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A GILTI Fix for an Employment Tax Glitch

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I. INTRODUCTION

Most Americans who have ever held a job probably know that the paycheck they receive does not contain the full amount that they earn for their work. Instead, their earnings have been reduced to reflect a number of items, including taxes. The federal government requires an employer to withhold two types of tax: income tax and employment tax. A worker can frequently adjust the amounts that get withheld in income tax. These adjustments will simply affect the size of the refund they receive or the payment they must make when they file their annual income tax return. However, there is no way for a worker to adjust the employment taxes that are taken out of their pay. They are a nonnegotiable obligation that comes with the privilege of earning a wage.¹

The employment tax system does not operate in such a rigid and inflexible way, however, for individuals who are self-employed. Rather, the system permits many of them to control how much of their earnings are subject to tax.² In tax circles, we call that amount the tax base. And the tax savings can be quite dramatic for someone who can successfully remove a substantial amount of their earnings from the employment tax base. Two prominent cases will illustrate this point.

In 2004, John Edwards was a top contender for the Democratic nomination for president.³ At the time, he was a U.S. senator from North Carolina.⁴ However, before entering public office, he earned millions as a self-employed trial lawyer with a firm that bore his name.⁵ In 1997 alone, his earnings exceeded $26 million, while his tax returns showed that he avoided

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² See discussion infra Sections III.B–C.


⁴ Id.

roughly $600,000 in employment tax on his earnings between 1995 and 1999.\(^6\)
He accomplished this by causing his firm to pay him an annual salary of $360,000, while receiving the rest of his earnings as a distribution of profits from the firm.\(^7\)
In other words, he artificially reduced his tax base by choosing to underpay himself for the work he did for himself. He still had access to the rest of the money he earned. He just withdrew it from the firm as a dividend instead of as a wage, which did not trigger any employment tax.

This is an equal opportunity technique that both Democrats and Republicans have exploited. During his 2012 campaign to be the Republican presidential nominee, Newt Gingrich released his tax returns. They showed that he was the sole owner of two companies, both of which paid him compensation that was a fraction of what he earned through them for writing books and giving speeches.\(^8\) He paid employment tax on the amounts he received as compensation.\(^9\) However, he avoided $69,000 in tax on the amounts he received as a dividend.\(^10\) Neither Gingrich nor Edwards had to pay back taxes, but their political images suffered.

These two cases drew enough attention to this tax avoidance maneuver that it has become known as the Gingrich-Edwards Loophole.\(^11\) The technique is one specific example of the options that self-employed individuals have to limit what they pay in employment tax. The other options are variations of the same theme: The taxpayer operates a business through a company that they own and control, and the company pays a fraction of its earnings to the taxpayer as compensation for their work while allowing the taxpayer to access the lion’s share of the profits as a distribution of profits.\(^12\)

The Gingrich and Edwards cases might be extreme examples where most fair-minded individuals would agree that the two presidential candidates

\(^6\) Id.
\(^7\) Id.
\(^9\) See Koba, supra note 5.
\(^10\) Id.
\(^12\) See discussion infra Sections III.B–D.
should have been required to include more of their earnings in their employment tax base. However, it might be more difficult to say how much should count and how much, if any, should be exempt. For Gingrich and Edwards, one could imagine a rationale for including all of it. After all, the earnings derived by their firms were almost entirely a product of their labor. Therefore, it would seem to exalt form over substance to pretend that the amounts they received as a distribution of profits should be excluded from their employment tax base. Those amounts were earnings from work just as much as the paycheck an employee receives from an unrelated employer.

In fact, the employment tax statutes are intended to tax earnings from work. Unfortunately, when the individual doing the work is self-employed, it can be difficult to isolate the earnings derived from the individual’s labor as opposed to the returns on any capital that the business might require. Consider self-employed plumbers. They could not ply their trade unless they had a vehicle to drive from location to location along with their equipment. In the absence of a vehicle and other business assets, we would expect their earnings to be close to zero. So, those assets play an essential role in helping the business generate profits. The question is, how big of a role?

If the plumber chose to purchase any of the property used in the business, the cost of the property should offset any revenues generated over the time the asset is used in the business. Accounting and tax rules already accomplish this through the technique of depreciation.

13. See Koba, supra note 5; Novack, supra note 8.


that the property played in generating profits. The answer has important implications if the employment tax rules hope to impose a tax on labor and nothing else. Every dollar in profits that is attributable to capital investments reduces the profits that would be attributable to the labor of the owner.  

Unfortunately, existing employment tax statutes make no effort to differentiate the returns on capital and labor on any principled basis. Instead, the statutes produce largely arbitrary outcomes. At one extreme, some individuals, like Gingrich and Edwards, can limit their tax base to obscenely low amounts that bear no resemblance to the contribution that their personal efforts played in producing the income. Taxpayers typically enjoy this flexibility if they operate through a business entity, like a partnership, limited liability company, or corporation. At the other extreme, individuals who operate as sole proprietors have no flexibility whatsoever, causing their employment tax base to include virtually all the profits from their business, even though their business may require a substantial capital investment. So the employment tax laws simultaneously require some individuals to overstate their tax base while permitting others to understate theirs.

What’s more, the inequities favor the wealthy. Income derived from a business accounts for an increasing share of an individual’s total income as one moves up the income ladder. A recent analysis based on tax returns from 2017 shows that income from a business accounts for over 25% of the income of taxpayers whose adjusted gross income (AGI) exceeds $1 million. For those whose AGI falls between $200,000 and $1 million, business income accounts for roughly 15% of the total. By comparison, for all other

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17. The analysis would be different if the plumber leased the property used in the business. In that situation, any revenues would be offset by the lease payments and any other business expenses. I.R.C. §§ 63, 162. The residual profits would necessarily represent the earnings from the plumber’s labor because every other factor of production has been accounted for as an expense.

18. See discussion infra Part IV.

19. See generally Cong. Budget Off., supra note 15 (describing how the employment tax base includes some capital income, while the base excludes certain labor income).


21. See infra note 58 and accompanying text.

22. See discussion infra Part III.


24. Id.
taxpayers, business income accounts for no more than 5% of their total income. This pattern is magnified at the highest levels of income. Another study based on data from 2014 returns showed that business income accounts for almost half of the income of individuals in the top 0.1%, compared to roughly 30% for individuals at the top 1%. Therefore, for high-income taxpayers, business income is a more significant component of total income—both as a share of total income and in absolute terms. More significantly, approximately 75% of business income reported by these high-income taxpayers actually represents income attributable to the work that the owner performs for the business. That is because they operate through a formal business entity that permits them to do what Gingrich and Edwards did: disguise their labor income as business profits. By comparison, less sophisticated, lower-income individuals are much more likely to earn business profits as sole proprietors, making them obligated to treat all their profits as labor income. In short, the more flexible rules mostly benefit high-income taxpayers, while the inflexible rules mostly penalize low-income taxpayers. Therefore, until the employment tax rules are reformed, they will enable the rich to get richer faster, helping to expand the gap separating the haves and the have nots.

These inequitable outcomes would not occur if it were possible to isolate the returns on labor from the other profits derived by a self-employed individual. However, it is unrealistic to expect that any mechanism will precisely isolate such amounts. Nevertheless, that should not deter policymakers from attempting to devise a mechanism that will be an improvement over the current situation, even if it falls short of absolute perfection. The 2017 Tax Act did nothing to alleviate this situation.

