any time in the year was, (1) an officer earning more

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[44] Although a sole proprietor cannot participate in a cafeteria plan, the sole proprietorship can sponsor a cafeteria plan for its employees. In addition, the spouse of the sole proprietor can participate in the plan (and cover the sole proprietor as a dependent) if he or she is a bona fide employee and can cover the sole proprietor as a dependent under the plan. A partnership can sponsor a cafeteria plan for its employees even though the partners cannot participate. In addition, similar to a sole proprietorship, the spouse of a partner can participate in the plan (and cover the partner as a dependent) if he or she is a bona fide employee. Although a more than 2% shareholder in an S corporation cannot participate in a cafeteria plan, the S corporation can sponsor a cafeteria plan for its employees. However, unlike sole proprietorships and partnerships, spouses, children, grandchildren or parents of more than 2% shareholders cannot participate in the cafeteria plan because of the stock ownership attribution rules of Section 318. Limited liability companies are generally treated as partnerships for federal tax purposes and therefore, members cannot participate in a cafeteria plan. In situations where individual members are not treated as partners in a partnership or as self-employed persons, it is not clear whether or not they can participate in a cafeteria plan. However, if the limited liability company has eligible employees, it may be possible to establish a cafeteria plan for these employees.

[45] Code § 125(g)(2).

than $130,000, (2) a 5 percent owner, or (3) a one percent owner having annual compensation of more than $150,000. The provision also places limits on the negative effect of this provision for larger companies by providing that no more than 50 employees shall be treated as officers. If there are fewer than 50 employees that would be treated as officers, then the greater of 3 or 10 percent of the employees would be treated as officers (subject to the 50 employee limit). Effectively this means that the larger the firm is, the more they can discriminate. Self-employed individuals are treated as employees and their entire earned income as compensation.[46]

To apply these nondiscrimination rules to the real world, use an example of a C corporation (because virtually any other small business owner is disqualified from taking the benefits) that has one employee and one owner. To have a cafeteria plan, the owner would have to provide three times the benefit (75 percent) of the cafeteria plan benefits to the employee if he wanted to qualify for exclusion, a sort of reverse discrimination. That is because the "key employee" could enjoy only 25 percent of the total benefits under the arbitrary rule provided in Section 125(b)(2). This means that corporations with fewer than four employees must advantage employees over owners to take advantage of the plan.

2. Solution

Eliminate the requirement that the beneficiary needs to be an employee as well as reference to ownership as a criterion for determining fairness in distribution. Eliminate any reference to "key employees." Benefits could be based on salary or years of service or both. Again, the regulations should provide dozens of examples of permissible distributions of benefits.

E. Section 127 – Educational Assistance Programs

1. Problem

In order to encourage educational assistance programs, employers are permitted to provide employees up to $5,250 per year of "educational assistance." That amount is a deduction against income for the employer and excludible from income by the employee. This assistance can be for any purpose, not just for job-related education. "Educational assistance" covers payment for tuition, fees, books, supplies and equipment, with the exception of payment for graduate-level courses or meals, lodging, transportation, or tools or supplies.[47] However, there are certain provisions that effectively exclude small business owners from qualifying.

First, under Code § 127(b)(2), the program must benefit employees under a classification found by the Secretary not to be discriminatory in favor of "highly compensated employees." Again, under § 414(q), a "highly compensated employee" can be one who owns more than 5 percent of the company directly or indirectly.[48]

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[46] Code § 416(i)(3).

[47] Other than textbooks that may be retained after the course ends.

[48] Under IRC § 416(i)(1)(B)(i)(I) and (II), the term "5 percent owner" means "any person who owns (or is considered as owning within the meaning of § 318) more than 5 percent of the outstanding stock of the corporation or stock possessing more than 5 percent of the total companied voting power of all stock of the corporation, or … if the

The operation of these sections make ineligible almost all LLC members, LLP partners, sole-proprietors, most limited partners, general partners, and S Corporation shareholders, as well as C Corporation shareholders who own a small amount of the company.

There is also a double layer of discriminatory treatment in the "anti-discrimination" rules. Under Code § 127(b)(3), not more "than 5 percent of the amounts paid or incurred by the employer for educational assistance during the year may be provided for the class of individuals who are shareholder or owners (or their spouses or dependents), each of whom … owns more than 5 percent of the stock or of the capital or profits interest in the employer."

This effectively prevents any family business owner from qualifying, and most small business owners from qualifying. As a result of this provision, gross inequities result. Under the general Code § 414(q) highly compensated provisions, a Vice President of a widely held company such as General Motors who makes $300,000 per year may be eligible for "educational assistance"; however, an owner-employee in a small grocery store who makes $30,000 per year would be ineligible. The application of this rule is explained in greater detail in the regulations.

The double layer of discrimination provides an objective rule that discourages a small business owner who is even willing to provide a universal plan. Let's say, for example, that a company has 5 employees, two of whom are allocated 6 percent of the profits and loss, and one of whom owns 82 percent of the company. Add further the fact that the two employee-owners are sons of the principal owner. Under Code § 127(b)(3), 95 percent of the benefit must go to the two employees who are not of "the class of individuals who are shareholders or owners." Only 5 percent, or $250 each (if divided equally) could go to the sons even if the maximum amount of $5,250 were provided to each of the two employees. In other words, the owner-employees could take only one-tenth of the benefit provided the employee. If, however, the firm had 500 employees, a much greater proportion of the tax-favored benefits could flow to the owner-employees. Here, if 50 employees including the owner-employees were provided $1,000 in educational assistance each, one-tenth of the employee workforce, the sons could be provided an even greater amount of benefit without running foul of the provision. We question whether there is any difference between these two examples apart from the size of the firm.

Also, large unionized employers are given an additional benefit. Union members are excluded from the analysis even if they are not provided the educational benefit (so long as educational benefits were part of good faith bargaining for a union agreement). Hence, although a large firm might have a discriminatory plan if union members were

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employer is not a corporation, any person who owns more than 5 percent of the capital or profits interest in the employer." Under § 318, an individual "shall be considered as owning the stock owned, directly or indirectly, by or for … his spouse, … his children, grandchildren and parents." In addition, stock owned directly or indirectly by or for a partnership or estate shall be considered as owned operationally by its partners or beneficiaries, and a more than 50 percent owner of a corporation shall be considered as owning the stock owned directly or indirectly by or for such corporation in relative proportion to the stock he owns.

non-union employees, their plan will not be discriminatory as a result of the presence of the union.

Even though non-highly compensated employees in a non-union company do not want to participate in a plan, they must be counted for purposes of determining if the plan is discriminatory. By the same token, a union member who really wants to participate won't be counted if union leaders entered into a plan that contemplated but rejected educational benefits on his behalf. In other words, union management is not held to the same scrutiny as company management.

