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REFORMING THE TAX TREATMENT OF S-CORPORATIONS AND LIMITED LIABILITY COMPANIES CAN HELP STATES FINANCE PUBLIC SERVICES

By Michael Mazerov

Nineteen states impose only nominal taxes on businesses organized as subchapter S Corporations (S-Corps) or Limited Liability Companies (LLCs) even though these entities — which generate about one-fourth of all business receipts — benefit from state services just as businesses that are subject to state corporate income taxes do. In addition, many of the states that do impose meaningful taxes on S-Corps and LLCs would benefit by updating their tax laws in this area, such as by equalizing their tax treatment of the two kinds of entities. By reforming their policies toward S-Corps and LLCs, states can strengthen their revenue systems to help deal with budget problems states now face.

Opportunities to Improve the Tax Treatment of S-Corps and LLCs

S-Corps and LLCs generally are exempt from the federal corporate income tax; they are “pass-through entities” that pass through their profits each year to their owners, who pay income taxes on these profits.¹ (In the case of S-Corps, those owners are almost always individual taxpayers; in the case of LLCs, the owners may be individuals, corporations, partnerships, or other LLCs.) According to the Internal Revenue Service, in 2003 there were 3.3 million S-Corps and 1.3 million LLCs operating in the United States, including many large and profitable businesses.

Almost all states have conformed to the federal pass-through treatment of S-Corps and LLCs by exempting them from their corporate income taxes. Nonetheless, every state except Idaho has deemed it appropriate to levy a tax or annual fee directly on these business entities in addition to

KEY FINDINGS

- Businesses organized as subchapter S Corporations or Limited Liability Companies generate roughly one-fourth of all business receipts. Yet 19 states impose only nominal taxes on these entities even though they benefit from state services just as businesses that are subject to state corporate income taxes do.
- These 19 states should consider imposing meaningful levies on S-Corps and LLCs as a source of additional revenue to help close the major budget gaps many of them are facing.
- The 31 states that impose significant taxes and fees on S-Corps and LLCs should determine whether reforms are warranted. In particular, state tax laws should not treat LLCs more favorably than S-Corps.

taxing the profits received by their owners.² Some of those fees are very small, but in 31 states, the tax or fee makes a significant contribution to state revenue.

Like all businesses, S-Corps and LLCs benefit from numerous services provided by state governments — from the court systems that enforce their contracts to the education systems that furnish them with trained workers. Businesses receive these benefits even in years in which they are unprofitable. It is reasonable, accordingly, for states to impose modest taxes or fees on these entities to ensure that they help fund the public services they receive. Entity-level taxes are also justified by the fact that state governments grant these entities the privilege of doing business in a legal form that provides “limited liability” for their owners.

In light of the severe fiscal crisis confronting nearly all states in the next several years, elected officials should review any taxes and fees that have not been changed in recent years to determine if they are still sufficient, compare their policy choices to those in other states, and consider adjusting taxes and fees upward if appropriate. Specifically:

- The 19 states that impose only small, flat fees on S-Corps and LLCs could supplement them with a meaningful tax that varies with the size of the business’s assets, profits, or gross receipts. The fees could also be increased to take recent inflation into account.
- The 16 states that tax LLCs more favorably than S-Corps could level the playing field by equalizing the taxes or fees that apply to these entities.
- The one state that lacks any form of tax or fee — Idaho — could impose one.

How States Tax S-Corps and LLCs

Table 1, which details the taxes and annual fees states currently levy on S-Corps and LLCs, shows the following:³

- Thirty-one states plus the District of Columbia impose a significant tax or annual fee (other than a fixed-dollar registration fee or tax) on S-Corps *or* LLCs.⁴
- Seventeen states plus the District of Columbia impose a significant tax or annual fee on *both* S-Corps and LLCs. (The amounts due are not always equivalent.)
- The most common form the taxes take is a franchise tax levied on the net worth or capital stock — rather than the income — of these businesses.⁵ Such franchise taxes generally also apply to corporations subject to the state’s corporate income tax.
- Three states — California, Illinois, and Massachusetts — impose corporate income taxes on S-Corps and LLCs at tax rates lower than those that apply to general corporations.
- The District of Columbia, New Hampshire, and Tennessee impose their regular corporate income taxes on S-Corps and LLCs, and Texas imposes on these entities a tax that can be viewed as a modified corporate income tax. Because these four jurisdictions do not or cannot tax the income passed through to individual S-Corp and LLC owners (New Hampshire, Tennessee, and Texas do not have personal income taxes; the District of Columbia is barred by federal law from taxing the personal income of non-residents even if it is earned in the District),