25. Id.
26. Matthew Smith et al., Capitalists in the Twenty-First Century, 134 Q.J. ECON. 1675, 1690 fig.I(B), 1691 (2019). The figures represent profits from all business firms, including C corporations, S corporations, partnerships, and sole proprietorships. Id. at 1685.
27. Id. at 1721. In order to measure the amount of labor income included in the owner’s profit share, the researchers compared a firm’s profits immediately before and after the premature death of an owner or the retirement of an owner. Id. at 1710–21.
28. Id. at 1684; see also infra notes 66–108 and accompanying text.
29. See, e.g., Darrell Zahorsky, The Pros and Cons of a Sole Proprietorship, BALANCE SMALL BUS., https://www.thebalancesmb.com/sole-proprietorship-the-right-business-structure-2951775 (last updated Dec. 10, 2018) (noting the low-cost and simplified management requirements of starting a sole proprietorship); see also infra note 58 and accompanying text.
Initially, the drafters included a provision that would have limited the employment tax base to amounts determined to represent the labor income of self-employed individuals.\textsuperscript{31} That same provision also would have eliminated the discretion that such taxpayers now have to reduce their employment tax base. Unfortunately, the provision was removed at an early stage of the legislative process and never reappeared in any form.

Yet, the 2017 Tax Act included another provision that might serve as a framework for future efforts to isolate labor income for employment tax purposes. Known as the GILTI tax, this new provision is designed to prevent companies from avoiding U.S. tax on income generated by foreign affiliates.\textsuperscript{32} Although the acronym stands for Global Intangible Low Taxed Income, the tax does not require the foreign affiliate to own any intangible assets. Instead, the statute merely seeks to determine the profits that are subject to U.S. tax and the profits that are exempt from U.S. tax. Under the statute, the exempt portion is the amount attributable to a 10% return on the adjusted tax basis of the affiliate’s investments in tangible business property.\textsuperscript{33} All profits exceeding that amount are subject to U.S. tax.\textsuperscript{34} As a practical matter, the 10% return is the statute’s way of answering the following question: How much did the foreign affiliate’s capital investments contribute to the firm’s profits? The GILTI rules assume that the contribution is equal to 10% of the adjusted tax basis of such property.

The capital investments made by a foreign affiliate of a multinational enterprise are comparable to the capital investments that a self-employed individual might make in their business. The only difference is that the residual profits will represent something different in each context. For a multinational enterprise, the GILTI statute treats the amount as intangible income that is subject to U.S. tax. In the self-employment context, such residual profits will represent the business owner’s labor income. For this reason, the GILTI rules might inform a set of reforms that would cause self-employed individuals to determine their employment tax base in a more consistent and principled way.

This Article will describe in greater detail the basic contours of such a reform. Before doing so, Part II describes the existing employment tax rules, focusing on the various ways they apply to a self-employed individual. Part

\begin{itemize}
\item \textsuperscript{31} See infra notes 159–170 and accompanying text.
\item \textsuperscript{32} I.R.C. § 951A (2018).
\item \textsuperscript{33} I.R.C. § 951A(b)(2)(A).
\item \textsuperscript{34} I.R.C. § 951(b)(1).
\end{itemize}
III explains how certain self-employed individuals can use the rules to limit their employment tax base and the tax they owe. Part IV describes the distortions and inequities that are produced under the current employment tax rules. Part V recounts legislative efforts to isolate labor income and shows how those efforts came to bear fruit in the GILTI rules and elsewhere in the 2017 Tax Act. Part VI describes a framework for reform inspired by the GILTI rules. Part VII concludes.

II. THE EMPLOYMENT TAX SYSTEM AND THE SELF-EMPLOYED INDIVIDUAL

The rules for computing the employment tax base for a self-employed individual will depend on the tax classification for the business. That classification will partly depend on the state law business form that someone uses to operate their business.

A. Business Forms and Tax Classifications

State law generally offers the following four options for conducting a business: the sole proprietorship, the limited liability company (LLC), the corporation, and various forms of the partnership. If a self-employed person is the only owner, the menu of options consists of the sole proprietorship, the LLC, and the corporation. In situations where the individual has a business partner, the menu consists of the partnership (and its variations), the corporation, and the LLC.

Each state law business form has a default tax classification. Nevertheless, in many instances, the owners of the business can choose a different tax classification. The firm’s tax classification will dictate which set of employment tax rules will apply to the firm's owners. The relevant tax classifications are the C corporation, the S corporation, the partnership, and the disregarded entity. Any firm that is incorporated under state law is a C corporation by default, but the owners can elect to classify the firm as an S corporation if certain conditions are met. Any state law partnership is

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35. The tax classification will also dictate the extent to which the firm’s profits are subject to the income tax. The profits of a C corporation are taxed to the firm when earned, and again to the shareholders when they receive the profits as a dividend. See I.R.C. §§ 11, 61(a)(7). In every other case, each owner of the firm is taxed on their share of the firm’s profits, whether they receive an actual distribution or not. Id. §§ 702 (partnerships), 1366 (S corporations), 61(a)(2) (disregarded entities). The firm itself pays no tax on its profits. Id. §§ 701 (partnerships), 1363 (S corporations).

classified as a partnership for tax purposes by default. However, the owners can elect to classify the firm as either a C corporation or an S corporation for tax purposes. The options for LLCs depend on whether the company has only one member or not. A single member LLC is disregarded for tax purposes. However, it can elect to be classified as a C corporation or an S corporation. A multimember LLC is classified as a partnership by default. But it can elect to be classified as a C corporation or an S corporation. The sole proprietorship is disregarded for tax purposes. It is the only business form that cannot choose a different tax classification. The remainder of this Article will refer to businesses by their tax classifications.

B. The Employment Tax Statutes

The U.S. has two separate employment tax regimes: the Federal Insurance Contribution Act (FICA) and the Self-Employment Contribution Act (SECA). Both statutes impose two separate taxes. The first is a 12.4% tax earmarked to finance the social security program. The second is a 2.9% hospital insurance tax, which raises funds to support the Medicare program. There is a limit on the amounts that are subject to the social security tax. Known as the contribution and benefit base, it is fixed at $142,800 for 2021.

1363(a) (2005) (the S corporation election).
38. Id. § 301.7701-3(a) (the C corporation election); I.R.C. §§ 1362(a)(1) (2018), 1363(a) (2005) (the S corporation election).
40. See supra note 38.
42. See supra note 38.
43. By regulation, only those unincorporated business ventures involving more than one person constitute a separate business entity for tax purposes. Treas. Reg. § 301.7701-1(a)(2) (2019). As a result, a sole proprietorship is not a separate business entity in the eyes of tax law because it is an unincorporated business venture undertaken by only one person. See Treas. Reg. § 301.7701-1(a)(2) (providing examples of when ventures qualify as separate business entities).
44. See 26 U.S.C. §§ 3101 (2018), 1401(a) (detailing FICA and SECA, respectively).
Any amounts above that limit are exempt from the tax. The contribution and benefit base is adjusted each year to reflect increases in the average wages of the U.S. economy. The SECA and FICA taxes are coordinated so that the social security tax will never apply to an amount exceeding the contribution and benefit base in effect for any year. By operating in this way, the rules ensure that anyone whose income includes earnings from multiple sources will not be at a disadvantage compared to someone who does not.

Unlike the social security tax, the Medicare tax is imposed on an individual's entire employment tax base. Moreover, starting in 2013, in order to help pay for Obamacare, an additional 0.9% Medicare surtax has also applied to the extent the taxpayer’s income exceeds certain thresholds. For a married couple filing a joint return, the threshold is $250,000, for unmarried individuals, it is $200,000, and for married individuals filing a separate return, it is $125,000.

FICA is the original statute that Congress enacted to fund the social security program. It generally covers anyone who works as an employee. Congress passed SECA later when it wanted to extend social security coverage to certain self-employed individuals. However, there are two instances when FICA—not SECA—determines the employment tax liability of a self-employed person: when the business is conducted through a C corporation or an S corporation. The tax law treats those firms as separate legal entities that are distinct from their owner, even if they are wholly owned by one person. In the employment tax context, this means that an individual

48. However, as a candidate for President, Joseph Biden proposed imposing the tax on earnings above $400,000, in addition to the amounts below the contribution and benefit base. See, e.g., Melanie Waddell, Biden’s Plan Would Create Payroll Tax ‘Donut Hole,’ THINKADVISOR (Sept. 16, 2020, 11:20 AM), https://www.thinkadvisor.com/2020/09/16/biden-plan-payroll-tax-donut-hole/.


