Identifying and Estimating the Effect of Incentives for S Corporations to Underreport the Labor Income of Their Owners

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Abstract

Many, but not all, S corporations have an incentive to underreport the labor compensation of their owners to help those owners minimize their payroll tax liability. This technical note accompanies a set of tables that define two strategies S corporations might use to accomplish that. The note explains how the two strategies work, how we identified the S corporations for which they are viable, and how we estimated the extent to which the strategies are used. To estimate utilization, the tables compare average compensation of owners of S corporations for whom a strategy is not viable with that of S corporations for which the strategy is viable. The amount by which the latter is lower than the former is a measure (albeit imperfect) of the extent to which the strategy is being used. Tables are disaggregated either by industry or by categories defined by the number of owners and whether the income pool out of which compensation would be paid is positive or negative.

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Introduction and Background

Business owners typically contribute capital to the business in the expectation of receiving a return on that capital (that is, capital income). The capital income of owners includes distributions of profits (frequently in the form of dividends) and capital gains attributable to the company's retained earnings or other factors that create value. Owners may also contribute labor to the business, whether by producing goods or services for sale or performing management functions. For that labor, they receive compensation (or labor income), typically in the form of wages or a salary. Labor and capital income are taxed differently from one another. Of particular interest in this note is the Federal Insurance Contributions Act (FICA) tax—which is dedicated to the Social Security and Medicare Trust Funds. That tax is intended to cover only labor income and applies to the wages and salaries of employees of all firms and to the labor income of owners of corporate businesses.[1] However, for some legal forms of organization there may be incentives to underreport the labor income of their owners (effectively recharacterizing it as capital income) to help the owners avoid the FICA tax.

This technical note focuses on one form of organization—the S corporation, so named because of the subsection of the tax code in which it is defined. Many, but not all, S corporations have an incentive to underreport the labor income of their owners to help them avoid the FICA tax. This note describes two strategies for underreporting the labor income of owners and identifies the conditions under which each of those strategies makes no owners of an S corporation worse off (hereafter referred to as a strategy's "viability"). It accompanies detailed tables that tabulate the number of S corporations for which each strategy is viable and, as a rough measure of the extent to which a strategy is utilized, compares the reported compensation paid by S corporations for which a strategy is viable with that paid by S corporations for which it is not viable.

The S Corporation as an Organizational Form

The S corporation is one of several organizational forms that U.S. businesses can take. Unlike C corporations, which are subject to the corporate income tax, the profits of S corporations are treated like those of unincorporated businesses—that is, they are "passed through" to their owners (whether or not they have been distributed) and taxed only through the individual income tax (see Table 1). Passive S corporation owners (that is, those who do not materially participate in the business) whose income exceeds certain thresholds must also pay a "net investment income tax" (NIIT) on their profits.[2]

Unlike other pass-through entities (but like C corporations), S corporations must pay their owners "reasonable compensation" for services rendered before making any cash distribution of their profits.[3]

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[1] Employee contributions to certain retirement accounts, such as 401(k) plans, also represent labor income that is included in the FICA tax base (although they are excluded from the individual income tax base). Owners of partnerships and sole proprietorships are not subject to the FICA tax. Instead, they pay the Self-Employment Contributions Act tax—also dedicated to the Social Security and Medicare Trust Funds. That tax applies to a significant share of capital income as well as labor income and is beyond the scope of this note. For more detail, see Congressional Budget Office, *The Taxation of Capital and Labor Through the Self-Employment Tax* (September 2012), www.cbo.gov/publication/4168.

[2] The income thresholds are $200,000 for unmarried taxpayers and $250,000 for married taxpayers filing joint returns. The rate of tax is 3.8 percent. Other sources of income subject to the tax include interest, dividends, capital gains, royalties, and net rental income.

