BUSINESS TAXATION IN THE UNITED STATES

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Introduction

The purpose of this article is to provide the Russian legal professional with a basic overview about the manner in which business profits are defined and taxed in the United States. These materials should be read in conjunction with two companion articles on US tax law which were also prepared for the September 1997 tax seminar in Petrozavodsk. The companion piece on individual income taxation should be read first, then this article, and finally, the materials on adjudication and enforcement of tax obligations.

Social Policy Considerations Effecting US Tax Legislation

The study of any system of taxation, or any of its subparts, must be undertaken with an understanding of the social policies which underlie the system. In the United States, overall tax policies mandate uniformity in application and enforcement. In the specific business context, US tax policies seek to encourage the productive investment of capital by allowing the deductibility (non-taxability) of the "costs of production", so that only true "profits" are taxed.

Effect of Selection of Form of Business Entity on Taxation

There are several basic forms of business entity in the United States. The simplest is a "sole proprietorship", which is essentially an individual doing business in an unincorporated form. The purist might credibly argue that a business which is operated as a sole proprietorship is not a "business entity" at all, since it does not have a separate legal existence from its owner. For this reason, business revenues and expenses which are earned by a sole proprietor are

reported on a "schedule" (an additional page) which is attached to the taxpayer's individual federal income tax return. An individual's federal income tax return is known as Form 1040, and the schedule in question is known as Schedule C. If the business is operated by a partnership (an unregistered contractual relationship between two or more persons), the partnership must file an "information" federal income tax return. This return, which is known as Form 1065, reflects business revenues and expenses, and calculates the amount of taxable income (or loss) which is attributable to the partnership as a whole. Attached to Form 1065 is Schedule K-1 which sets forth the distribution of taxable income (or loss), as between or among the partners, in accordance with the terms of the partnership agreement. The taxable income or loss amounts which are set forth for each partner on his or her Schedule K-1 must be reported by the taxpayer on his or her federal individual income tax return (Form 1040). The partnership return is described as an "information return", since there is no taxation at the partnership level. The tax is only levied at the individual level, on that portion of the partnership's taxable income which is attributable to each individual partner, and which is therefore included on his or her individual federal income tax return. Partnership taxation is sometimes described as "flow-through taxation", since the taxable income is not taxed at the partnership level, but instead, "flows through" to the individual level.

For tax purposes, there are fundamentally two types of corporations, the S Corporation and the C Corporation. S Corporation status, which affords its shareholders the benefit of "flow-through" taxation (like a partnership), is only available for certain types of corporations. For purposes of this analysis, it is sufficient to assume that S Corporation status, or its functional equivalent, is only available to corporations which have 35 or fewer shareholders. The S

Corporation files federal income tax Form 1120S, which, in many respects, is analogous to partnership Form 1065. Form 1120S calculates the amount of taxable income (or loss), and then orders it to be distributed to the shareholders, again pursuant to Schedules K-1, in accordance with the shareholders' respective rights within the corporate structure.

In the case of a (typically larger) C Corporation, profits are taxed first at the corporate level, and after-tax profits must be distributed as dividends, or can be retained (within limits) as earnings. Under such circumstances, the amount which is left in the hands of the shareholders, after both corporate-level and individual-level tax, is therefore less. In the United States, this phenomenon is known as "double taxation".

To illustrate the effect of double taxation versus flow-through taxation, consider the following example. Assume corporate profits of $10,000, a C Corporation federal income tax rate of 35%, and an individual federal income tax rate of 30%. If the profits are the product of business which was conducted as an S Corporation, they are not taxed at the corporate level, and are therefore fully taxed, at the 30% individual rate, at the individual level, leaving after-tax "discretionary" income, in the hands of the shareholder, of $7,000. If, on the other hand, the profits are the product of business which was conducted as a C Corporation, they are first taxed at the 35% corporate tax rate, leaving $6,500 for distribution as dividends. In the hands of the shareholder, the $6,500 of dividends are again subject to taxation, this time at the 30% individual tax rate, leaving only $4,550 ($6,500 x .7) in after-tax "discretionary" income (a combined effective tax rate of 54.5%). The desirability of avoiding such double taxation is obvious. Thus, when the S Corporation option is available, it will usually be used. This preferential tax treatment is made available to small corporations because the "separateness" of a corporation is

deemed to be, in part, a function of its size, and because "small" corporations are (in some ways) more like a collection of individuals (a partnership) than a separate business entity. Number of shareholders is, of course, an imperfect measure of corporate "size", and the number 35 is admittedly arbitrary.