50. See I.R.C. §§ 1402(b), 3121(a) (2018). Thus, for example, if an individual has $150,000 of wages from employment in 2021, the FICA social security tax would apply to the first $142,800, leaving nothing earned as self-employment income subject to the tax. See I.R.C. § 3121(a). Alternatively, if an individual has $40,000 of wages in 2021, the entire amount would be subject to the social security tax, while up to $102,800 of self-employment income would be subject to the social security tax under SECA. See I.R.C. § 1402(b).


52. I.R.C. § 1401(b)(2)(A) (SECA), 3101(b)(2) (FICA).

53. Id.

54. Id. at supra note 14, at 70–72.

55. Id. at 72–73.
who works for a corporation that they own is treated as an employee of the firm, even if there are no other shareholders. Such an employee–owner will be subject to employment tax solely on amounts they receive as wages from the firm, just like anyone who works for an unrelated employer.\textsuperscript{56}

The employment tax base is determined in a different way under SECA, which applies to any self-employed individual engaged in business through a partnership or a disregarded entity. The SECA tax base is referred to as net earnings from self-employment (NESE).\textsuperscript{57} If the firm is disregarded, NESE includes all the profits derived by the business, other than certain items of passive income, like certain rentals from real estate, corporate dividends, interest, and gains from the sale of capital assets.\textsuperscript{58} In other words, the statute essentially assumes that all of the active business profits are attributable to the owner’s labor, even in situations where the business requires a combination of labor and capital.

In the case of a partnership, however, SECA uses two different methods to determine someone’s tax base, depending on whether the owner is a general partner or a limited partner in the firm. The tax base of a limited partner consists solely of amounts they receive as “guaranteed payments” for their work.\textsuperscript{59} This is roughly analogous to amounts that would qualify as wages under FICA. A limited partner is not subject to employment tax on any amounts that are earmarked for them as a distributive share allocation of the firm’s profits.\textsuperscript{60} There is a historical explanation for this rule. When it was adopted, limited partners were expected to be passive investors who ran the risk of losing their liability protection if they played an active role in managing the firm. Thus, their profit shares generally would not represent any form of compensation for their work.\textsuperscript{61} Rather, to the extent they performed any services for the firm, a limited partner would have been specifically compensated for doing so. The guaranteed payment was expected to capture that. Even though most state laws now permit limited partners to play active roles in the firm without jeopardizing their liability protection, the tax rules have not been updated to reflect this change.

If someone is a general partner in a partnership, their employment tax

\textsuperscript{56} I.R.C. §§ 3101(a), 3111(a) (2018).
\textsuperscript{57} I.R.C. § 1402(a) (defining “net earnings from self-employment”).
\textsuperscript{58} Id. §§ 1402(a)(1)–(3).
\textsuperscript{59} I.R.C. § 1402(a)(13).
\textsuperscript{60} Cf. id.
\textsuperscript{61} See Fritz, supra note 14, at 830–31 (citing sources).
base consists of both their distributive share allocation of the firm’s profits (other than the same passive items that are excluded from the tax base of a sole proprietor) and any guaranteed payments that they are entitled to receive.62 This parallels the way sole proprietors are treated; everything counts as income from labor, even in situations where the business entails a combination of both labor and capital.

III. OPTIONS TO CONTROL THE EMPLOYMENT TAX BASE

Both FICA and SECA are intended to impose a tax on income from labor, as opposed to any returns on capital.63 Yet, when someone is self-employed, the statutes almost never operate that way for two reasons. For some taxpayers, the statute rigidly requires them to treat virtually all their business profits as labor income. For other taxpayers, the statute permits them to artificially limit what counts as labor income. These glitches are best understood by considering each business classification in turn.

A. Disregarded Entities

Sole proprietors and single member limited liability companies are disregarded as separate entities for tax purposes. When a taxpayer operates a business in one of these ways, their employment tax base will include all the income derived by the business other than certain items of passive income.64 Because there is no way to modify that outcome, the tax base will necessarily include the returns on any capital invested in the business, making it overinclusive.

B. C Corporations

The FICA tax will apply to a self-employed individual when that person operates a business that is classified as a C corporation.65 In that situation, only amounts that the firm pays to the employee–shareholder as remuneration for employment count as “wages” from employment.66 The tax base simply

62. I.R.C. §§ 1402(a), 1402(a)(13).
63. Dilley, supra note 14, at 74.
64. I.R.C. §§ 1402(a)(1)–(3).
65. See supra note 56 and accompanying text.
66. I.R.C. § 3121(a); see also Rev. Rul. 59-221, 1959-1 C.B. 225.
will not include the individual’s share of any other profits of the business, including dividends or undistributed earnings, even if those amounts solely represent the product of their labor. Moreover, these items will not be subject to SECA either.67

Because FICA limits the tax base to amounts received as ‘wages,” self-employed individuals operating through a C corporation can control their employment tax liability. They can decide whether they receive a wage, how much they receive, and when they receive it. That enables them to control whether they pay any FICA tax, how much they pay and when they must do so.

Not only is there an opportunity to understate the earnings that are attributable to one’s labor, there is also an incentive to do so when one operates through a corporation. Prior to the changes introduced by the 2017 Tax Act, there was an incentive for a C corporation to understate the compensation it paid to employee–owners when the firm was subject to tax at the lowest marginal rates and to overstate it when the firm was subject to tax at the highest marginal rates.68 The 2017 Tax Act replaced the marginal tax schedule on corporate income and replaced it with a flat rate of 21%.69 The legislation also modified the marginal tax rates that apply to individuals.70 The combined changes have made the C corporation a more attractive tax avoidance vehicle for self-employed persons.71 These individuals will continue to be better off in at least two scenarios. One option is to withdraw the earnings as a dividend. The combined tax on such a payment will be lower than the combined tax on a payment structured as wages.72 The other option is to simply allow the earnings to remain with the firm.73 That would limit the

70. See id. § 1(j).
71. One team of scholars went so far as to quantify the number of firms that would reclassify themselves as C corporations. See Penn Wharton Budget Model, Projecting the Mass Conversion from Pass-Through Entities to C-Corporations 1, https://budgetmodel.wharton.upenn.edu/issues/2018/6/12/projecting-the-mass-conversion-from-pass-through-entities-to-c-corporations (last updated June 13, 2018).
73. See David Kamin et al., The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation, 103 MINN. L. REV. 1439, 1454 (2019).
tax to the 21% corporate tax without triggering any income or employment taxes that would apply to amounts that the firm transfers to its owners.

As a technical matter, if the corporation pays someone for work, the law requires that any compensation they receive be “reasonable.” However, that requirement has an important limitation. It has never been used to create a payment that the firm never made to a worker. Therefore, it fails to restrain a self-employed person who refuses a salary and simply allows the firm’s earnings to remain in the firm. At most, the reasonable compensation requirement permits the government to assert that a payment structured as a corporate dividend should be treated as wages for income and employment tax purposes. However, because the government is in no position to audit every tax return filed by a closely held corporation, the vast majority of these cases are left undetected and unprosecuted. In the rare instance when a business is selected for audit, the government must engage in a complex inquiry into the facts and circumstances of each case, draining scarce resources and sometimes leading to costly litigation.

Even when it does pay compensation to an employee–shareholder, a C corporation can also limit the employment tax liability if it pays careful attention to the timing of the payment. Because compensation in excess of the FICA contribution and benefit base is exempt from the OASDI component of the tax, employment taxes can be saved by compressing multiple years’ compensation into a single year. Therefore, even when the employment tax is triggered, the tax liability can be managed and controlled by the individual who owns and controls the corporation that employs him.