2. Solution

Require publication of the awards of these benefits, and publish the criteria for selection and eligibility as part of the employee agreement. Eliminate any reference to ownership in the firm as determining eligibility for benefits or bearing on the potential discriminatory allocation of benefits. Allow the benefits to be tested over a 5 year window as a function of compensation paid, ensuring equitable distribution of benefits as a function of compensation, accomplishment, years of service or both.

F. Employee Stock Options

1. Problem

Through stock options an employer has an alternative means of compensating employees for services, past, present and expected. Options may be more favorable than cash from a strategic and tax perspective. They offer employees the prospect of equity returns. They can foster a sense of employee loyalty and investment, thereby enhancing productivity. They normally grant the right to purchase stock at a set price at some future point without the business having to relinquish working capital. Stock options are particularly advantageous if the stock allows the employee to be effectively paid without having to treat as taxable income either the original pay or the future appreciation until the option is exercised (at which time it will not be ordinary income).[49]

The two popular tax-leveraged means of granting options include the Incentive Stock Option (ISO) and the Employee Stock Purchase Plan (ESPP). An ISO is granted to an employee by an employer corporation (or its parent or subsidiary) to buy stock in one of these corporations. There are no regular income tax consequences when an ISO is granted or exercised; the employee has capital gain when the stock is sold at a gain.[50]

There are certain limitations on ISOs. Stock acquired through the exercise of an ISO cannot be disposed of within two years after the option is granted or one year after the stock is transferred to the employee.[51] Also, during the entire time from the date an ISO is granted until three months before its exercise, the option holder must have been

[49] Such options may be more tax-advantaged still if they permit the business a deduction immediately upon issuance, but allow the employee to defer until the date of his choice the exercise of that option. This can happen only in the event the option has no ascertainable value at the time it was granted.

[50] Code § 421(a).

[51] Code § 422(a)(1).

an employee of the option granter (or its parent or subsidiary).[52] Where there is a disposition before this requisite holding period expires, income is includible in the employee's tax year within which the disposition takes place. Then, gain on the disposition is realized as ordinary income to the extent of the lesser of the fair market value (FMV) of the option stock on the date of exercise, minus the option price.[53]

Under an ESPP, options are issued to employees pursuant to an employer plan to buy stock in the employer. The employee pays no tax on the option or stock until he disposes of the stock. If the option price at least equals the stock's FMV at the time it was granted, the gain is capital gain.[54]

There is an additional benefit to these options plans not always considered. Companies are not required to collect payroll and withholding taxes on either ESPPs or ISOs. So, in addition to the treatment of the assets as a long term capital asset – which effectively reduces the maximum tax rate to 20 percent – the payroll taxes on what is effectively compensation is forgiven. This reduces the marginal tax rate as much as 15.3 percent.

The ISO and ESPP provisions disproportionately advantage larger employers. Of course, as "stock options" this benefit is in the form of compensation available only to corporations. However, they are also generally not available to employees who own 10 percent of the total combined voting power of all classes of the stock of the employer[55] even if the entity is a corporation.[56] Hence, they are not available as an additional incentive to many existing shareholder-employees of small firms. Moreover, ESPPs must not be discriminatory.[57] This rule means in effect that no employee owning 5 percent or more of the combined voting power or value of all classes of stock of the employer corporation can benefit.

What makes the respective 10 and 5 percent exclusions for ISOs and ESPPs inequitable is the assumption they are based on the power that the manager has over the firm. Here is an incongruity between large and small company managers. Executives of large employers often can negotiate large stock option agreements because of their bargaining position and a friendly relationship with the board, yet the large capitalization of the company makes it unlikely they will own 10 percent or more of the outstanding shares. Excluding owners of small firms from the benefits they share with their workers is one more disincentive for the expanded use of these benefits.

2. Solution

Ownership requirements are not relevant and references to them should be removed. Furthermore, ISOs and ESPPs may be allotted on the basis of salary or weighted with years of service, without reference to ownership requirements.

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[52] Code § 422(a)(2) and 422(a)(6).
[53] Reg. § 1.422A-1.
[54] Code § 423(a) and (c).
[55] Code § 422(b)(6).
[56] However, Code § 422(b)(6) does not apply if the option is at least 110 percent of the FMV of the stock and is not exercisable until after 5 years.
[57] Code § 423(b)(4).

G. Section 129 – Dependent Care Assistance Programs

1. Problem

Under Code § 129, an employee may exclude up to $5,000 of payments received from an employer under a written "dependent care assistance" plan. "Dependent care assistance" is the payment of amounts by an employer that, if paid by an employee, would be considered employment-related expenses under the child care credit rules. These rules, provided in Code §21, allow for the costs of a housekeeper, maid, babysitter or a cook in the event the person needing care is under the age of 13 years (*i.e.* a nanny), or is a dependent of the taxpayer who is physically or mentally incapable or caring for himself.

Again, however, the provision seeks to ensure equitable distribution of the tax benefit, but it does so at the expense of small employers because of the anti-discrimination rules. There are several layers of anti-discrimination rules. Most damaging is the requirement that "not more than 25 percent of the amounts paid or incurred by the employer for dependent care assistance during the year may be provided for the class of individuals who are shareholders or owners (or their spouses or dependents), each of whom … owns more than 5 percent of the stock or of the capital or profits interest in the employer."

Like other well-intended provisions, these mandatory allocation requirements can lead to absurd results. Consider a family firm where each member of the family works in the company. There are five members of the family and five employees. Under these rules, a family member must be willing to provide the employees three times the value he receives under a Dependant Care Assistant Program if the plan is to be considered eligible. In other words, the law subsidizes the larger firms, but the law is counting on a small firm owner to act against his direct personal interest for the good of his employees.

It should be noted that this absurd result will obtain regardless of whether or not any of the children directly own a share of the company. That is because the attribution rules for determining stock ownership under Code §1563 will apply (as they apply to most other nondiscrimination rules where stock ownership is a factor). While these attribution rules are complex, an individual will be considered to own stock, directly or indirectly, by or for his children. An individual who owns more than 50 percent of the total combined voting power of all classes of stock entitled to vote shall be considered as owning the stock in such a corporation owned directly or indirectly by his parents, grandparents, grandchildren or children. The rules go on for several pages. The same 10-person family firm would be similarly affected even if the father merely employs his four sons, none of whom own any stock.

The section incorporates other iterations of the nondiscrimination rules as well.[58] For example, in addition to the mandatory sharing rule, the dependent care assistance programs incorporate the nearly ubiquitous rule that the plan not discriminate in favor of "highly compensated" employees. The reference here is to Code § 414(q). The IRS must affirmatively find that the program does not favor "highly compensated"

[58] Code § 129(d)(2)(3)(4) and (8).

employees. Finally, there is a benefit rule, where the average benefit provided to employees who are not "highly compensated" must be at least equivalent to 55 percent of the average benefits provided to "highly compensated" employees.

All these rules discourage small firm owners from providing benefits to their employees because small firm work forces, by definition, have a significantly higher proportionate share of equity owners. Few small business owners are absentee landlords or detached managers. The higher the relation of equity share owners to employees, the more likely the plan will be considered discriminatory.