TABLE 1
TAXES AND ANNUAL FEES IMPOSED ON SUBCHAPTER S CORPORATIONS AND LIMITED LIABILITY COMPANIES

(States with only fixed-dollar taxes and fees in italics)

	S CORPORATIONS						LIMITED LIABILITY COMPANIES					
	Type of Tax or Fee				\$ Range of Taxes/Fees		Type of Tax or Fee				\$ Range of Taxes/Fees	
	Corporate Income Tax	Franchise Tax on Net Worth or Capital	Other General Business Tax	S Corp-Specific Tax or Fee	Minimum Combined Amount	Maximum Combined Amount	Corporate Income Tax	Franchise Tax on Net Worth or Capital	Other General Business Tax	LLC-Specific Tax or Fee	Minimum Combined Amount	Maximum Combined Amount
Alabama		X		X	\$110	\$15,010		X			\$100	\$15,000
<i>Alaska</i>				X	\$50	\$50				X	\$50	\$50
<i>Arizona</i>				X	\$45	\$45						
Arkansas		X			\$150	None				X	\$150	\$150
California	Lower rate			X	\$825	None				X	\$810	\$12,600
<i>Colorado</i>				X	\$10	\$10						
<i>Connecticut</i>				X	\$325	\$325				X	\$260	\$260
Delaware			X	X	\$100	\$165,025				X	\$250	\$250
Dist. of Columbia	Regular			X	\$225	None	Regular			X	\$225	None
<i>Florida</i>				X	\$150	\$150				X	\$139	\$139
Georgia		X		X	\$40	\$5,030				X	\$30	\$30
<i>Hawaii</i>				X	\$15	\$15				X	\$15	\$15
Idaho												
Illinois	Lower rate	X		X	\$75	None	Lower rate			X	\$250	None
<i>Indiana</i>				X	\$10	\$10				X	\$10	\$10
<i>Iowa</i>				X	\$23	\$23				X	\$23	\$23
Kansas		X		X	\$50	\$20,050		X			\$50	\$20,050
Kentucky				X	\$190	None				X	\$190	None
Louisiana		X		X	\$35	None				X	\$25	\$25
<i>Maine</i>				X	\$85	\$85				X	\$85	\$85
<i>Maryland</i>				X	\$300	\$300				X	\$300	\$300
Massachusetts	Lower rate	X		X	\$556	None				X	\$500	\$500
Michigan			X	X	\$25	None			X	X	\$25	None
Minnesota				X	\$100	\$5,000				X	\$100	\$5,000

TABLE 1 (Continued)
TAXES AND ANNUAL FEES IMPOSED ON SUBCHAPTER S CORPORATIONS AND LIMITED LIABILITY COMPANIES

(States with only fixed-dollar taxes and fees in italics)