[3] The IRS states that "[t]he amount of compensation will never exceed the amount received by the shareholder either directly or indirectly." (See "Wage Compensation for S Corporation Officers," IRS Fact Sheet 2008-25, August

That compensation reduces the profits of the corporation that are subject to income taxes, but the recipient must pay both income and FICA taxes on the amount. In 2022, an employee's wages up to $147,000 are taxed under FICA at a rate of 15.3 percent and amounts above that are taxed at 2.9 percent—all split equally between the employer and the employee.[4] An additional Medicare tax of 0.9 percent (paid by the employee) is levied on wages in excess of the same income thresholds that apply to the NIIT.

Not every corporation can qualify for S corporation status. A qualifying corporation must be a domestic business entity and can have no more than 100 shareholders—none of which can be another for-profit business or a nonresident alien. Only one class of stock is permitted and certain lines of business, mostly in the finance industry, are ineligible.

Material Participation of Owners

The aforementioned material participation standard consists of a series of tests that are applied by each owner when reporting their S corporation profits or losses on Schedule E of Form 1040. The most important test is whether the owner contributed at least 500 hours of labor during the year. If so, then their participation is deemed to be material and they report their profits and losses as "nonpassive." Other tests for material participation include contributing at least 100 hours of labor if no other owner or employee contributed more or having been deemed a material participant in 5 of the last 10 years. The final test is a "facts and circumstances" test that gives owners a great deal of leeway in classifying themselves. In theory, owners who do not meet the material participation standard report their profit and losses as "passive."

Owners, however, frequently have an incentive to mischaracterize their level of activity and that incentive can run in either direction. (This incentive is distinct from the incentive to mischaracterize labor income as capital income, but it affects how precisely the mischaracterization of income can be identified.) For example, the material participation standard is key to determining whether S corporation profits are subject to the NIIT. At the same time, however, it is also key to determining whether their profits can be offset by passive losses from another business. Those two factors set up competing incentives—a desire to avoid the NIIT provides an incentive for high-income taxpayers to report S corporation profits as "nonpassive," but the presence of passive losses from other businesses provides an incentive to report profits as "passive."

For purposes of this note, it is important to recognize that many passive owners contribute no labor and can legitimately report reasonable compensation of zero. In contrast, nonpassive owners, with few exceptions, contribute labor. Therefore, their reasonable compensation should be positive. The incentive of owners to mischaracterize their level of activity, however, interferes with any effort to quantify the underreporting of labor income. Some self-described passive owners who receive no

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2008, irs.gov/pub/irs-news/fs-08-25.pdf.) Thus, if no distribution of profits is made, no compensation need be paid either. However, if an S corporation makes a cash distribution of profits, that distribution must be preceded by the payment of reasonable compensation for services provided. If the distribution includes profits from prior years, then it must be preceded by reasonable compensation for services provided in all of those years. Thus, although an S corporation can report zero compensation of owners in years it does not make a cash distribution of profit, that only defers the liability for FICA tax until the year the profits are distributed.

[4] Tax revenues resulting from the 12.4 percent rate on wages up to the cap are dedicated to the Social Security Trust Fund; those resulting from the 2.9 percent rate on all wages are dedicated to the Medicare Trust Fund.

compensation might, in fact, be material participants for whom compensation is being underreported. Conversely, the absence of compensation reported by some self-described nonpassive owners might actually reflect their lack of material participation.[5]

Incentives to Misreport Income

Subjecting the compensation of S corporation owners to FICA taxes creates an incentive for many S corporations to report less as compensation and more as profits. Estimates of the impact of that incentive vary widely. The Government Accountability Office estimated that S corporations underreported the reasonable compensation of their owners by $23.6 billion in 2003 and 2004, which is about 6 percent of their estimate of the correct amount.[6] Another study covering that time period, however, estimated that the amount reported by S corporations as "officers' compensation" fell short of the economic value of their owners' labor between 2000 and 2004 by 35 percent.[7] Estimates from a more recent study implied that reported officers' compensation fell short of the reasonable compensation standard by 38 percent.[8]

The incentive is most straightforward for an S corporation with a single owner. Multi-owner S corporations are more complicated. Such firms can benefit from underreporting owners' compensation using any number of strategies. Not all those strategies are available to every multi-owner firm, however. Here, we focus on two strategies—the proportional-to-labor-contribution (LC) strategy, which potentially results in owners receiving the highest combined after-tax incomes, and the proportional-to-ownership-shares (OS) strategy, which is available to the most firms.