2. Solution

Eliminate the requirement that "not more than 25 percent of the amounts paid or incurred by the employer for dependent care assistance during the year may be provided for the class of individuals who are shareholder or owners (or their spouses or dependents), each of whom … owns more than 5 percent of the stock or of the capital or profits interest in the employer." All references to ownership should be eliminated.

H. Section 137 – Adoption Assistance Programs

1. Problem

Sometimes the Code has a tendency to exclude simply because individuals earn too much in a given year. One particularly troublesome provision is § 137's prohibition against small employers benefiting from adoption assistance.

Under § 137, an employee may exclude amounts paid or expenses incurred for qualifying adoption expenses connected with the adoption of a child by the employee, if the amounts are furnished under an adoption assistance program in existence before the adoption expenses are incurred. The total amount excludable per child is $5,000 ($6,000 for child with special needs, increasing after 2001 to $10,000). However, the excludible amount is phased out for taxpayers with adjusted gross income beyond a certain level (this year it is phased out if the taxpayer earns more than $75,000 and fully eliminated when the Adjusted Gross Income (AGI) reaches $115,000).

The effect of this provision is subtle, but it clearly discriminates against small business owners who have finally reached a point in their lives when they may have both the time and the resources to adopt a child. The income of small business owners is more volatile than that of employees, although over their lifetime they may earn no more than an employee. This provision also assumes that a year of income beyond $75,000 is representative of the years of toil involved in starting and building a firm.

2. Solution

Eliminate the income phase-out for small business owners.

I. Section 274 – Employee Achievement Awards

1. Problem

An employee can exclude the costs of awards, which would otherwise be includible in compensation and taxable to the employee. Code § 74(c)(2) permits exclusion of up to $400 per employee ($1,600 for a qualified plan award) if the employer can deduct such an award. Section 274 defines the circumstances under which such an award is deductible. The award must be given as part of a "meaningful presentation" under conditions that don't create likelihood that the payment is disguised compensation.[59] The award must be of tangible personal property.[60] Such an award must also be part of a permanent, written, nondiscriminatory plan of the employer. Furthermore, no deduction is permitted for an employee achievement award given to managerial, administrative, professional or clerical employees if it is safety related.[61]

The nondiscrimination rules, as in other cases, are not explained with certitude. Regulation § 1.274-8(b)(5) provides that a plan is discriminatory when all the facts and circumstances of the particular case say it is. An award plan may fail to qualify because it is discriminatory in its actual operation even though the written provisions of the award plan are nondiscriminatory.

2. Solution

The nondiscrimination test in practice should be repealed. Whether or not the plan is properly administered is actionable in state court. Employees already have civil remedies.

J. Stock Redemptions in Family Businesses

1. Problem

A corporation's reacquisition of its own stock from a shareholder in exchange for cash or property is treated as a distribution to the shareholder with all the attendant tax consequences. However, if the purchase is treated as a "redemption," it is considered a payment for the stock (i.e. a sale or exchange for which capital gains treatment is allowed). Stock is only considered "redeemed" under narrow circumstances.[62] The redemption must either be "substantially disproportionate" with respect to the redeeming shareholder, a complete redemption of all of the shareholder's stock in the corporation, "not essentially equivalent" to a dividend, a partial liquidation of the distributing corporation, or a redemption to pay death taxes.

These rules work against family firms, which almost always are small firms. For instance, a redemption is "substantially disproportionate" if immediately after the redemption the ratio of the shareholder's voting stock (and common stock both voting and nonvoting) to the corporation's total outstanding voting stock is less than 80 percent of the ratio immediately before the redemption. Moreover, the shareholder must own less than 50 percent by vote of the corporation's total voting stock.[63] Under the constructive ownership rules set forth in Code § 302, an individual is considered as

[59] Code § 274(j)(3).
[60] Reg. § 1.274-3(2)(iv).
[61] The nondiscrimination rules here are specified in 1.274-3(d).
[62] Code § 302(e).
[63] Code § 302(b)(2)(B) and (b)(2)(C).

owning stock owned, directly or indirectly, by his spouse, children, grandchildren and parents.

To take an example, assume a father and son each owned 60 and 40 percent (respectfully) in Jones and Son, Inc. Since both father and son actually own 60 shares and 40 shares, they are *each* treated as owning all 100 shares. If they were unrelated partners, such as Jones and Smith, then Sanford could sell most of this shares and pay only capital gains taxes on the sale. If he sold the shares back to a family business so that the son could take control, he would be taxed on ordinary income and other tax items as if the amounts received were a distribution.

The result works against small firms in this way: it may be impossible for a family member to "redeem" a "substantially disproportionate" amount of stock, unless the company was large enough to ensure that his shares and that of his families did not total 50 percent of the company.

2. Solution

The attribution rules should not be applied to redemptions in family businesses. Family members should be treated no differently than unrelated parties.

II. Provisions that Favor Corporations – An Entity Favored by Large Firms

A. Section 1402 – Inclusion of Returns from Capital as Self-Employment Wage Base Income

1. Problem

Several years ago, a coalition of nearly 30 business organizations, from the National Small Business Association (NSBA) to the Securities Industries Association, complained about a proposed rulemaking under Internal Revenue Code § 1402(a)(13). The ruling ostensibly sought to "clarify" current law by "eliminat[ing] uncertainty" in determining the self-employment tax base for limited partners and limited liability company (LLC) members. However, the rulemaking would have achieved clarity by improperly subjecting the entire earnings of these small business owners to the self-employment wage base (i.e. to payroll taxes) if they either work for more than 500 hours in the business or the business is in a "service" sector industry. Hence, the proposal would have applied the 15.3 percent payroll taxes to returns on capital for many limited partners and LLC members.

The underlying motive for the rulemaking was called into question because it was proposed on the heels of a 1994 Clinton Administration legislative proposal to subject all the earnings of certain S Corporations to the Medicare component of payroll taxes to pay for the healthcare package. In that legislation, the Administration failed initially to recognize that subjecting capital returns of S Corporation shareholders to employment taxes was bad policy, but at least recognized that such a monumental change would have to be done through legislation.

After much hand-wringing, Congress eventually imposed a moratorium against final promulgation of the rulemaking at the insistence of the coalition. The coalition successful argued that the proposed regulation was unsound because the employment tax wage base was historically meant to be limited to wages and net earnings from self-employment, and not expanded to include returns on capital by business owners.[64] If the proposal were finalized, many LLC members, LLP partners, limited partners would have experienced an effective marginal tax increase of 2.9 percent.