	S CORPORATIONS						LIMITED LIABILITY COMPANIES					
	Type of Tax or Fee				\$ Range of Taxes/Fees		Type of Tax or Fee				\$ Range of Taxes/Fees	
	Corporate Income Tax	Franchise Tax on Net Worth or Capital	Other General Business Tax	S Corp- Specific Tax or Fee	Minimum Amount	Maximum Amount	Corporate Income Tax	Franchise Tax on Net Worth or Capital	Other General Business Tax	LLC- Specific Tax or Fee	Minimum Amount	Maximum Amount
Mississippi		X		X	\$50	None						
Missouri		X		X	\$20	None						
<i>Montana</i>				X	\$15	\$15				X	\$15	\$15
Nebraska				X	\$13	\$11,995				X	\$5	\$5
Nevada				X	\$225	\$11,200				X	\$100	\$100
New Hampshire	Regular		X	X	\$100	None	Regular		X	X	\$100	None
New Jersey			X		\$550	\$2,050				X	\$350	\$250,050
<i>New Mexico</i>				X	\$63	\$63				X	\$63	\$63
New York			X		\$30	\$4,505				X	\$30	\$4,505
North Carolina		X			\$53	None				X	\$200	\$200
<i>North Dakota</i>				X	\$25	\$25				X	\$50	\$50
Ohio			X		\$0	None			X		\$0	None
Oklahoma		X			\$0	\$20,000						
<i>Oregon</i>				X	\$60	\$60				X	\$50	\$50
Pennsylvania		X			\$0	None		X			\$0	None
<i>Rhode Island</i>		X		X	\$550	\$550		X		X	\$550	\$550
South Carolina		X			\$25	None						
<i>South Dakota</i>				X	\$30	\$30				X	\$50	\$50
Tennessee	Regular	X		X	\$120	None	Regular	X		X	\$300	None
Texas			X		\$0	None			X		\$0	None
<i>Utah</i>				X	\$12	\$12				X	\$12	\$12
<i>Vermont</i>				X	\$285	\$285				X	\$275	\$275
Virginia				X	\$100	\$1,700				X	\$50	\$50
Washington			X	X	\$59	None			X	X	\$59	None
West Virginia		X		X	\$75	None		X		X	\$75	None
<i>Wisconsin</i>				X	\$25	\$25				X	\$40	\$40
Wyoming				X	\$50	None				X	\$50	None
Number of states	6	16	8	41			4	6	5	39		

they have chosen to fully tax the income of the entities themselves. Alaska and Florida also do not have personal income taxes, but unlike New Hampshire and Tennessee they do *not* impose their corporate income taxes on S-Corps or LLCs.

- States in which the tax that applies to businesses generally is not a conventional corporate income tax almost always apply this tax to S-Corps and LLCs as well. Examples include the Michigan Business Tax, New Hampshire Business Enterprise Tax, Ohio Commercial Activities Tax, and Washington Business and Occupation Tax.
- In 19 states plus the District of Columbia, the taxes that apply to S-Corps are not capped in dollar terms. The taxes that apply to LLCs are not capped in 12 states.
- Of the taxes and fees that are imposed at fixed dollar amounts, the lowest are \$10 fees imposed by Colorado and Indiana; the highest is a combined franchise tax and fee of \$550 in Rhode Island.
- Idaho is the only state that does not impose any type of tax or annual fee on S-Corps or LLCs.

Potential Revenues from Taxes on S-Corps and LLCs

The 3.3 million S-Corps and 1.3 million LLCs in the United States generate 19 percent and 5 percent of all U.S. business receipts, respectively, according to 2003 data from the IRS.⁶ However, little state-by-state data exist with which to estimate the potential revenue impact of imposing or expanding taxes and fees on these entities. The IRS does not publish profits data for either S-Corps or LLCs on a state-by-state basis, and the national profits data it publishes for LLCs is combined with data for partnerships.

However, two states, California and Pennsylvania, publish some information that suggests the order of magnitude of potential receipts. In 2006, California's 1.5 percent special income tax that applies to S-Corps generated \$962 million in revenue, or slightly more than 10 percent of the \$9 billion generated by the regular corporate income tax the state imposes on "C" Corporations at a flat 8.84 percent rate.⁷ Pennsylvania's 0.724 percent Capital Stock/Franchise Tax (currently being phased out) generated \$170 million from S-Corps and \$93 million from LLCs in 2002; combined, these amounts represented 28 percent of total collections from this tax, which regular "C" Corporations also pay.⁸

Most states publish data on the number of LLCs formed in the state or registered to do business there. For the states that impose only flat-dollar fees on LLCs, Table 2 shows the revenue potential of increasing the existing fees to \$250 and \$500 per year. While the revenue from such fees would not be large in relation to state budgets, it could be large enough to forestall the need for particular program cuts during the current fiscal crisis.