C. S Corporations

A shareholder–employee of an S corporation exercises the same power to

76. “The examination rate for individual returns declined from 1.1 percent to 0.6 percent from 2010 to 2018,” with the largest declines occurring at the high end of the income spectrum. Congressional Budget Office, Trends in the Internal Revenue Service’s Funding and Enforcement 11 (July 2020), https://www.cbo.gov/publication/56467. The examination rate for corporate returns declined from 1.4 percent to 0.9 percent during the same period. Id. at 12. See also Roberts, supra note 72, at 167 (explaining how the IRS lacks the funds to audit every corporation).
77. E.g., Charlotte’s Off. Boutique, Inc., v. Comm’r Internal Revenue, 121 T.C. 89, 91 (2003) (holding that royalties paid to sole shareholder–employee should be treated as wages subject to FICA tax), aff’d, 425 F.3d 1203 (9th Cir. 2005).
control their employment tax base as does their C corporation counterpart. They can simply minimize or eliminate the wages they receive from the firm. However, the incentive to do so is even stronger in the case of an S corporation. Unlike a C corporation, an S corporation is not subject to tax on its earnings.\textsuperscript{78} Instead, each owner pays tax on their share of the firm’s profits, whether they receive any or not.\textsuperscript{79} Thus, actual distributions of profits are generally tax free to the recipient, while any wages paid by the firm will reduce its profits dollar for dollar.\textsuperscript{80} Both profits and wages are subject to income tax at the marginal rates, which range from 10\% to 40.8\%.\textsuperscript{81} However, the wages will trigger the employment tax, while the profit shares will not.\textsuperscript{82}

In other words, there is never a financial incentive for an S corporation shareholder–employee to receive a wage as compensation for their work.

Prior to the 2017 Tax Act, there was overwhelming evidence that S corporations grossly understated the compensation paid to controlling owners with alarming frequency. In 2006, 56\% of S corporations had one shareholder, while another 28\% had two shareholders.\textsuperscript{83} These closely held firms routinely paid nothing to their officers in the form of compensation. For single shareholder S corporations, the rate was 58\% in 2005, while the rate was 29\% when the corporation had two shareholders.\textsuperscript{84} A separate study from 2000 revealed a similar pattern. In that year, “78.9 percent of all S corporations were either fully owned by a single shareholder (69.5 percent) or more than 50 percent owned by a single shareholder (9.5 percent).”\textsuperscript{85} When the corporation had only one owner, the average salary paid out to the owner equaled only 41.5\% of firm profits.\textsuperscript{86} More recent studies show that the situation has not improved. In a study of S corporation returns for 2013, 30\% of the firms reported no form of compensation expense to the owners or to anyone else.\textsuperscript{87} Moreover, owner compensation has accounted for a decreasing

\begin{footnotesize}
\textsuperscript{78} I.R.C. § 1363(a) (2018).
\textsuperscript{79} Id. § 1366.
\textsuperscript{80} Id. §§ 1368 (distributions), 162(a) (deductions).
\textsuperscript{81} Id. §§ 1(j) (income tax), 1411 (Medicare surtax).
\textsuperscript{82} See id. §§ 3101(a), 3111(a).
\textsuperscript{83} 1 NAT’L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS 313, chart 1.20.7.
\textsuperscript{84} Id. at 314, chart 1.20.8.
\textsuperscript{85} TREASURY INSPECTOR GEN. FOR TAX ADMIN., ACTIONS ARE NEEDED TO ELIMINATE INEQUITIES IN THE EMPLOYMENT TAX LIABILITIES OF SOLE PROPRIETORS AND SINGLE SHAREHOLDER S CORPORATIONS 3–4 (2005).
\textsuperscript{86} Id. at 5.
\textsuperscript{87} Susan C. Nelson, Paying Themselves: S Corporation Owners and Trends in S Corporation Income, 1980–2013 8–9, fig.1 (Dep’t of the Treasury, Off. of Tax Analysis, Working Paper No. 107,
\end{footnotesize}
share of the amounts that the owner receives from such firms. In the early 1980s, officer compensation accounted for 80% of their total income from the firm. Since 2010, that figure has been below 40%.

There is very little to constrain S corporations from underpaying their controlling owners. The reasonable compensation requirement, which at least theoretically permits the government to attack dividends as disguised compensation in the C corporation setting, is impotent if an S corporation simply retains its earnings. In cases where the firm makes a payment that is not structured as compensation, the government could try to recast the payment as disguised compensation. Unfortunately, as in the C corporation context, the government is ill-equipped to perform the kinds of audits that would help detect all potential instances of disguised compensation. As a result, the vast majority of these cases probably go unchallenged. The few that are caught have the potential to draw the government into protracted litigation, putting further pressure on the government’s limited resources.

The changes introduced by the 2017 Tax Act did not materially alter an individual’s incentive to use an S corporation to avoid employment tax. The most significant change is that the owners of an S corporation can claim a deduction equal to 20% of their share of the firm’s business profits net of any compensation paid to the owners. The amount of the deduction is determined under a complex procedure that partly depends on the amount of compensation that the firm pays. But it has two opposing impacts. On the one hand, any wages will offset the firm’s business profits, reducing the

88. Id. at 16 fig.6.
89. Id.
90. Id.
91. See supra notes 74–77 and accompanying text.
amount of the deduction. On the other hand, for certain high-income taxpayers, the amount of the deduction is subject to a limit that is partly based on the amount of wages paid. So, more wages can also translate into a larger deduction. One scholar has determined that the net effect of these two opposing pressures is an incentive for employee–owners to receive wages equal to two-sevenths of business profits. Below that point, each additional dollar of compensation generates tax savings that exceed any tax liability, while above that point, each additional dollar of compensation triggers a tax liability that exceeds the tax savings. In either case, the employment tax base will not reflect the actual amount of labor income attributable to the owner in any meaningful way.

D. Partnerships

Under current law, a partner’s exposure for the self-employment tax is purely a function of the nature of the interest the partner owns in the partnership. For general partners, the tax base consists of the partner’s entire share of partnership income other than certain items of passive income. The tax will also apply to any guaranteed payment the partner receives from the firm. For a limited partner, the tax base consists solely of any guaranteed payments received for the performance of services; it does not include the partner’s share of partnership income.

Someone who is a general partner can limit their employment tax exposure by holding the lion’s share of their investment in the form of a limited partner interest. Under that structure, only the partner’s relatively small profit share associated with the general partnership interest will be included in the tax base. Multi-member LLCs are classified as partnerships by default, and the members are treated as partners for tax purposes. However, because there is no clear way of knowing whether to treat an LLC

99. Id. § 199A(b)(2)(B).
103. Treas. Reg. § 1.1402(a)-1(b) (as amended in 1974).
104. I.R.C. § 1402(a)(13).
member as a general partner or a limited partner, taxpayers are left to their own devices. On the one hand, it would seem appropriate to treat a member as equivalent to a general partner because, under the default rules, all members are entitled to participate in the management of the company. On the other hand, one could argue that the limited partnership rules should apply on the grounds that a member enjoys limited liability from the debts and obligations of the business, the hallmark of a limited partner’s status as such. Understandably, the absence of a clear rule has been an invitation for some to contend that a member must observe the rules that apply to limited partners. Taking that position minimizes the member’s employment tax base to the payments they receive in exchange for their work.

Over the past decade, courts have stepped in to eliminate the statutory ambiguities, generally adopting the government’s position that an individual will not be treated as a limited partner for employment tax purposes if the individual is an active participant in the business or if they can exercise management powers. The Internal Revenue Service has also launched a compliance campaign to target instances where taxpayers inappropriately claim to qualify for the exemption available to limited partners. However, litigation is labor intensive and can only be expected to reach a small minority of offenders.