There are two lingering problems. First, although the moratorium passed, it was a temporary stopgap measure that has now expired. Second, although the moratorium temporarily solved the problem for small firm owners that function through LLCs, LLPs and limited partnerships, the self-employed's income has always been fully subject to the SECA wage base. Of course, the self-employed should not be subject to self-employment taxes on their returns to capital any more than should an owner of an S Corporation. The self-employment tax (SECA) is a payroll tax, and as such, is correctly limited to reasonable returns for labor, as opposed to returns from capital or entrepreneurial risk. Whether or not a taxpayer should be subjected to SECA should,

[64] In initiating it in regulatory form, Treasury ignored many procedural requirements to protect small business.

in a correct analysis, depend upon whether or not the taxpayer's remuneration was in nature of compensation for services or for some other purpose. For instance, S Corporation owners pay SECA taxes only on reasonable compensation as do limited partners. Owners of generally larger C Corporations pay the comparable FICA tax (split between employer and employee) on reasonable compensation.

For no particularly good reason, the Treasury has imposed payroll taxes on the self-employed by eliminating any distinction between payroll and earnings from capital and entrepreneurial risk for the owners/operators of these firms.

2. Solution

The self-employed should be entitled to escape tax on returns on capital. The rules should be consistent among forms of entity. The moratorium should be made permanent.

B. Section 162(l) – Health Insurance Costs of Self-Employed Individuals

1. Problem

An age-old thorn in the sides of small business owners has been the disparity in the treatment of deductibility of health insurance costs. A self-employed[65] person is now able to deduct a share of their insurance costs for medical care for the taxpayer, his spouse and dependents. However, this amount is being phased in, and only 60 percent is eligible in 2001 and 70 percent in 2002. Only in the year 2003 and thereafter will all such costs be deductible.

It should be noted that this "victory" is muted by more than the slow phase in. First, there is required month-by-month test to determine if the self-employed person is eligible to participate in the plan of his or her spouse. The deduction is not permitted if the taxpayer is eligible to participate in a subsidized health plan. No deduction is allowed to the extent "that the amount of such deduction exceeds the taxpayer's earned income … derived by the taxpayer from the trade or business with respect to the plan providing the medical coverage."[66]

Perhaps most importantly, Code § 162(l)(4) provides that "the deduction allowable by reason of this subsection shall not be taken into account in determining an individual's net earnings from self-employment within the meaning of § 1402(a)." What does this provision mean? It effectively means that the health insurance deduction of a corporation will be allowed for purposes of the employee or employer share of FICA or Medicare tax (jointly known as the payroll taxes). However, the self-employed person is not eligible to deduct this amount against the net earnings from self-employment.

By way of example, let us assume that a corporate employer pays the $6,000 of health insurance in a year for an employee, who is also an owner. Assuming the

[65] Code § 401(c) defines a "self-employed individual" as one who, with respect to any taxable year, "has earned income."
[66] Code § 162(l)(2)(A).

nondiscrimination rules are met, the corporation gets a deduction of $6,000. If on the other hand the owner were self-employed, the deduction is allowable against income for income tax purposes only (not against net earnings from self-employment). The owner would have to earn effectively $7,084 in order to make a payment of $6,000 for self-employed health insurance costs. This is on top of the already disproportionately high and rising health insurance costs for the self-employed, where the working uninsured are more likely to be found.

2. Solution

Nothing is recommended on the income deduction side. The long battle and phase-out period would be over before Congressional action. However, we recommend allowing self-employed health insurance costs to be deductible for purposes of calculating self-employment income.

C. Meals and Entertainment Deduction

1. Problem

Section 162 of the Code – one of the key provisions that prevents the Code from being a gross receipts tax – allows a deduction for ordinary and necessary expenses in carrying on any trade or business. Under the rubric of this provision falls such basic deductions as salaries, traveling expenses and charitable contributions.

Section 274 (k), however, provides that the deduction for meals and entertainment is only allowable to the extent of 65 percent of the amount of such expense (increasing to 80 percent in 2008) for food and beverages consumed while away from home. If not consumed away from home, these expenses are deductible only to the extent of 50 percent of their cost. Apart from these limitations are tough substantiation and record-keeping requirements. Meal and entertainment costs are deductible only when they are "directly related" to the active conduct of a business or when they precede or follow a substantial bona fide business discussion.

The provision was obviously justified by the old claim of the "three martini lunch." Why should small firms be able to deduct a consumption item when they had the benefit of that consumption? The problem is that if many business owners had their preference, they would be spending time having lunch for lunch's sake. As much as they might enjoy the camaraderie and relationship with clients or prospective customers, they would actually prefer to reduce marketing costs and other incidental expenses that are necessary to, but precedent to, making money for the company. In other words, the only reason for business meals for small firms is that they are a basic form of marketing. This form of marketing is considerably more important to small firms.

In addition, if one is traveling away from home (and therefore has to incur additional costs for luggage handling, meals, tips, etc.), one would normally be entitled to an "IRS meal allowance" which provides a per diem allowance to avoid the onerous record-keeping requirements. The IRS permits this allowance as a way to approve a certain expenditure as deductible while away from home, usually about $30 per day. However, the allowance is unavailable to individuals owning more than 10 percent of the employer's outstanding stock. If self-employed, the deduction is claimed on Schedule C, where it is subject to the 50 percent reduction.

It is interesting to note as we are on this subject that the penalties for small firms are quite easily juxtaposed against the benefits for large firms. If a large firm has a company cafeteria, or a chef in the executive suites, that firm will not only be able to fully deduct the costs of providing those meals, but the employee will be allowed to exclude the value of those meals from income.

1. Solution

Congress should seek to provide balance between the treatment of on-site meals and entertainment functions of larger corporations and the necessarily different realities of smaller businesses. Also, Congress should give additional weight to the necessity of these marketing costs in small firms.

D. Section 170(e) – Charitable Contributions of Inventory Property

1. Problem

Not even charitable contributions are exempt from the disparity between small and large firms. When property is given to a qualified charitable donee, a charitable contribution is generally allowed to the extent of the property's FMV at the time of the gift, whether or not it has appreciated.[67] However, a gift of ordinary-income type property is limited to the FMV minus the amount of ordinary income or short term gain that would be declared if the property had been sold by the donor for its then FMV. For purposes of this restriction, ordinary income property is that property which, if sold by a donor at its FMV at the date it was created, would have resulted in some amount of gain other than long-term capital gain. Among the types of property considered ordinary income property are inventory items (property held for sale to customers), capital assets that are held for less than one year, depreciable property or business property (*e.g.* equipment). Therefore, the amount a non-corporate entity could deduct is essentially the basis of the inventory, either what it costs to buy or manufacture.

Notwithstanding this rule with respect to ordinary income property, C Corporations are afforded a significant advantage. A C Corporation that contributed inventory, property held primary for sale to customers in the ordinary course of its trade or business, or depreciable or real property used in its trade or business makes only half the required reduction for ordinary income property. There are certain restrictions placed on a C Corporation's utilization of this special provision. For example, the contribution must be to a Code § 501(c)(3) organization. Further, that organization must seek the care of the ill, the needy or infants, or the contribution must be of either computer technology equipment to elementary and secondary schools or scientific property to tax-exempt scientific research organizations or higher education institutions. However, the provision is of great advantage.