**TABLE 2: POTENTIAL REVENUE GAIN FROM INCREASING LLC REGISTRATION FEES
IN STATES WITH FIXED-DOLLAR FEES LESS THAN \$500**

	Number of LLCs in State	Current LLC Fee	Revenue Gain from \$250 LLC Fee (\$M)	Revenue Gain from \$500 LLC Fee (\$M)
Arkansas	41,771	\$150	\$4	\$15
Colorado	196,116	\$0	\$49	\$98
Connecticut	168,643	\$260	\$0	\$40
Delaware	466,146	\$250	\$0	\$117
Florida	446,525	\$139	\$50	\$161
Georgia	NA	\$30	NA	NA
Hawaii	37,414	\$15	\$9	\$18
Idaho	12,062	\$0	\$3	\$6
Indiana	121,759	\$10	\$29	\$60
Iowa	48,732	\$23	\$11	\$23
Louisiana	176,125	\$25	\$40	\$84
Maine	23,387	\$85	\$4	\$10
Maryland	90,407	\$300	\$0	\$18
Mississippi	81,682	\$0	\$20	\$41
Missouri	218,732	\$0	\$55	\$109
Montana	45,963	\$15	\$11	\$22
Nebraska	26,788	\$5	\$7	\$13
Nevada	128,891	\$100	\$19	\$52
New Mexico	NA	\$63	NA	NA
North Carolina	191,871	\$200	\$10	\$58
North Dakota	NA	\$50	NA	NA
Oklahoma	NA	\$0	NA	NA
Oregon	101,344	\$50	\$20	\$46
South Carolina	NA	\$0	NA	NA
South Dakota	13,167	\$50	\$3	\$6
Utah	114,445	\$12	\$27	\$56
Vermont	NA	\$275	NA	NA
Virginia	168,164	\$50	\$34	\$76
Wisconsin	145,745	\$40	\$31	\$67

NA = Not available

Why Imposing Entity-Level Taxes on S-Corps and LLCs Make Sense

States impose taxes and fees on S-Corps and LLCs because these entities receive substantial benefits from state and local government services. Most obviously, states provide significant concrete benefits to all for-profit enterprises, including S-Corps and LLCs. States substantially finance K-12 and higher education systems, which furnish businesses with a productive workforce. They maintain a legal and regulatory system that enforces business contracts and discourages commercial fraud. They provide public transportation networks that enable businesses to obtain inputs and get their products to market. Since S-Corps and LLCs benefit at the entity level from these services, they should share the responsibility of financing them.

Moreover, S-Corps and LLCs enjoy special legal advantages, granted by state governments, not available to other forms of businesses. Unlike, for example, sole proprietorships — the simplest and most common form of business organization, which also “pass through” profits to their owners’ tax returns — LLCs and S-Corps are “limited liability entities.”⁹ They exist separate and apart from their owners and have rights separate from their owners’ rights.

For example, property can be held in the name of an S-Corp or LLC. In addition, *all* of the owners of these businesses enjoy “limited liability” for the firm’s debts.¹⁰ (This means that if the firm’s debts ever exceed its assets, the most that the owners can lose is their investment in the business; creditors cannot tap the owners’ personal financial resources to make themselves whole.) Because the ability to do business in the form of a corporation or LLC that provides limited liability for owners is a privilege state governments grant, it has long been recognized that states have the right to impose “franchise” or “privilege” taxes on these entities in exchange.¹¹

The public benefits described above accrue to S-Corps and LLCs even if the business is not yet profitable, never becomes profitable, or is not profitable in a particular year. Fortunately, most of the entity-level taxes and fees imposed by states on S-Corps and LLCs are not based solely on the firm’s profitability. Instead, they tend to be either fixed fees or taxes that are calculated on the basis of the firm’s gross receipts or net worth. Thus, such taxes and fees serve as “alternative minimum taxes” and ensure that the businesses make at least a modest financial contribution toward state services, even in years in which they are not profitable.

Equalizing the Tax Treatment of S-Corporations and LLCs

Table 1 shows that in approximately half of the states that levy a significant, variable tax or fee on S-Corps or LLCs, the two types of entities pay different amounts.¹² In many of these instances, business franchise taxes apply only to S-Corps, while LLCs are subject to a small fee at most. This unequal treatment is generally a historical accident flowing from the fact that LLCs did not exist at the time states enacted their franchise taxes.¹³

It is difficult to justify imposing higher taxes and fees on S-Corps than on LLCs from the standpoint of either fairness or economic efficiency. LLCs provide both of the major benefits of S-Corporation status — limited liability for all owners and freedom from corporate income taxation — with none of the major restrictions. For example, federal and state rules on S-Corps regarding the number and characteristics of owners and the ways in which profits may be distributed among them do not apply to LLCs.