Single-Owner Firms

For a single-owner S corporation, the amount reported as reasonable compensation has no impact on the owner's income tax liability because both the compensation and the profits (which have been reduced by the amount of compensation) are taxed at the same rate. FICA tax liability, however, depends on how the income is reported—amounts reported as compensation are subject to the FICA

[5] The possible exceptions are strictly hypothetical because owners never explicitly identify themselves as passive or nonpassive with respect to a particular S corporation or partnership. Instead, they aggregate the passive and nonpassive income from all S corporations and partnerships and report those numbers separately on Schedule E. As explained below, the practice of aggregating income over all S corporations and partnerships poses at least as many challenges to identifying passive and nonpassive owners as does the incentive to mischaracterize activity levels.

[6] U.S. Government Accountability Office, "Actions Needed to Address Noncompliance with S Corporation Tax Rules," (December 2009), www.gao.gov/new.items/d10195.pdf.

[7] Nicholas Bull and Paul Burnham, "Taxation of Capital and Labor: The Diverse Landscape by Entity Type," *National Tax Journal*, vol. 61, no. 3 (December 2008), p. 414, www.ntanet.org/NTJ/61/3/ntj-v61n03p397-419-taxation-capital-labor-diverse.html

[8] See Matthew Smith, Danny Yagan, Owen Zidar, and Eric Zwick, "Capitalists in the Twenty-First Century," Quarterly Journal of Economics, vol. 134, no. 4 (November 2019), pp. 1675-1745, doi.org/10.1093/qje/qjz020. They estimate that 2.2 percent of gross sales of S corporations can properly be characterized as labor income. That equals 61 percent of reported officers' compensation, implying that such compensation is underreported by 38 percent [0.61/(1+0.61)].

tax, but amounts reported as profits are not. Thus, to minimize FICA taxes, every sole-owner has an incentive to reduce reported compensation and increase reported profits.[9]

Such a strategy can be successful because the meaning of "reasonable compensation" is somewhat nebulous. In the context of nonprofit organizations, the IRS has defined it as "the value that would ordinarily be paid for like services by like enterprises under like circumstances."[10] That definition is, however, strictly conceptual—it does not carry the force of law. In fact, that definition is immediately followed by "[r]easonableness is determined based on all the facts and circumstances." That gives taxpayers considerable latitude to favorably present their "facts and circumstances" to the IRS.

Multi-Owner Firms—the Proportional-to-Labor-Contribution (LC) Strategy

The LC strategy involves estimating each owner's reasonable compensation for labor contributed and reducing it by a fixed percentage. However, doing so and distributing the additional profit in proportion to ownership shares does not always make every owner better off. Specifically, owners who contribute a relatively high share of labor compared to their ownership share would be worse off under the LC strategy than if the reasonable compensation standard had been followed, even though the strategy would enable them avoid FICA taxes. That renders the strategy nonviable. When the LC strategy is viable, however, the greatest benefit to owners is realized by reducing each owner's compensation by 100 percent.

To illustrate a viable LC strategy, consider Mary and John who own an S corporation that earns $100,000 in a year, half of which is properly paid out in labor costs (direct compensation of owners and the employer's share of FICA taxes) and half of which is passed through to the owners as profits. Each owner can dissolve the firm if dissatisfied with his or her share of the combined return on capital and labor. If both Mary and John own 50 percent of the shares and contribute 50 percent of the labor, then both Mary and John would be equally better off by reporting compensation of zero (Scenario 1—see the top half of Table 2). By doing so, the combined after-tax income of the two owners would increase by $6,218—with each owner receiving half of that amount ($3,109).