106. Revised Uniform Limited Liability Company Act § 407(a), (c) (Nat’l Conference of Comm’rs on Unif. State Laws 2006). The self-employment tax was drafted to apply different rules to general and limited partners because, at the time this distinction was drawn, a limited partner ran the risk of losing their limited liability if they participated in the management of the partnership’s business. See 2 STAFF OF JOINT COMM. ON TAX’N, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986 277–87 (2001). State laws now permit limited partners to participate in management without jeopardizing that protection. See id.


110. E.g., Renkemeyer, Campbell & Weaver, LLP v. Comm’r., 136 T.C. 137 (2011) (requiring individuals who held both management units and investing units in a partnership to include their entire allocation of firm profits in their self-employment tax base); Riether v. United States, 919 F. Supp. 2d 1140 (D.N.M. 2012) (requiring two spouses who were the sole members of an LLC to include the entire allocation of firm profits in their self-employment tax base); Castigliola v. Comm’t of Internal Revenue, 113 T.C.M. (CCH) 1296 (T.C. 2017) (requiring members of a member managed professional LLC to include their entire allocation of firm profits in their self-employment tax base).

IV. ARBITRARY OUTCOMES UNDER CURRENT LAW

The inconsistent rules and opportunities to control the employment tax base have produced outcomes that are hard to defend. Simply put, the employment tax base for a self-employed individual will almost never approximate their labor income. This is confirmed by the few studies that have attempted to quantify the extent to which the employment tax base overstates or understates labor income.

Two government economists examined business tax returns filed between 2000 and 2004 to determine the share of business income that was a product of the owner’s labor. They used a regression technique to estimate the extent to which employment tax base either overstated or understated the owner’s labor income. There were substantial disparities between the amounts that were subject to employment tax and what the researchers determined to be the “true” labor income of the firm’s owners. Not surprisingly, the employment tax base is overstated for sole proprietors and general partners and understated for other self-employed individuals. For sole proprietors, over 21% of the income subject to employment tax was income from capital. For general partnerships, 36% of the income subject to employment tax was income from capital. By contrast, in limited partnerships, only 31% of income from labor was subject to employment tax. For S corporations, only 65% of income from labor was subject to employment tax. The owners of closely held C corporations also understated their true labor income, reporting only 87% of the total amount as part of their employment tax base.

An earlier study by the Congressional Budget Office reached consistent conclusions. Focusing on returns for profitable partnerships and sole proprietorships filed for 2004, that study quantified the extent to which the

112. Bull & Burnham, supra note 65, at 413.
113. Id.
114. Id. at 414 tbl.9
115. Id.
116. Id.
117. Id.
118. Id.
119. Id.
120. Id. The researchers defined a closely held C corporation as any C corporation with fewer than 75 shareholders. Id. at 398 n.4.
121. CONG. BUDGET OFF., supra note 15, at iv.
SECA tax base failed to reflect returns on labor.\textsuperscript{122} The study concluded that only 58\% of the tax base reflected labor income, while the remaining 42\% reflected capital income.\textsuperscript{123} Equally troubling, the study found that the labor income included in the base represented only 44\% of the labor income for the business owners.\textsuperscript{124} In other words, the employment tax base fails to reflect labor income in a very substantial way, overstating it in some cases and understating it in others. This outcome is not surprising, considering the haphazard way the rules operate and the incentives built into the law.

These two studies examined periods of time that predated the 2017 Tax Act. As explained above, that legislation changed the landscape in some significant ways. The corporate tax is now imposed at a flat rate of 21\% instead of at graduated rates ranging from 15\% to 35\%.\textsuperscript{125} Furthermore, the owners of unincorporated firms can now claim a deduction for qualified business income.\textsuperscript{126} Those developments can be expected to affect taxpayer behavior in different ways, as explained above. However, the larger point is that the employment tax base is determined in an inconsistent and unprincipled manner, preventing it from reflecting labor income and only labor income.

V. LEGISLATIVE EFFORTS TO ISOLATE LABOR INCOME

The GILTI rules adopted as part of the 2017 Tax Act may be the first tax provisions ever enacted to contain an objective procedure for isolating the returns to capital from the other components of business profits. However, they do not represent the first attempt that Congress has made to devise such rules. That honor belongs to a 2014 legislative proposal that endeavored to harmonize certain employment tax reforms with proposed changes to the taxation of business profits.\textsuperscript{127} Those proposals ultimately informed key aspects of the 2017 Tax Act, including the GILTI rules.

\textsuperscript{122} Id. at vi fig.1.
\textsuperscript{123} Id.
\textsuperscript{124} Id.
\textsuperscript{125} I.R.C. § 11(b) (2018).
\textsuperscript{126} See supra notes 96–99 and accompanying text.
\textsuperscript{127} See H.R. 1, 113th Cong. (2d Sess. 2014).
A. The Tax Reform Act of 2014

The Tax Reform Act of 2014 attempted to overhaul the U.S. tax system in some fundamental ways. Authored by Representative David Camp, the Democratic Chairman of the House Ways and Means Committee, its overarching objective was to eliminate a variety of deductions in order to expand the tax base, thereby permitting Congress to reduce the statutory tax rates without adversely affecting revenues. One of its signature features was a reduction in the corporate tax and the top individual tax to 25%. That would have established superficial parity in the tax rates that would apply to profits across all business firms. In addition, the proposal would have required all partners and S corporation owners to determine their employment tax base under a uniform set of rules. Those rules divided these business owners into two groups: the active owners and the passive owners. Someone would be an active owner if they were a material participant in the business, as measured by a well-developed set of objective standards that appear in the passive activity loss rules, while anyone else was a passive owner. The employment tax base for a passive owner was limited to the compensation they received for their work. For active owners, the employment tax base included these same amounts, but also included the owner’s share of the firm’s profits (other than the passive items of income that are already excluded from the SECA tax base). However, an active owner was entitled to a deduction equal to up to 30% of the combined amount.

129. The parity is not complete because corporate profits are subject to tax again when they are distributed to the owners as dividends. I.R.C. § 61(a)(7) (2018).
130. JCT REPORT ON TITLE I, supra note 128, at 82–85.
131. Id.
132. See I.R.C. § 469(h). Under the legislation, the participation of an individual’s spouse and lineal decedents also would be considered to determine whether the owner was a material participant. JCT REPORT ON TITLE I, supra note 128, at 85.
133. JCT REPORT ON TITLE I, supra note 128, at 84–85.
134. Id. at 83.
135. Id. at 84–85. However, for an active S corporation owner, their employment tax base would never be less than their wages subject to FICA. Id. at 84.
This adjustment was designed to reflect the historical portion of the U.S. domestic product that represents non-labor income.\textsuperscript{136} The Tax Reform Act of 2014 was never formally introduced as a bill.\textsuperscript{137} However, many of its key themes are reflected in certain parts of the 2017 Tax Act.