Accordingly, there is no obvious reason why state taxes and fees should be higher on S-Corps than on LLCs. This is all the more true because the S-Corporation rules were designed to — and primarily still do — benefit closely held, family-owned businesses, while LLCs often closely resemble many non-publicly traded corporations that are subject to corporate income taxes. Giving LLCs more favorable tax treatment can also adversely affect the efficient allocation of economic resources by giving them an artificial competitive advantage over S-Corps.¹⁴ In short, in those states in which S-Corporations are still subject to higher taxes/fees than LLCs, policymakers may wish to equalize the tax treatment.

One state, New Jersey, imposes *higher* levies on LLCs than on S-Corps in some circumstances. The state's annual fee on LLCs is levied at a flat amount per owner (\$150), with a \$250,000 cap, whereas the state's annual tax on S-Corps ranges between \$500 and \$2,000. Thus, an LLC with numerous owners can face a significantly higher tax liability than would an S-Corporation. Since S-Corp rules were designed primarily to benefit family-owned businesses, it could be argued that an LLC with a large number of members does not deserve the same beneficial tax treatment and should pay somewhat higher taxes and fees than a comparable S-Corporation.

Mitigating State Entity-Level Taxes on Smaller S-Corps and LLCs

Policymakers in states not currently levying entity-level taxes or fees on S-Corporations and LLCs may be reluctant to impose such charges out of fears that they would fall on very small businesses. This need not be a concern.

One reason is that many S-Corporations and LLCs are not very small businesses. Over 500,000 S-Corps have annual receipts greater than \$1 million, for example.¹⁵ Indeed, very large corporations are occasionally organized as S-Corps and LLCs. For example, the Tribune Company, a media conglomerate, is an S-Corporation, and Chrysler is an LLC.¹⁶

In any case, policymakers can avoid excessively burdening small businesses by exempting them from whatever taxes or fees they choose to impose. For example, Missouri's franchise tax does not apply to S-Corps with less than \$1 million in Missouri assets, and Minnesota's annual fee on S-Corps and LLCs does not apply unless the sum of the business's property, payroll, and sales in the state exceeds \$500,000. Even fixed-dollar fees can be set at levels that are fair and affordable for the very smallest of businesses, while rising for larger firms. For example, the New York minimum tax is just \$25 for S-Corps with New York receipts of less than \$100,000 annually but rises to \$4,500 for S-Corps with receipts above \$25 million.

Conclusion

About three-fifths of the states have determined that it is appropriate to impose some type of significant tax or fee on S-Corporations and Limited Liability Companies for the legal privileges they enjoy and the public services they receive. States that do not impose such levies should consider instituting them as a small part of addressing the major fiscal crisis that many states now face. Other states might consider equalizing their taxation of S-Corps and LLCs or adjusting fixed-dollar fees that have not been changed in recent years.

Notes

¹ Limited Liability Companies can elect to be treated as taxable corporations for federal tax purposes. The discussion in this paper applies to LLCs that have *not* made such an election but rather have chosen to be treated as tax-exempt pass-through entities.

² Owners of S-Corps and LLCs are subject to tax each year on their pro-rata share of the business's profits, whether or not the profits have actually been distributed to them. Many states require or allow the businesses to pay the personal income taxes owed by the owners to ensure that they are in fact paid (especially by out-of-state owners) and to relieve the owners of the need to file an income tax return. Taxes paid by S-Corps and LLCs on behalf of the owners are not the subject of this report and are not included in Table 1.

³ The two principle sources of the information presented in Table 1 are: Robert W. Jamison, William N. Kulsrud, Linda Ethridge Curry, and Teresa Stephenson, *2009 Multistate Tax Guide to Pass-Through Entities* (CCH, 2008), and John C. Healy and Michael S. Schadeewald, *2009 Multistate Corporate Tax Guide on CD-ROM* (CCH, 2008). Where it was contradictory, ambiguous, or appeared to be out-of-date, the information contained in these two references was verified with selective review of state statutes, regulations, and tax forms.

⁴ Nearly all states require LLCs and/or S-Corps to file an annual report with the secretary of state and to pay an annual fee at the same time. In states in which the fee is due every other year, the amount shown in Table 1 is one-half of the biennial amount due. In states in which higher fees apply to S-Corps and LLCs formed out of state, the lower fee applicable to in-state entities is shown.