To illustrate nonviability, consider the case in which Mary owns 80 percent of the shares and receives a corresponding share of the passed-through profits while John contributes 80 percent of the labor and is compensated accordingly (Scenario 2—see the bottom half of Table 2 or Table 3a). When income is properly reported, Mary's after-tax income is $36,257 while John's is $32,526. Claiming that reasonable compensation was zero would increase their combined after-tax income from $68,783 to $75,000, but one of the two owners would be worse off. John's after-tax income would drop by more than half while Mary's would nearly double. It is impossible in these circumstances to misreport the nature of the

[9] There are countervailing incentives that apply to certain owners, including sole-owners. For example, as owners approach retirement age, they may find it advantageous to report compensation accurately because doing so would maximize their future Social Security benefits. Those countervailing incentives are beyond the scope of this note.

[10] See www.irs.gov/charities-non-profits/exempt-organization-annual-reporting-requirements-meaning-of-reasonable-compensation. The IRS has not explicitly addressed the definition of reasonable compensation in the context of for-profit corporations.

income without causing John's after-tax income to decline. It would not be in John's self-interest to agree to the LC strategy.[11]

How great must the mismatch between labor contribution shares and ownership shares be before John objects to the LC strategy? In the very special case in which each owner's labor contribution share is equal to one minus their ownership share, Mary's ownership share could not exceed 54.52 percent before John would object to employing the LC strategy (Scenario 3—see the right-most column of Table 3b), making the mismatch 9.04 percentage points (54.52 percent ownership share – 45.48 percent labor contribution share). Moving beyond the special case depicted in Scenarios 1, 2, and 3 widens the allowable mismatch somewhat. But even in the most extreme case in which Mary provides no labor contribution at all, her ownership share could not exceed 16.58 percent before John would object to the LC strategy (Scenario 4—see the right-most column of Table 3c).

Note that the above examples assume that the LC strategy is pursued to the fullest mathematically possible extent. For actual taxpayers, however, it might be more rational to pursue the LC strategy less aggressively. In many service industries, for example, reporting zero owners' compensation seems clearly inconsistent with the nature of the business, which might attract the attention of IRS auditors. Hence, one might expect firms pursuing this strategy to select a percentage by which to reduce compensation of less than 100 to avoid unwanted attention. Henceforth, firms will be classified with reference to the LC strategy according to both viability and utilization as follows:

- *LC irrelevant*—owners contribute no labor
- *LC full*—owners contribute labor, the strategy is viable, and it appears to be fully utilized (although that might represent deferral of tax liability rather than avoidance),
- *LC partial*— owners contribute labor and the strategy is viable but not fully utilized, and
- *LC nonviable*—owners contribute labor, but the strategy is not viable.[12]

Multi-Owner Firms—the Proportional-to-Ownership-Shares (OS) Strategy

The OS strategy involves reducing each owner's compensation in proportion to ownership share. Because the resulting profits will be also distributed according to ownership share, that means each owner will recover the lost compensation plus the value of the FICA tax that was saved. The OS strategy is more complicated to implement than the LC strategy, but it is available to many more S corporations. In fact, every S corporation in which all owners contribute some labor can employ the strategy. The strategy involves the following steps:

[11] It would be possible for Mary to make a side payment to John of at least $17,526 that would make him whole and therefore willing to go along with the strategy. The existence of such a payment, however, would constitute evidence of intent to violate the legal requirement that owners be paid reasonable compensation for their labor. We recognize that such side payments probably occur, but the evidence of such payments is inherently missing from the tax data and so they cannot be accounted for in this analysis.

[12] The fact that reasonable compensation need not be paid in every year—only in years in which cash distributions of profits are made—implies that there should be a fifth classification of *LC deferred*, separate from the *LC full* group. However, such behavior cannot be detected in the tax data, which does not distinguish between distributed and undistributed profits. Thus, care must be taken in interpreting the share of S corporations that are classified as *LC full*.

1. Divide each owner's labor contribution share by their ownership share and identify the owner with the lowest value (the reference owner). That value becomes the firmwide capital adjustment factor. Note that if the reference owner's labor contribution share is zero, the capital adjustment factor will also be zero, which renders the strategy nonviable.
2. Multiply the capital adjustment factor by each owner's ownership share.
3. For each owner, subtract the product in Step 2 from the labor contribution share to get the optimal percentage of firm-wide reasonable compensation that should be paid to them under the OS strategy.
4. Recalculate each owner's after-tax income using the compensation calculated in Step 3.