What the provision effectively means is that the government has provided a sort of monetary award for C Corporations beyond their mere donative intent. Let us take an example. Assume a hearing aid manufacturer were to contribute $10,000 of hearing aid equipment to a 501(c)(3) charity dedicated to the hearing impaired. It costs $4,000

[67] Reg. § 170(A)-1(c).

to manufacture the hearing aid, and this is the basis the company has in the assets. If the contribution were made by a sole-proprietor, an LLC, LLP, a partnership, limited partnership or S Corporation, that business would be able to deduct the basis in the inventory (what it pays for it). In other words, its after-tax benefit would be ($10,000 minus $6,000 (or $4,000)) times "x," where "x" is the tax rate to which it is subjected. However, if the business were a C corporation, by virtue of that fact alone, it could deduct ($10,000 minus (50 percent of $6,000)) times "x," where "x" is the tax rate to which it is subjected. Its deduction would be $7,000. If both companies had a 35 percent effective marginal tax rate, the value of the deduction would be $2,450 for the C Corporation and $1,400 for the non-corporate business (or S corporation).

Despite paying at the same tax rate, the advantage for the corporation is that it enjoys a tax benefit one-third as large as the non-corporate entity. However, there is also another way of looking at this. If the corporation had sold the inventory at the same tax rate, the corporation would have paid $2,100 in taxes for an after tax profit of $3,900. The unincorporated firm would have also paid $2,100 in taxes for an after-tax profit of $3,900. Hence the loss to the C Corporation from income it would have otherwise received was $1,450. The loss to the unincorporated firm was $2,300. The large firm was advantaged because it was able to lower its cost of giving, and enjoy a greater contribution from the public to encourage that giving and the public accolades that redound to its benefit.

2. Solution

Treat small manufacturers in the same manner as C Corporations, or repeal the special advantage provided C Corporations.

E. Section 165 – Fruitless Searches for Business

1. Problem

When a business searches for or investigates a new venture for purchase or merger there is a question about when it may deduct the expenses associated with that search. A corporation that makes expenditures may deduct them as a loss when it abandons the effort. However, an unincorporated taxpayer is generally precluded from deducting expenditures made in fruitless searching for or investigating a new business venture. An exception applies if the business of the corporation is locating or promoting new ventures. Additionally, once a taxpayer has focused on the acquisition of a specific business or investment, unsuccessful start-up expenses that are related to an attempt to acquire that business investment are deductible as business or investment losses.

There is also a disparity when expanding an existing business. Under § 195, start-up expenses must be capitalized unless the taxpayer chooses to amortize them over 60 months. These start-up expenses include investigating the creation, acquisition or establishment of an active trade or business,[68] creating an active trade or business,[69]or any activity engaged in for profit and for the production of income before the day the

[68] Code § 195(c)(1)(A)(i).
[69] Code § 195(c)(1)(A)(ii).

active trade or business begins.[70] Expansion of businesses are considered equivalent to start-up expenses, unless the taxpayer can show that the businesses contemplated and operational are "closely related" and the acquisition will not create distinct assets or change the nature of the taxpayer's activities. These standards are far more easily met in the event of a corporation whose charter is say, "to conduct any business lawful in Nevada," or similarly wide charge. Additionally, the very fact an organization is large makes it more likely say, for example, that wholesale and retail businesses will already merge. This is a distinction not based directly on size, but rather on the eclectic nature of the business lines which correspond with size.

Solution

Eliminate the distinction between C Corporations and other forms of entity.

[70] Code § 195(c)(1)(A)(iii).

III. Fringe Benefit Disparities

A. Reg. § 1.61-21(f) – The Use of "Commuting Value Method"

1. Problem

"Fringe benefits" are taxable compensation to the recipient if they are provided in connection with the performance of services by that person. A distinction is drawn here between compensation, and legitimate and largely *de minimus* benefits, for which an exclusion is justified.

How much must be included as a taxable fringe benefit as a general rule? In general, an employee who receives a taxable fringe benefit must include in gross income the FMV of the benefit minus: (1) payments for the benefit, (2) amounts specifically excluded by some Code provision.[71]

There are numerous fringe benefits that are effectively available only to large firms and their employees. One such benefit is a subsidy for transportation. Let us take an example of an employee who uses an employer's vehicle for *bona fide* but "noncompensatory" reasons, *i.e.* commuting. Under regulations,[72] the value of an employee's use of a vehicle, including an automobile for commuting purposes only, is considered by the IRS as $1.50 per one-way commute (e.g. from home to work or work to home). If there is more than one employee who commutes in a single vehicle, the commuting benefit is still $1.50 per one way commute for each employee. This means that the employee need only include $1.50 per one-way commute as the value of the compensation he or she receives for the use of the vehicle for going to and from work, even if he or she is the only occupant. Ironically, even if the commuting is by a chauffeur commuting to and from the corporate headquarters 80 miles away, the rule applies.

However, this method of evaluating the benefit received is not available to "control employees" (certain owner employees, higher-paid employees and directors).[73] Under the regulations § 1.61-21(f)(1)(ii), a "control employee" is an employee who is an elected officer with compensation greater than $50,000, a director of the employer, one who makes more than $100,000 or who owns a one percent or greater equity, capital or profits interest.

2. Solution

Eliminate the exclusion for "control employees."

B. Section 132(f) – Qualified Transportation Fringe Benefits

1. Problem

[71] IRC Reg. § 1.61-21(b)(1)
[72] §1.61-21(f).
[73] §1.61-21(f)(1).

There are other benefits that help larger employers lower labor costs and hire and retain their employees. Under a panoply of somewhat confused public policy incentives, an employee can exclude from income qualified transportation fringe benefits up to a specified dollar amount. For example, the value of transportation in a commuter highway vehicle is excludible if it is in connection with travel between the employee's residence and a place of employment (such a vehicle has to have seating capacity for 6 adults). The value of transit passes is also excludible. The law also excludes qualified parking at or near the employer's business premises.

These benefits are not truly "fringe," in the sense that they can involve significant amounts. For 2001 up to $180 a month of qualified parking and up to $65 a month of the combined value of transit passes and vanpools may be excluded. The $65 exclusion for transit passes and vanpools is to rise to $100 after 2001 and be adjusted for inflation thereafter.[74] If the employer pays the employee cash, who then uses the cash to buy transportation or parking, the employee will be fully taxed on the cash receipt.

Several exceptions limit the ability of small employers to avail themselves of these benefits. The self-employed cannot take advantage of the incentive. Also, no partner, 2 percent S Corporation shareholder nor independent contractor can exclude the value of qualified transportation fringe benefits.[75] On the other hand, the CEO of a multinational, publicly traded C Corporation can exclude such benefits.

2. Solutions

Eliminate the prohibition against business owners taking advantage of this incentive.