A C Corporation is treated, for tax purposes, as an entirely separate entity. It files federal income tax Form 1120, and pays its own corporate-level tax, eventually distributing dividends to its shareholders as the board of directors sees fit. There are limitations on the extent to which the C Corporation may retain earnings. It may do so, for example, in order to retain appropriate levels of operating reserves, and to some extent, for capital expenditures. These limitations are balanced by the shareholders' right to reasonable dividends, which they can enforce, if necessary, through court intervention, to the extent that retained earnings bear no reasonable relationship to the corporation's purposes. In this respect, the board of directors' decisions are accorded presumptive validity in the absence of strong evidence to the contrary.

Political Considerations

It is often said that legislators are predisposed toward taxing corporations because they do not vote. Even so, shareholders do vote, and as such, recent trends in American tax legislation have increasingly tended to equalize business-related taxation, regardless of the form through which the business is conducted. Although small business tends to be taxed uniformly, and enjoys the benefits of flow-through taxation, "big business" remains subject to double taxation.

Deductible (Non-Taxable) Expenses

Taxable business income is calculated by deducting from gross revenues a broad variety of expenses which, in the aggregate, may be described as the "costs of production". The deductible costs of production fall into many categories. The space limitations of this article will only permit us to touch briefly on three types of deductible business expenses: depreciation, wages and inventory. These three areas have been selected because they are treated somewhat differently in the Russian and U.S. systems. Fundamentally, each of these sub-categories of the costs of production are more fully deductible in the United States. There are legitimate policy reasons for both the Russian and US approaches. Those reasons, and their effects, are worth noting.

1. ***Depreciation***. Under US law, the cost of property which is used in business can be "recovered" (deducted) over its realistic useful life. Different types of property have different depreciation periods which, for the most part, reflect their actual useful lives. Arguably, a "pure" depreciation system should have this attribute, and should permit only "straight-line" depreciation. In other words, property which has a five-year useful life would be depreciable at a rate of 20% of its value per year.

As an incentive to capital investment, however, US tax law often permits the business taxpayer to depreciate property at a rate which is more rapid than "straight-line". In addition, US business taxpayers are permitted to deduct depreciation of up to $17,500 per year for depreciable property which was placed into service during that tax year, thereby providing a further incentive for all businesses, especially small businesses, to make capital investments.

Some international tax commentators distinguish the Russian tax system by observing that the useful lives over which many types of depreciable property can be depreciated are

unrealistically long, and that the governmental permission which is necessary in order to utilize "accelerated" depreciation methods is both difficult to obtain and not uniformly available.

2. ***Wages***. In the United States, for the most part, there is no limitation on the amount of wages which can be deducted. In contrast, limitations on the deductibility of Russian wages, to a small multiple of "minimum wage", leave the employer with a difficult choice. It can either pay the higher, not fully-deductible wages, and thereby subject itself to taxation on a portion of its cost of production, or it can forego the payment of higher wages, and arguably thereby compromise the quality of its workforce.

Economic theorists say that the Russian approach to limiting the deductibility of wages serves the legitimate macroeconomic goal of discouraging "wage inflation", and therefore, inflation in general. Whether this legitimate consideration outweighs the economic impact of taxing a portion of the cost of production is a question which is beyond the scope of this article.

3. ***Inventory***. Tax treatment of inventory also has an impact on the calculation of taxable profits. This is particularly true during periods of inflation, and during times of changes in inventory levels. Periods of growth in inventory, such as during the business' initial start-up, and also during subsequent periods of growth, can have a deceptive effect on apparent levels of profitability. As such, different inventory accounting methods can have a marked effect on tax payments, and therefore, on the availability of retained earnings during periods of high demand for capital, and often simultaneously, reduced levels of cash flow.

The Employer's Duty to Withhold Estimated Taxes on Wages Paid to Employees

The US tax system places a duty on employers to withhold taxes on wages which are paid to employees. The rationale is simple. If the employer does not withhold, the likelihood that the government will be able to collect the taxes which are due is diminished. In this respect, a distinction is made between "employees" and "independent contractors".