\textbf{B. The 2017 Tax Act}

In 2016, the Republican leadership in the House of Representatives released a Tax Reform Blueprint that built on some of the ideas and themes reflected in the 2014 Democratic proposal.\textsuperscript{138} First, it envisioned a reduction in the corporate tax down to 20\%.\textsuperscript{139} In order to establish parity in the taxation of business profits across all business firms, it also contemplated a special, preferential rate of tax on the income from S corporations, partnerships, and sole proprietors.\textsuperscript{140} The original idea was simply to limit the tax on such income to the rate imposed on corporate profits.\textsuperscript{141} However, the Blueprint always envisioned a system that contained a mechanism to ensure that any element of labor income embedded in a taxpayer’s business income was subject to tax at ordinary rates.\textsuperscript{142} Unlike the 2014 Democratic proposal, the Republican Blueprint also advocated a shift toward rules that allowed the tax system to operate more like a consumption tax so that income from savings and investment would enjoy some form of tax relief.\textsuperscript{143}

The broad themes expressed in the Republican Blueprint were later incorporated into a Unified Framework that was endorsed by both the Trump Administration and the Republican leadership in both Houses of Congress.\textsuperscript{144}

\begin{flushleft}
\textsuperscript{136} \textit{Id.} at 83. Incidentally, recent empirical studies have demonstrated that labor has accounted for a declining share of national income. One study based on data from the Bureau of Labor Statistics determined that the labor share declined from 63\% to 57\% between 1980 and 2016. \textsc{James Manyika et al., A New Look at the Declining Labor Share of Income in the United States} 6 exhibit 2 (Peter Gumbel et al. eds., 2019).

\textsuperscript{137} \textit{H.R.1 - Tax Reform Act of 2014}, \textsc{Congress.gov}, https://www.congress.gov/bill/113th-congress/house-bill/1 (last visited Feb. 4, 2021) (showing the act was introduced but no other action was taken).


\textsuperscript{139} \textit{Id.} at 25.

\textsuperscript{140} \textit{Id.} at 17, 23.

\textsuperscript{141} \textit{Id.} at 17.

\textsuperscript{142} \textit{Id.} at 20.

\textsuperscript{143} \textit{Id.} at 24–25.

\textsuperscript{144} \textsc{Dep’T of Treasury, Unified Framework for Fixing Our Broken Tax Code} (2017).
\end{flushleft}
One of its five core principles was to provide tax relief to businesses, especially small businesses.\footnote{145}{Id. at 3.} It expected to achieve this by lowering the corporate tax to 20\%, while reducing the tax on other business profits to 25\%, with rules to ensure that this preferential rate would not apply to amounts representing labor income.\footnote{146}{Id. at 7.} The framework also endeavored to adopt a territorial system of taxation to replace the existing one that imposed tax on a person’s worldwide income.\footnote{147}{Id. at 9.} In order to protect the U.S. tax base, the plan was to incorporate rules that would subject foreign earnings to U.S. tax at a lower rate.\footnote{148}{Id.}

These broad themes were eventually reduced to legislative language in two separate bills, with a different one introduced in each house of Congress.\footnote{149}{Lee A. Sheppard, Money Talks: Passthrough Provisions of the Tax Reform Bills, 157 TAX NOTES 1477, 1478–79 (Dec. 11, 2017) (stating that the House and Senate had separate versions of the bill).} However, there were elements that were common to each bill.\footnote{150}{Id. at 1479.} First, each bill restructured the corporate tax from a graduated tax up to 35\% to a flat tax of 20\%.\footnote{151}{H.R. REP. NO. 115-409, at 226 (2017) (proposing a corporate flat tax of 20\%); STAFF OF J. COMM. ON TAX’N., 115TH CONG., DESCRIPTION OF THE CHAIRMAN’S MARK OF THE “TAX CUTS AND JOBS ACT” 55 (2017) (changing the graduated corporate rate to a flat 20\%).} In addition, consistent with the Blueprint and the Unified Framework, the drafters attempted to provide comparable tax relief to businesses that were not subject to the corporate tax.\footnote{152}{Martin A. Sullivan, Economic Analysis: Your Easy Guide to Passthrough Rules in the Conference Report, 158 TAX NOTES 23 (Jan. 1, 2018); Donald B. Susswein, Understanding the New Passthrough Rules, 158 TAX NOTES 497 (Jan. 22, 2018).} This came in the form of a special maximum tax on a new category of income called qualified business income. It represented a portion of the taxpayer’s share of the profits from S corporations, partnerships, and sole proprietorships. Neither bill imposed this tax on the taxpayer’s entire share of income from these businesses because doing so would have permitted the tax relief to extend to the labor income that the taxpayer may have derived through the business.\footnote{153}{Sheppard, supra note 149, at 1478; Susswein, supra note 152, at 497.} That would have been inconsistent with the principles outlined in the Republican Blueprint and the Unified Framework. Instead, the idea was for
the relief solely to benefit the returns on capital invested in such firms.154 This was important for two related reasons. First, the drafters wanted to preserve the distinction that the tax code historically has drawn between income from labor and other forms of income.155 Second, preserving that distinction would be consistent with the way the corporate tax—and the reduction in that tax—would operate.156 Any wages paid by a corporation reduces the profits that are subject to the corporate tax. Thus, to the extent that the amount paid out as wages accurately reflects the income from labor, the residual corporate profits represent a return on capital. So, a cut in the corporate tax effectively represents solely a cut in the tax on the returns on the capital invested in the business. The drafters wanted to achieve the same outcome for unincorporated businesses.157

Under the House bill, the return on capital was determined in different ways depending on two factors: whether the firm was a service business, and whether the taxpayer was an active participant in the firm.158 As a general rule, none of the income derived by a service firm was assumed to consist of a return on any capital.159 For non-service firms, the return on capital would depend on whether the taxpayer was an active participant in the business or not.160 For passive participants, their entire share of the firm’s profits would be treated as a return on capital, just like shareholders in a corporation.161 For active participants, the bill assumed that any amounts invested by the firm in capital assets would earn a return at the rate of 7 percentage points above the short-term applicable federal rate (AFR+7).162 However, under the bill, no less than 30% of a taxpayer’s share of a firm’s income would represent a return on capital.163 The drafters considered AFR+7 to be a normal return.164 The 70/30 split reflects the ratio of labor income to capital income in the

154. Susswein, supra note 152, at 497.
155. Id.
156. Id.
157. See Sullivan, supra note 152, at 23.
159. Id. at 21.
160. Id. at 22.
161. Id.
162. Id.
163. Id. at 18.
national economy. The idea of using a 70/30 ratio can be traced back to the
democratic legislation introduced in 2014 by Chairman Camp. Although
simple to administer, this procedure was criticized for having the potential to
produce inaccurate and inequitable results because there is no universally
agreed upon method for teasing out the components of business profits.

For individuals, the distinction between capital returns and labor income had two impacts on their tax liability under the bill. First, to the extent the
profits from a flow through business were determined to represent returns on
capital, the taxpayer’s share of those profits would be subject to income tax at
no more than 25%. That compares to the bill’s top marginal rate for
individuals of 39.6%. Second, the taxpayer’s share of any profits exceeding
this amount was treated as income from labor and included in the employment
tax base.

The House bill contained one other provision that required the law to
isolate the portion of a firm’s income attributable to the returns on capital. It
was described as a base erosion rule and it represents an early version of the
GILTI rules that were ultimately enacted into law. Under the House bill, a
10% owner of a foreign corporation was subject to tax on their share of the
foreign corporation’s income exceeding a specified return on amounts
invested in tangible property other than land. As under the rules for
segregating the profits of passthrough firms, the provision assumed that any
amounts invested by the firm in capital assets would earn a rate of return of
AFR+7. The provision had the effect of exempting from U.S. tax the return
on the capital investments made by foreign affiliates. Any earnings exceeding
that threshold would be taxed to the owners of the firm. However, the owners
would be entitled to exclude half of the amounts allocated to them. That
effectively caused these residual amounts to be taxed at half the taxpayer’s

165. Id. at 5.
166. See supra notes 128–136 and accompanying text.
167. See Emily L. Foster, Tax Bill’s Passthrough Business Income Rules Raise Concerns, 2017 TAX
NOTES 214–15 (Nov. 7, 2017) (quoting another source); Marie Sapirie, Passthroughs Get 25 Percent
Rate Under Brady Bill, 157 TAX NOTES 734, 734–35 (Nov. 6, 2017) (citing another source); see also
Reynolds & Neubig, supra note 30.
168. JCT REPORT ON H.R. 1, supra note 158, at 17.
169. Id. at 7.
170. Id. at 22.
171. Id. at 265.
172. Id. at 265.
173. Id.
marginal rate.