The LC and OS strategies yield the same results under Scenario 1, but Scenario 2 provides a good illustration of the implications of implementing the OS strategy. In that case, Step 1 yields labor-contribution-to-ownership-share ratios of 0.25 for Mary (0.20/0.80) and 4.00 for John (0.80/0.20), making Mary the reference owner and 0.25 the firm's capital adjustment factor. Multiplying the capital adjustment factor by Mary's and John's ownership shares yields 0.20 for Mary (0.25 * 0.80) and 0.05 for John (0.25 * 0.20). Subtracting those values from their labor contribution shares yields zero for Mary (0.20 – 0.20) and 0.75 for John (0.80 – 0.05). The implications of that are that the OS strategy dictates that Mary report zero compensation (a result that holds for every reference owner), which is $10,000 less than reasonable compensation for her labor contribution. John would report compensation of $37,500, which is 75 percent of the firm-wide reasonable compensation amount of $50,000 and $2,500 less than reasonable compensation for his own labor contribution. For each owner, profits would increase by the same amount that compensation (including the employer's share of the FICA tax) decreased. Ultimately, following the OS strategy would increase Mary's after-tax income by $1,244 and John's by $311 (see Table 3a). In this case, the OS strategy would prevail because it is viable while the LC strategy is not.

Under Scenario 3, in which John was indifferent under the LC strategy, $18,970 of John's compensation shifts to profits under the OS strategy, increasing his after-tax income by $2,359 (see Table 3b). Once again, all of Mary's compensation ($22,740) shifts to profits and her after-tax income increases by $2,828. The OS strategy is, therefore, viable. The combined increase in after-tax income is less than under the LC strategy by $1,031, but John is better off under the OS strategy. In the absence of side payments, we have no way of determining whether John's preference for the OS strategy or Mary's preference for the LC strategy would prevail.

Under Scenario 4, Mary starts out with no compensation, meaning that no compensation can be shifted to profits. That renders the OS strategy nonviable, meaning that the LC strategy would prevail (see Table 3c).

Unlike the LC strategy, the OS strategy can be pursued to the fullest mathematically possible extent without creating conditions that would easily attract the attention of IRS auditors. Thus, there are fewer constraints to fully utilizing the OS strategy than there are to fully utilizing the LC strategy (although the countervailing incentives mentioned in footnote 9 still apply). Henceforth, firms will be classified with reference to the OS strategy according to both viability and utilization as follows:

- *OS full*—viable and fully utilized,
- *OS partial*—viable but not fully utilized, and

- *OS nonviable*.

Ideal Generalized Tests for the Viability of Underreporting Strategies

The above examples are all limited to two-owner S corporations and are premised on knowing each owner's true contribution of labor. Retaining the latter premise, tests can be devised to determine which underreporting strategies are viable for any given S corporation, regardless of the number of owners. Determining which strategy would dominate when both are viable is more complicated and beyond the scope of this note.

Testing for the viability of the OS strategy is simple—the strategy is viable for any S corporation in which all owners contribute some labor. Testing for the viability of the LC strategy is more complicated. The most straightforward test involves the following steps:

1. Calculate the after-tax income of each owner under a "compliant" scenario by applying the FICA tax rate to reasonable compensation for the owner's labor and the income tax rate to the sum of compensation and profits.
2. Calculate the after-tax income of each owner under a "noncompliant" scenario by zeroing out compensation (thus eliminating any FICA tax), redistributing the higher resulting profits in proportion to ownerships shares, and applying the income tax rate to the new level of profits.
3. Compare the results of the "compliant" and "noncompliant" scenarios for each owner.
4. Recognize the LC strategy as viable only if every owner's after-tax income is higher under the "noncompliant" scenario.

Tests using less extreme noncompliance in Step 2 will give the same viability result if the ratio of reported compensation to reasonable compensation is the same for all owners.