[74] Code § 132(f)(2)(A).
[75] Code § 132(f)(5)(E).

IV. Provisions That Benefit Firms Large Enough to Qualify

A. Section 119 – Meals at Employer-Operated Eating Facilities

1. Problem

If a small employer were to pay for the meals of an employee, the employee would have to pay tax on the FMV of those meals.[76] However, employees are entitled to exclude an amount that equals the value of the meal when eating at an employer's business premises. Specifically, Code § 119 provides that meals or lodging furnished to an employee and his family (spouse and dependents) is nontaxable to the employee if the meals and lodging are furnished by or on behalf of the employer for the convenience of the employer (e.g. meals supplied because eating places near work are scarce, or because employees must for valid business reasons remain on-premises until their shifts end),[77]and in the case of meals, they are consumed on the employer's business premises.

The exempted employees are determined to have paid an amount of the meal equal to the direct operating costs of the facility attributable to the meals, even though the meals are provided for free.[78] Direct operating costs are the costs of the food and beverages served and the labor of related services performed primarily on the facility's premises.[79] As an added benefit, if more than half of the employees to whom the meals are furnished are furnished them for the convenience of the employer, all meals are excluded regardless of their business purpose.

Of course, this particular provision does not limit itself to large firms. Small restaurants, for example, might take advantage of this rule because they have built-in food service facilities. However, the requirement that the meals be provided on the employer's business premises means that the only non-food service firms that could qualify are those large enough to have their own cafeteria. If General Motors has their own executive cafeteria, for example, it would be able to deduct the cost of food service to employees, their spouse and their children, and the employees would be able to exclude that benefit from their compensation no matter how often the benefit was received. If however, a worker of the Tiny Manufacturing Shop down the road, without a cafeteria, were to go to McDonald's, the price of the meal would not be deductible (and of course the income used to buy the meal would already have been taxed as compensation to the employee). If the small firm owner were to buy the McDonald's products for a picnic, that would be excludible, but only occasionally.

It should be pointed out that the eligibility criterion that "eating places near work are scarce" is a self-fulfilling economic policy. When small firm restaurants and eating facilities have to compete against tax-subsidized facilities within the large complex,

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[76] There is an exception for "occasional meals" and "supper money" paid to employees.
[77]Reg. §1.119-1(a)(2).
[78]Reg. §1.132-7(c).
[79]Reg. §1.327(b)(1).

they are unlikely to form. After all, the combined economic cost to an employee and employer of eating at an outside facility is clearly significant. The combined cost to the employer and employee of $10.00 of meals eaten on premises is $10.00. If the worker were to buy $10.00 of food off-premises, he would have to earn as much as $17.60.[80]

2. Solution

Eliminate the benefit provided for corporate cafeterias, or extend the benefit in the form of monetary allowance to small firm employees. For example, the law could provide that small firm employees are allowed to exclude $10.00 per day in meal costs when the meal is eaten in the geographical proximity for the benefit of the employer.

B. Section 132 – On-Premise Athletic Facilities

1. Problem

A close relative to the exclusion provided for on-premise meals, is the exclusion provided for on-premises athletic facilities. Under Code § 132(j)(4)(A), "gross income shall not include the value of any on-premise athletic facility provided by an employer to his employees." The term "on-premises athletic facility" means "any gym or other athletic facility which is … located on the premises of the employer, … operated by the employer … substantially all the use of which is by employees of the employer, their spouses and their dependent children."

As a result of this provision, the significant value of health club memberships is deductible to firms that are large enough to support the fixed costs of such a facility. Additionally, the employee's family can exclude the value of that facility from their income. Like the case of meals provided on-premises, this benefit raises the relative costs of a health club membership to a small firm employee or owner who is not able to deduct that service. Using our analogy, a taxpayer in a 28 percent tax bracket would have to earn $1,760 from a small business to buy a membership valued at $1,000, while the large firm's cost is $1,000. This not only creates different tax treatment depending on whether or not an employee works for a firm with an athletic facility with the concomitant federal benefit provided a large firm employee, but it disfavors the formation of small health clubs that could serve this function without subsidy. For instance, if a large firm were to contract out its health club to be run by a small firm, the large firm employees would have to include the value of those memberships in income despite the fact it is provided on the same basis to the large firm employees.

2. Solution

See above. Small employers should be able to exclude the cost of fitness facilities from the gross income of their employees as a fringe benefit.

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[80] A worker in a 28 percent tax bracket with 15.3 percent combined employee and employer payroll taxes, faces a tax-inclusive rate of 43.3 percent. That worker would need to earn $17.60 in order to have remaining $10.00 with which to buy lunch.

V. Accounting Issues

A. Tax Year Selection

1. Problems

Under the Code, a taxpayer's choice of a method of accounting is important for tax planning because the deferral of income or acceleration of loss can be a significant advantage. The old adage, "a dollar today is worth more than a dollar tomorrow," applies to the choice of a taxable year because the ability to defer recognition of income until a later year can postpone considerably the payment of taxes on that income. Over time, the value of that deferred tax payment can add up because of the time value of money (opportunity cost).

For this reason, it is to the advantage of a business to establish a taxable year that begins beyond the taxable year of its owners. A taxable year that begins on January 30, for example, means that income earned by the corporation can be deferred until after the end of the recipient's taxable year, which is normally a calendar year. Often taxpayers do not have much control over when they must take into income various items of income; however, the choice of a tax year, is one accounting method over which corporations do have control.

The same is not true for pass-through entities. A sole-proprietorship must use the same tax year as the proprietor, usually a calendar year. Thus a calendar year employee who later operates as sole-proprietorship must use generally that calendar year for the proprietorship.[81] An S Corporation must have a "permitted year," but this permitted year is generally a calendar year.[82] Unless a partnership can satisfy the IRS that there is a business purpose for a different tax year, a partnership must adopt the tax year of all its principal partners (5 percent or more partners),[83] the tax year of one or more of the partners having an aggregate interest in partnerships profits and capital of more than 50 percent,[84] or a calendar year. In most cases, this ends up being a calendar year. C Corporations are given considerably more leeway in establishing their taxable year, and may adopt any 12 month fiscal year.

2. Solution

All forms of entity should be able to elect fiscal years.

B. Reg. Section 6081 – Extensions for Filing Returns

1. Problem

By virtue of administrative fiat and Form 7004, a corporation can get an automatic six-month extension from its original due date. On the other hand, a partnership who filed an extension on Form 8800 can only qualify for an automatic three-month

[81] Code § 441.
[82] Code § 1378.
[83] Code § 706(b)(1)(B)(iii).
[84] Code § 706(b)(1)(B)(ii).

extension of time for filing the partnership return. The partnership rules apply to LLCs and LLPs and limited partnerships, which are creatures of state law. They are also the same rules that apply to sole-proprietors.[85]

2. Solution

Small firm owners should be granted an automatic six month extension as are corporations.

[85] Reg. §§ 1.6081(3)(d) and 1.6081-2.