The full House approved both the GILTI provisions and the rules for passthrough firms.174 However, the employment tax provisions did not appear in the bill as reported out of Committee or in any later version of the legislation.

The bill introduced in the Senate also endeavored to tax the returns to capital at a lower rate. However, it did not do so explicitly in cases where the income was derived through a passthrough firm. By contrast, a more explicit approach was incorporated into the bill’s GILTI rules.

Like the legislation introduced in the House, the original Senate bill imposed a special, low rate of tax on a new category of income called qualified business income.175 It accomplished this tax cut by authorizing taxpayers to claim a 17.4% deduction for their share of the profits from passthrough business firms.176 On its face, the legislation did not distinguish between returns to capital and labor income. However, there were several aspects of the new rule that reflected the philosophy articulated in the Republican Blueprint. Most significantly, the deduction was not made available to high income taxpayers when the profits were derived by a service firm.177 In addition, any amounts that the taxpayer received as compensation for any services performed for the firm would not be eligible for the deduction.178 Meanwhile, any investment-type income derived by the firm also would not be eligible, which reinforced the bill’s objective to target the tax relief to returns on capital invested in an active business, not passive income.179 The bill reported out of committee retained these essential elements, as did the bill approved by the entire Senate.180 The only meaningful difference is that the deduction was increased from 17.4% to 23%.181

Not all aspects of the provision were consistent with the overarching effort to prevent the tax cut from reaching labor income. Most significantly,
the bill imposed a limit on the amount of the deduction that could be claimed, capping it at 50% of the wages paid by the firm. 182 There are two explanations for this feature. First, it represents an attempt to limit the cost of the new rule. 183 Second, it reflects the fact that the Senate’s version of the rule was modeled after the manufacturing deduction that would be replaced by the new provision. 184 Therefore, in both the House and Senate bills, the intention behind the qualified business income rules was to provide tax relief to returns on capital. The only difference is that the House bill did so explicitly, while the Senate bill did so in a more indirect and cumbersome manner. A revised version of the Senate provision would ultimately be included in the legislation that was enacted into law. 185

Elsewhere in the Senate bill, the drafters included a set of provisions that would ultimately be adopted as the GILTI rules. 186 Like its counterpart in the House, the provision required any 10% owner of a foreign corporation to pay tax on their share of a portion of the firm’s undistributed earnings. 187 The idea was to prevent taxpayers from avoiding U.S. tax on the unrepatriated earnings of foreign subsidiaries as part of the shift to a territorial system of taxation. Under the provision, the earnings would be exempt from U.S. tax to the extent they represented a return on the capital investments made by the firm overseas. 188 Such returns were assumed to be equal to a 10% return on the adjusted tax basis of the firm’s investments in tangible property other than land. 189 Any business profits exceeding this amount would be included in the taxable income of the foreign corporation’s 10% owners. 190 This followed the general pattern of the counterpart measure in the House bill. The only meaningful difference for our purposes is that they used a different method.

182. Id. at 217.
183. See Sheppard, supra note 149, at 1478.
184. See id. at 1479.
185. H.R. Rep. No. 115-446, supra note 180, at 222. The final bill reduced the deduction from 23% to 20%. Id. In addition, the wage limit was revised so that the deduction was limited to the lower of either 50% of W-2 wages or the combination of 25% of such wages and 2.5% of the non-depreciated cost of business property. Id. This change effectively made the deduction available to real estate firms. Lynmley Browning & Benjamin Bain, Trump, Real Estate Investors Get Late-Added Perk in Tax Bill, BLOOMBERG (Dec. 17, 2017), https://www.bloomberg.com/news/articles/2017-12-18/trump-real-estate-investors-get-last-minute-perk-in-tax
186. JCT CHAIRMAN’S MARK, supra note 175, at 227.
187. Id.
188. Id.
189. Id.
190. Id.
for isolating the returns to capital.

The Senate bill used the same method for isolating the returns to capital in a related area. The legislation included a provision that was referred to as the FDII rules, which stands for "foreign derived intangible income." Broadly speaking, they are the domestic counterpart to the GILTI rules.

The FDII rules allow domestic corporate taxpayers to claim a deduction equal to 37.5% of a portion of the profits generated from selling goods or services to foreign buyers for use outside the United States. In effect, the rule would cause a taxpayer to pay tax at a lower rate on the income that is eligible for the deduction. The deduction eligible portion was the amount of profits that exceeded the returns on any capital used to generate such income. That residual amount was determined under a formula which assumed that the returns were equal to 10% of the adjusted tax basis of the firm’s investment in tangible property other than land. The GILTI and FDII rules from the Senate bill were incorporated into the final legislation and enacted into law.

Thus, the international provisions in both the Senate and House bills reflected a consistent effort to segregate returns on capital from other components of business income. The only difference is that the bills employed different ways of doing so. The House bill assumed that a capital investment earned a return equal to APR+7 percent, while the Senate bill assumed a 10% rate of return.

The original House bill extended its approach beyond the income tax rules and incorporated it into the employment tax rules. That would have allowed the two systems to operate in harmony.
However, because Congress extracted the employment tax reforms while retaining a version of the new rules for qualified business income, the 2017 Tax Act made a bad situation worse. It fails to cure the dysfunctional way the employment tax rules operate in the case of a self-employed individual, while magnifying a discontinuity in the way the income tax system interacts with the employment tax system.

It is not entirely clear why the employment tax provisions were removed from the House bill. One observer expressed the view that they were extracted for revenue reasons.\textsuperscript{200} However, that seems unlikely. Aside from making the employment tax system operate in a more rational way, the change would have eliminated the rules that historically have allowed owners of pass-through firms to avoid the employment tax.\textsuperscript{201} That would have made it a revenue raiser. According to another observer commenting on the final bill enacted into law, it may have been too difficult or too unpopular to distinguish the returns on capital from labor income.\textsuperscript{202} It is hard to understand how it might be too difficult to devise a mechanism to segregate returns on capital when the GILTI and FDII rules do exactly that. On the other hand, it is entirely conceivable that Congress was pressured by influential constituents to discard the proposed employment tax reforms. The typical top earner derives the lion’s share of their income as an active owner in a business.\textsuperscript{203} The House measure would have eliminated their ability to disguise their high tax labor income as low tax business profits. Whatever the reason for the omission, now that the law includes a way to segregate returns on capital, it would seem to be possible to use that same procedure to determine the amount of labor income that should be included in the employment tax base for a self-employed individual. If incorporated into the employment tax rules, such a change would address the most problematic feature of the system: the absence of a mandatory procedure to objectively determine a self-employed individual’s labor income.\textsuperscript{204}

\begin{flushleft}
\textsuperscript{200}\textsuperscript{200} Sheppard, \textit{supra} note 149, at 1481. \\
\textsuperscript{201}\textsuperscript{201} Foster, \textit{supra} note 167 (quoting Robert K. Keatinge). \\
\textsuperscript{202}\textsuperscript{202} Susswein, \textit{supra} note 152, at 497. \\
\textsuperscript{203}\textsuperscript{203} See \textit{supra} notes 26–28 and accompanying text. \\
\textsuperscript{204}\textsuperscript{204} A more complete and comprehensive set of reforms would include an elimination of the deduction for qualified business income. Few believe it serves any worthwhile policy objective. \textit{E.g.}, Sullivan, \textit{supra} note 152, at 23. At the very least, the provision should be restructured so that it targets returns on capital in a more surgical way.
\end{flushleft}
The employment tax provisions incorporated into the 2017 Tax Act as introduced in the House provide a useful framework for potential reforms. Those rules addressed situations where the taxpayer is an owner in a pass-through firm. Under those rules, if the taxpayer was a material participant in a service firm, the taxpayer’s employment tax base would include their entire share of the firm’s active business income, in addition to any payments they received for their work. Meanwhile, if the taxpayer was a material participant in a non-service firm, the taxpayer’s employment tax base would include 70% of those amounts (i.e., their profit share plus any compensation for work). However, the taxpayer had the option to determine their labor income by assuming that the firm earned a specified rate of return on the adjusted basis in the capital assets used in the business. The original bill assumed that the rate of return is AFR+7%. However, in view of the procedure incorporated into the GILTI rules, the rate would be 10% under this proposal.