⁵ The net worth of a business is its assets minus its liabilities. The net worth is also equal to the initial equity investments of owners plus all subsequent (net) injections of equity capital, plus all profits earned by the firm since its inception that were retained rather than paid out as dividends. Capital stock is defined differently among the states that calculate their taxes on this base; in some cases it refers to the initial investment of equity investors.

⁶ Internal Revenue Service, Statistics of Income Division. Data available at www.irs.gov/pub/irs-soi/03ib02ty.xls.

⁷ See the tables titled "S Corporations: Synopsis of Tax Liability Computations" and "C Corporations: Synopsis of Tax Liability Computations," both available at www.ftb.ca.gov/aboutFTB/Tax_Statistics/Reports/Business_Entities/Corporations/2006/PDF/2007_Tax_Liability_Computations_C_and_S.pdf.

⁸ Pennsylvania Department of Revenue, "Tax Year 2002 Statistics on Capital Stock/Franchise Tax [and] Corporate Net Income Tax," July 2007, Table 3 and 5. Available at www.revenue.state.pa.us/revenue/lib/revenue/2002_corp_tax_stats.pdf.

⁹ Limited liability for all owners is a characteristic of all corporations. From a legal standpoint, an S Corporation is no different than any other corporation; it is simply a conventional corporation that has the ability to elect tax-exempt status under federal tax law if it meets the requirements for such status. These include a maximum of 100 shareholders (who generally must be individuals) and the satisfaction of a number of other criteria.

¹⁰ There is another form of pass-through entity, the "limited partnership," in which virtually all owners enjoy limited liability. Every limited partnership, however, must have a "general partner" that does not have limited liability. Since that general partner can be a corporation or limited liability company, some limited partnerships effectively provide limited liability for all owners just as S-Corps and LLCs do. An argument can be made in that case that they should be subject to the same taxes and fees as S-Corps and LLCs, and in some states they are.

¹¹ In support of the federal corporate income tax enacted in 1909, President Taft stated, "[T]his is an excise tax upon the privilege of doing business as an artificial entity and of freedom from a general partnership liability enjoyed by those who own the stock." Opponents objected to this argument, pointing out that corporations are creatures of state governments, not the federal government — arguably conceding the point that states could tax corporations under this rationale even if the federal government could not. This history is discussed in Reuven S. Avi-Yonah, "Corporations, Society, and the State: A Defense of the Corporate Tax," *Virginia Law Review*, September 2004.

Avi-Yonah's article surveys the substantial debate that exists to this day as to whether there is a justification for an entity-level tax on corporations in addition to an income tax on corporate income received by individual owners of the corporation. Along with some other economists and legal theorists who have addressed this issue, Avi-Yonah rejects the argument that the federal corporate income tax is justifiable as a payment for the privilege of doing business in corporate form. He does not, however, address whether state corporate income taxes could reasonably be justified on such grounds.

¹² Thirty-one states plus the District of Columbia levy significant, variable taxes and/or fees on S-Corps or LLCs. In the following 17 states the taxes and fees are significantly different for the two types of entities: Arkansas, California, Delaware, Georgia, Illinois, Louisiana, Massachusetts, Mississippi, Missouri, Nebraska, Nevada, New Jersey, North Carolina, Oklahoma, South Carolina, Tennessee, and Virginia. In addition, many of the states that levy fixed-dollar taxes or fees impose them on S-Corps but not LLCs.

¹³ Wyoming was the first state to authorize LLCs, in 1977.

¹⁴ Some of the taxes and fees listed in Table 1 apply only to S-Corps and LLCs formed under the laws of the state, not to out-of-state S-Corps and LLCs doing business in the state. Where these taxes and fees are substantial, they may raise similar "level playing field" issues.

¹⁵ Internal Revenue Service, Statistics of Income Division. Data available at www.irs.gov/pub/irs-soi/03ib01ty.xls.

¹⁶ See: Associated Press, "Tribune Posts \$1.82B 1Q Gain on Tax Status Change; Sales Ebb," *International Herald Tribune*, May 9, 2008. See also the website of Chrysler LLC at www.chrysler.com.