VI. Costs of Compliance

1. Problem

No study on the disproportionate impact of tax laws would be complete without a discussion of what is perhaps the largest inequity – disproportionate compliance costs. Taxation gives rise to three main kinds of costs. There are distortions in resource allocation arising as individuals or enterprises respond to the tax structure, compliance costs, and administrative costs the government itself incurs in collecting revenue.

The first two costs are clearly the most important. While the economic costs of distortions are clearly present, they are difficult to quantify.[86] In a study conducted for the U.S. Small Business Administration,[87] "Taxes and the Choice of Entity for Small Business," Plesko studied the role that taxes play in organizational decisions. He found the U.S. tax code affects firms' decisions in employment, financing, investment and operations. This study provides empirical support for the role of taxes in firms' operations, showing that reaction to tax code changes occurs among firms of all sizes.[88]

The largest category of costs – compliance costs taxpayers incur as they fill in forms and make visits to tax offices – undoubtedly weighs more heavily on small employers. A new Tax Foundation study estimates that it costs individuals and businesses in the U.S. approximately $125 billion each year just to read the rules and fill out the forms necessary to comply with federal income tax laws. That comes to approximately a 12¢ compliance burden for every dollar the federal income tax collects.[89] Many substantial costs that are certainly part of the overall "compliance burden" were excluded from this estimate. For example, the productive value that people may have added to the economy if they had been working instead of filling out forms was excluded because

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[86] For example, the investment in a home today is highly leveraged. Mortgage interest payments are deductible against income for income tax purposes. When the home is sold the capital gain is forgiven on as much as $500,000 of that gain for a married couple filing jointly. In the case of a small business, the business is a capital asset that is taxed upon sale. Of course, since the income from that asset was also taxable, the business unlike a home is taxed twice: once on the appreciated value of the capital asset (which represents the capitalized value of the income stream) and once on the income stream. This means that homeownership is favored over investment in business.

[79]See, "Taxes and the Choice of Entity for Small Business, George A. Plesko, 1994, 93p. (Completed by George A. Plesko, 52 Richards Avenue, Sharon, MA 02067, under contract no. SBA-8037-OA-93; Order Number: PB95-239976 Cost: A06; A02 Microf.).

[88] Specifically, this study focused on the role of taxes in choosing between two different corporation entities-C corporations and S corporations-primarily explaining the tax rules surrounding S corporations. His results indicated that while S corporations have been a steadily increasing part of the U.S. tax code since 1958, changes brought about by the Subchapter S Revision Act of 1982 and the Tax Reform Act of 1986 fueled an explosive growth in their use. Since 1982, S corporations have been the fastest growing form of business-so much so that S corporations now account for nearly half of all corporations in the United States.

[89] Tax Foundation Background Paper No. 35 by economist J. Scott Moody.

estimating this "opportunity cost" was exceedingly difficult. The costs of the IRS, the Tax Court and all the litigation that taxpayers pay
for when in dispute with these institutions were excluded. The $125 billion annual figure, therefore, represents an incomplete estimate of the compliance burden the nation faces each year.[90] Other figures have been considerably higher.

Some work has been done in quantifying compliance costs and disaggregating these costs. The federal income tax is a grossly inefficient revenue system. In 1991, for example, the last year the cost of the system was examined in depth,[91] businesses spent three-fourths as much to comply with the tax laws as they paid in actual tax. The compliance burden is especially heavy on small corporations. Corporations with assets of $1 million or less (more than 90 percent of all corporations) paid a minimum of $382 in compliance costs for every $100 they paid in income taxes ($14 billion in compliance costs for $3.7 billion in income taxes). That represents about 90 percent of compliance costs for all corporations and about 4 percent of all corporate income taxes. Corporations with $250 million or more in assets paid about $3 in compliance costs for each $100 they paid in income taxes.[92]

In a 1988 study, Henry B. R. Beale (King Lin, Consultant) and others estimated that the average per unit cost increase for the smallest businesses was about 100 times that of the largest businesses due to IRS paperwork burdens.[93] Small corporations, including S Corporations, which they defined as businesses with 5 or fewer employees, were estimated to incur about ten times the IRS paperwork burden per employee of large corporations (an impact even more disproportionate if the small corporation files Form 1120). They found that partnerships incur seven or eight times the IRS paperwork burden per employee that large corporations do. Proprietorships

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[90] The study was based only on what the IRS estimates were the number of hours required to fill out each form, finding that taxpayers spend 4.3 billion hours in a year of income tax compliance. That is the equivalent of a work force of over 2,083,000 people, more than work in the auto industry, the computer manufacturing industry, the airline manufacturing industry, and the steel industry combined.

[91] The Internal Revenue Service is conducting a survey to measure the time and cost burden placed on business taxpayers in complying with federal income tax laws and regulations. The survey, sponsored by the IRS's Large and Mid-Size Business Division, includes a version for business taxpayers and one for practitioners. Approximately 2,500 taxpayers and 2,000 practitioners have been randomly selected from the IRS Business Master File to participate in the anonymous survey, says the online accounting resource. The survey seeks to gather information on businesses' costs related to outside preparation of tax forms and documents, as well as on the time and cost businesses spend on compliance activities within the company, according to the Web site. These may be associated with recordkeeping, purchase of tax software, internal preparation of tax forms and documents or any other income tax-related activity or product. According to Larry Langdon, commissioner, LMSB, the survey results will be used to identify areas where taxpayers' and practitioners' burdens may be reduced.

[92] Arthur P. Hall, "The Compliance Costs and Regulatory Burden Imposed by the Federal Tax Laws," Special Brief, January 1995, Tax Foundation.

[93] See, “Impacts of Federal Regulations, Paperwork, and Tax Requirements on Small Business,” by Microeconomic Applications, Inc., Washington, D.C. (Henry B. R. Beale, Principal Investigator; King Lin, Consultant. Completed under contract no. SBAHQ-95-C-0023 RESEARCH. Office of Advocacy No. 186 December 1998. U.S. Small Business Administration.);

incur about four times the IRS paperwork burden per employee (i.e. proprietor) that large corporations do. In fact, they estimated that corporations
which file Form 1120 must have net income of more than about $60,000 to generate tax revenues larger than the costs of the IRS paperwork burden. Other corporations, including S Corporations, must have net incomes in the $30,000 to $40,000 range before they generate tax revenues as large as their IRS paperwork burden. Proprietorships must have net incomes over $3,000 before they generate tax revenues as large as the IRS paperwork burden.