Like the House bill, this proposal uses the material participation standard to distinguish individuals whose employment tax base should include a portion of their share of a firm’s business profits. The test is a familiar and well-developed one that distinguishes individuals who actively work in a firm from those who do not. Under the House bill, the amount of a taxpayer’s labor income was based on the combination of the taxpayer’s profit share and payments for their work. However, their employment tax base would never be less than the payments they received for their work. Thus, assume someone was an active owner in a non-service firm. If they received 40% in wages and 60% as a profit share allocation, their employment tax base would be 40%, even though the default rule would otherwise treat only 70% as labor income. This is a sensible limitation that is also adopted by this proposal.

205. See supra notes 159–163 and accompanying text.
206. See I.R.C. § 915A (2018). There is considerable debate about the proper method for computing an appropriate rate of return on capital assets used in a business. See generally Reynolds & Neubig, supra note 30, at 7. The method utilized here is one of many possible alternatives. But it is not necessarily superior to the other options. The sole advantage for using it here is that it would be consistent with the procedure incorporated into the GILTI and FDII rules.
208. See JCT REPORT ON H.R. 1, supra note 158, at 17.
209. Id. at 22.
210. If the firm was an S corporation, the entire 40% would be subject to tax under FICA. If the
The GILTI rules recognize that any investment in business property could be financed with either equity, debt, or a combination of the two. As such, any investor would be entitled to enjoy the returns on such an investment only after any interest on such debt has been paid. Accordingly, in order to properly measure the return on the equity invested in such business property, the statute reduces the assumed 10% return by the firm’s net interest expense. A similar adjustment for interest expense would be in order for purposes of computing the employment tax base under this proposal. Because the adjustment reduces the amount of income attributable to a return on capital, it would translate into a larger amount of labor income.

Within the GILTI regime, the fixed rate of return applies to a base generally consisting of the adjusted tax basis of tangible business property other than land. However, if the objective is to approximate the income that is attributable to capital employed in a business, land should be part of this base. An investment in land is no less a factor of production than is other property used in a business. The GILTI rules were criticized for excluding land from the asset base.

In many cases, the depreciated basis of business property will reflect overly generous allowances that may grossly overstate the actual wear and tear sustained. For instance, the 2017 Tax Act introduced a temporary rule permitting taxpayers to claim a deduction equal to 100% of the cost of certain property, up from 50% of the cost. That deduction would cause the depreciated basis of the property to fall to zero, which would translate into zero income attributable to that particular capital investment. That clearly would not correspond to reality. These problems do not arise under the GILTI rules because they rely on an alternative depreciation system to determine the tax basis of property solely for purposes of computing the return on a firm’s capital investments. Because that system is built around the straight-line method of depreciation, it eliminates these distortions. The proposal being offered here would rely on the same system to determine the adjusted tax basis.

firm was an LLC, the entire 40% would be subject to tax under SECA.

212. I.R.C. § 951A(d).
213. Cf. I.R.C. § 1221(a)(2). It might be appropriate to also include certain intangible assets whose cost is subject to amortization. See id. § 197.
214. Schler, supra note 207, at 1755.
217. Id. § 168(g).
of property used in a business.

Although the original House bill provides a useful framework, it has one principal shortcoming. It does not address the opportunities for someone to reduce their employment tax liability when they operate through a corporation. There is already a concern that the C corporation is now more attractive than a passthrough entity for at least some taxpayers.\textsuperscript{218} The changes proposed here will make the C corporation more attractive to an even greater number of self-employed individuals, who can easily reclassify their firms by simply checking a box on a form.\textsuperscript{219} Firms that are C corporations offer their owners two viable ways to minimize their overall tax liabilities. The owners can decline to access the earnings in any form, or they can choose to access the earnings as a dividend. Both strategies are attractive options under current law, and either one would prevent the labor income of an active owner from appearing in their employment tax base.\textsuperscript{220} There have been several pleas to increase the corporate tax from the level set by the 2017 Tax Act. President Biden has proposed increasing it to 28%.\textsuperscript{221} Depending on the size of an increase, such a change could entirely prevent the C corporation from offering any tax savings opportunities to a self-employed person. However, absent an increase in the corporate tax, policymakers might be forced to consider potential ways to address the risk of wholesale employment tax avoidance through a C corporation.

One option would be a mandatory rule that would treat a portion of the income of a closely held C corporation as the labor income of its active owners. The tax code already contains a set of rules targeted at taxpayers who use the C corporation to avoid tax on investment income.\textsuperscript{222} Because only closely held firms have an incentive to use a C corporation for this purpose, the rule only applies when the firm has five or fewer individuals who own over half the stock in the firm for the last six months of the year.\textsuperscript{223} Firms with the same concentration of ownership are also the most likely to be used to disguise the labor income of their owners. An anti-abuse rule targeted at this class of firms might require the firm and the active owners to be taxed as

\textsuperscript{218} See supra note 71.
\textsuperscript{219} See Treas. Reg. § 301.7701-3(a) (2019).
\textsuperscript{220} See supra notes 72–73 and accompanying text.
\textsuperscript{223} Id. § 542(a)(2).
if the firm compensated the owner for their work. The amount of this constructive payment could be determined in the same way that this proposal would require the owners in passthrough firms to determine the amount of labor income derived through such a firm. This author has described a variation of this idea elsewhere. However, there may be other options to address the tax avoidance opportunities that the C corporation may offer. The most important thing for policymakers to understand is that employment tax avoidance will merely take a different form if the government does not address the full range of strategies that are available to practice it.

Putting aside the opportunities to use a C corporation to avoid employment tax, there is at least one loophole that will remain: the taxation of so-called carried interests. The term refers to the profit shares allocated to the managers of private equity funds. The typical fund is classified as a partnership for tax purposes. As compensation for their work, the fund managers receive a profits interest in the firm. That gives them a stake in the success of the fund, while also causing them to be partners in the firm. Under current rules, the manager is not taxed on receipt of the interest. Moreover, because the fund’s profits take the form of investment returns, any payment a manager ultimately receives will be treated as such. Under current rules, such items of income are excluded from the SECA tax base. The plan being offered here does not change that, which makes sense for the vast majority of business ventures outside the private equity context. Therefore, even under this plan, carried interests will remain excluded from the employment tax base until Congress addresses carried interests with more targeted legislation.

VII. CONCLUSION

The mere existence of tax reduction opportunities jeopardizes the integrity of the employment tax base. Equally important, the tax system

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224. This is not unlike the constructive dividend that the tax code employs to address the tax avoidance opportunities available through a controlled foreign corporation. See id. § 951(a).
cannot function in a fair and equitable way when individuals can control their tax liability. Simply put, individuals who are in materially similar situations will pay vastly different amounts in tax. That alone offends basic notions of equity. However, it is also difficult for the interests of fairness and equity to be served when the system permits an individual to dictate the rules they will observe and how they will observe them. When such options are available, tax outcomes will partly reflect how successfully someone has employed strategic measures to artificially reduce their tax liability.

The employment tax system is way overdue for reform. The 2017 Tax Act did nothing to improve the situation, and it may have increased the incentives for taxpayers to exploit the system’s shortcomings. However, the GILTI rules may offer policymakers a framework for real and lasting reform.