The employer must withhold taxes from the wages of employees, but is not required to withhold taxes from the wages of independent contractors. Both employees and independent contractors are agents of the employer. The difference lies in the extent to which the employer has control over the agent. If an employer has any substantial amount of control over the manner in which the agent carries out his or her duties under the agency relationship, the agent is considered to be an employee (and the employer has a duty to withhold). If, on the other hand, the employer has no control over the manner in which the agent carries out his duties under the agency relationship (except, of course, for having the contractual right to receive the agent's services in a timely manner and consistent with the terms of the agency relationship), then the agent is considered to be an independent contractor (and the employer has no duty to withhold). The law assumes that an agent is an employee, not an independent contractor, in the vast majority of cases.

An example of an independent contractor would be a landscaper who is hired by the developer of a hotel complex to install trees and shrubs. The job is defined on a set of plans, and a price and a completion date are fixed by contract. The landscaper uses his own tools, hires his own employees, and is otherwise free to complete the work in any manner which he deems appropriate. Since the landscaper is an independent contractor, the employer pays him the gross

amount of compensation, without deduction for taxes, and the burden to calculate and pay the appropriate amount of taxes falls on the landscaper. He is, from a tax standpoint, self-employed.

At the outset of employment, an employee (not an independent contractor) fills out a form (Form W-4) through which the amount of withholding is established. Different employees with the same income will sometimes pay quite different amounts of tax, depending upon their particular circumstances. For example, an employee who is unmarried and childless will pay a greater percentage of income tax than a co-worker who has a non-working spouse and three young children. As such, the two employees will instruct the employer, each by filling out a Form W-4, to withhold different amounts, each attempting to withhold an amount which will closely approximate the actual anticipated tax liability. The employer is allowed to rely upon the employee's instructions regarding the amount to be withheld, and has no liability if the employee's estimate proves to have been inadequate in retrospect. The obligation is on the employee to pay the shortfall when he files his annual income tax return.

Self-employed individuals are required to make quarterly estimated tax payments. In that way, the government gets its taxes in a (relatively) timely manner (quarterly), rather than having to wait until April 15 to receive taxes which are due on income which was earned during the preceding calendar year. The estimated payments are calculated by the taxpayer through an exercise by which he creates a tax projection which is based, as nearly as possible, upon his expected income, deductions and so on. The self-employed taxpayer is subject to interest charges and penalties if his estimated payments were less than the smaller of his previous year's tax liability or 90% of his actual liability for the year in question.

State Versus Federal Business Income Taxation

The discussion thus far has focused exclusively on federal income taxation. The taxpayer is also obligated, however, to pay state (and in some cases local) income tax as well. In some states, such as Vermont, the state income tax is set at a straight percentage of the federal income tax. This allows for simple administration, but causes state income tax revenues to be highly dependent upon federal tax policy. In recent years, in an attempt to decrease the federal deficit, the US Congress has decided that numbers of once-federal programs should become state programs (the process of devolution). As a result, the federal legislators have cut federal taxes as they have eliminated federal programs.

In states such as Vermont, where the state income tax is a straight percentage of the federal income tax, this has resulted in reduced state revenues when just the opposite has been necessary in order to fund the new-found state obligations. This process of devolution has raised calls for a "decoupling" of the Vermont state income tax from the federal. Even so, the administrative simplicity of the "piggy-back" approach is highly desirable, and Vermont will probably maintain this approach, adjusting the percentage as necessary during the period of devolution, until a new federal-state balance of fiscal responsibility is reached.

Conclusion

It is assumed in the United States (and it is largely true) that all taxpayers pay their taxes. This high level of tax collection allows tax rates to be set at a level which is not so high as to deter taxpayers from pursuing and reporting income-producing activity. The actual costs of production are not taxed (since they are fully deductible), and the investment of capital is

encouraged through various specific tax provisions, such as by permitting depreciation to occur at a rate which is faster than the actual rate of depletion. The tax law (including regulations) is freely available to the public, and the government provides taxpayer assistance in order to clarify and simplify the process. A tax policy which encourages investment and the productive use of capital is conducive to the goals of the free market.

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