In a recent study entitled "The Impact of Regulatory Costs on Small Firms," W. Mark Crain of the Center for Study of Public Choice at George Mason University and Thomas D. Hopkins, Dean of the College of Business at Rochester Institute of Technology,[94] summarized one of a series of research papers on compliance. They found that since the November 1995 study commissioned by the SBA that showed disproportionate regulatory and paperwork costs, the environment for small firms had not changed. They projected the total costs of federal regulations to be $843 billion in 2000, of which $497 billion fell on business and $346 billion fell on consumers or other governments. For firms employing fewer than 20 employees, the annual regulatory burden was $6,975 per employee—nearly 60 percent more than firms with more than 500 employees, at $4,463. Looking just at tax regulations, firms with between 20 to 500 employees incurred per employee costs of $1,202, whereas firms with more than 500 employees incurred per employee tax compliance costs of $562. Tax compliance paperwork has a disproportionately large effect on small businesses when compared with other regulatory burden.

It should be noted that the incidence of these costs is still unknown. Many economists believe that small employers have greater difficulty passing these costs along, and therefore actually bear the costs applied to them. Larger employees can "push forward" these costs in the product prices, and therefore pass these costs forward on their small business and consumer customers. There are secondary effects as well. For instance, we have mentioned the effects of compliance costs on pension coverage. Most of the uninsured and most of those who undersave are in small firms because of the cost of complying with the tax laws.

2. Solution

Provide small firms a substantial tax credit for administrative costs, or make available IRS agents for field visits as "customer service" professionals to offer
free help in setting up plans and resolving tax questions.

[94] This study was also done for the U.S. Small Business Administration under contract SBAHQ-00-R-0027 (2001, 60 pages) Order number: PB2001-107067. Small Business Research Summary (ISBN 1076-8904)

VII. Overall Recommendations

Throughout this report, we have made specific recommendations under each problematic provision cited. However, rather than having this report solely tabulate the specific inequities, we suggest a systemic solution in the future.

In particular, we recommend that before any changes are made to the Internal Revenue Code, the Joint Committee on Taxation staff be required to prepare as part of their analysis an equity assessment. Under such an assessment, the staff would – in addition to providing a revenue estimate and a description of the legislation – show the distribution of the tax expenditure by employee by size of firm and assess whether there would be a disparate impact on businesses by size.

This idea has precedence of sorts. In the late 1980s, the R&E tax credit was overhauled to make it more available to small firms. Although many lobbyists sought simply another annual extension, the U.S. Small Business Administration examined the tax expenditure being sold on the Hill as critical for the wellbeing of small firms. What they discovered was that, while small firms were highly innovative per employee (more than twice as innovative than large firms in first-of-type innovations) the R&E tax credit was virtually unavailable to start-up firms. The credit was largely taken by large firms within particular industries.

Additionally, we can look to the Regulatory Flexibility Act (RFA) first introduced in 1981. The RFA and later the Small Business Regulatory Equity and Fairness Act (SBREFA) require Federal agencies to take the views and interests of small firms into consideration when promulgating regulations in order to try to ensure that costs imposed by rulemakings do not disproportionately injure small firms, small nonprofits, small towns and townships. If the Federal government can seek to abide by the RFA in the case of thousands of rulemakings issued each year, then the U.S. Congress can do so when legislating.

We would predict with a high degree of certainty that virtually all of the provisions we cited in this report (those benefits which small firms can avail themselves of), are skewed in favor of larger companies. When Congress undertakes a change in the tax laws, both the public and Congress should be better informed about how such changes are distributed. Requiring the JCT staff
to undertake this analysis is one way of doing so.

VIII. Conclusion

We are grateful for the opportunity to expose some of the inequities in the U.S. tax laws. When we began this project, we thought we would highlight a few, mostly well-known inequities, such as the seemingly interminable inequity between the deductibility of health insurance premiums for the self-employed versus C Corporations. Unfortunately, our investigation uncovered much more. What we found were dozens of sections of the Internal Revenue Code which, on their face, disadvantage small firms. There is little doubt that this is just the surface of the problem.

The root causes of these disparities are several. Many were borne of the need of Congressional staff to increase administrative efficiency, to bolster compliance or to reduce revenue costs. In the cynical eyes of the parsimonious policymaker, Congressional staffer or Treasury lawyer, a small firm owner who has the power to decide on a particular fringe benefit would also have a greater tendency to divert fringe benefits to the objects of their desire. Restrictions placed on the "highly-compensated" are a good case in point. "Highly-compensated" is not what the name implies. Those denied the advantages of tax provisions in small firms need not be earning any more than those with greater managerial responsibilities (and power to influence business decision-making) in larger firms who can take full advantage of the tax-leveraged benefits. Ironically, concern over abuse of intracompany inequity eclipsed consideration that the very efforts to ameliorate that abuse would create inequities across the entire economy. In truth, many small firms exist as a sort of extended family where owners and employees benefit alike from collaborative efforts.

Other provisions grant special advantages to C Corporations without any apparent rationale. One cannot look at the inequities in individual provisions without understanding that the totality of laws always grants advantages to larger firms because their per unit compliance and paperwork costs are less.

There is an importance to the inequities of U.S. tax laws that does not obtain with other government rules. When other government rules – from labor to environmental law – become too burdensome, small firms can avoid certain lines of business. However, no small business owner can avoid taxes. The omnipresence of taxes permeates the economy. When tax laws are inequitable, they stand as a monolithic economic barrier to small firms, and ultimately reduce the benefits they can provide to the economy at large – entrepreneurs, workers and consumers.

There is a special irony to the development of tax inequities. Few policymakers allow an opportunity to pass without criticizing the Internal Revenue Code, and lamenting its unfairness. Treasury Secretary Paul O'Neill called the system an "abomination."[95] In 1976, President-to-be Jimmy Carter called for a "complete overhaul of our income tax system," declaring it, "a disgrace to the human race." Albert Einstein considered it "the hardest thing in the world to understand."[96] Author John Grisham stated, "It's a

[95] "O'Neill Lays Out Vision for Tax," Financial Times, May 18, 2001.

[96] He said, "This [preparing my tax return] is too difficult for a mathematician. It takes a philosopher."

game. We [tax lawyers] teach the rich how to play it so they can stay rich – and the IRS keeps changing the rules so we can keep getting rich teaching them."

Even fewer miss the opportunity to liberally sing the praises of small firms. "Small firms are the engine of the economy," "they create the most jobs," "they symbolize the American spirit." These are common soap-box expressions.

Those who espouse the virtues of small firms are not wrong, of course. According to the SBA, in 1997 small businesses represented over 99 percent of all employers, created nearly all of the new net jobs and accounted for 51 percent of the private sector output. Further, the SBA estimates that small businesses employ 53 percent of the private sector work force. More importantly, many of the tax expenditures are directed towards remedying social problems that are disproportionately present in small firms.

In researching and writing this seminal report, it was our hope that policymakers might become more aware that – far from being advantaged – achieving equity in the tax laws is something of an afterthought for small firms. We urge policymakers to use their willingness to help small firms, and their often expressed understanding of the unfairness of tax laws, to right these wrongs. Exposing and understanding the inequities among businesses should not be an academic exercise. In a longer term sense, we also call upon policymakers to look at the processes by which these inequities become law. Future disparities should be avoided before they are engrafted into the thicket of America's tax laws.