Tax data reflect what is reported by S corporations and their owners (that is, after income has been mischaracterized), not the economic reality. Thus, it is not possible to know with certainty what each owner's reasonable compensation for labor services is. Nevertheless, certain inferences about viability and utilization of underreporting strategies can be made using tax data.

Description of Data

To make the inferences and perform the quantitative tests described above, we drew a sample of Forms 1120S filed for tax year 2016, then attached all the needed supporting forms associated with the selected S corporations. We then compared the information on the Forms 1120S with the cumulative amounts from the associated Forms K-1 (the form S corporations must provide to each shareholder reporting their share of profits or losses) and W-2. To the extent that those amounts differed, we applied various techniques to reconcile them.

Drawing a Sample of S Corporations

Rather than simply draw a random sample of S corporations, we created 980 strata and drew a random sample within each of them. The strata were defined using characteristics that we deemed most likely to influence whether an S corporation would underreport the compensation of owners. We created the strata using three criteria:

1. *Presence or absence of net income on Form 1120S*. We observed that firms with net income were much more likely to report nonzero compensation of officers than firms without net

income. That is not necessarily dispositive because not all owners are officers and not all officers are owners, but the overlap is very high, so that distinction was used as a stratification criterion (See Appendix A for a discussion of the distinction between compensation of officers and owners and the size of the overlap).

2. *Number of owners*. The difficulty of creating the conditions in which all owners benefit from underreporting their compensation increases with the number of owners. Therefore, we used number of owners as another stratification criterion and created five categories: one owner, two owners, three owners, between four and seven owners, and eight or more owners.
3. *Industry*. The need for capital and labor contributions from owners varies by industry. Some industries (for example, holding companies) are conducive to having a few owners managing the business while the rest remain passive investors. Others (for example, group medical practices) typically require significant labor contributions from all owners. To capture as much of that diversity as possible, we recognized 98 separate industries.

We used two methods to determine the sample size in each stratum and generated a target sample size by weighting the two methods. The first method was simple proportional representation, using a constant sampling rate of 12 percent for each stratum. The second method was the Neyman Allocation method, in which the target sample size in each stratum is a function of the coefficient of variation (that is, the standard deviation divided by the mean) within that stratum. That method attempts to capture more of the within-stratum variation than does proportional representation. However, it can result in very small sample sizes in strata that are more homogeneous. The variable for which we calculated a coefficient of variation was total receipts, which encompasses business receipts, gross rents, and positive amounts of what is reported as “other income.”

To ensure an adequate sample size in each stratum, we gave proportional representation a weight of 0.4 and the Neyman Allocation method a weight of 0.6. That resulted in an overall sample size of 401,604, which is about 8.5 percent of all S corporations. Among the different strata, the sampling rates ranged from 1.1 percent (solo-practice dentists) to 100 percent (many strata, especially in the eight-or-more-owners category without net income). Sampling rates are summarized in Tables 4a and 4b.

From this sample, records whose tax year did not correspond to the calendar year (approximately 1 percent) were deleted as unusable. Because K-1s and W-2s are always issued on a calendar year basis, it proved impractical to consistently identify the ones to attach to non-calendar-year firms.

Appending Additional Required Data

To each Form 1120S in the sample, we appended all the Schedules K-1 issued by the corporation and all the Forms W-2 issued by the corporation to K-1 recipients. Before appending the W-2s, however, we enhanced them by estimating the following information derived from the Form 1040 (and supporting schedules) filed by the W-2 recipient:

- The marginal income tax rate on wages and nonpassive S corporation profits,
- The marginal income tax rate on passive S corporation profits,
- The marginal FICA/SECA tax rate, and
- The amount of passive partnership or S corporation income or loss.

The marginal income tax rates accounted for the regular income tax, the alternative minimum tax, the net investment income tax, and the phaseouts of personal exemptions, itemized deductions, and child credits. All of that was calculated using data from Form 1040 and its supporting schedules.[13] Marginal income tax rates of zero were assigned to owners who did not file a Form 1040.

Calculating the marginal FICA/SECA tax rate required accounting for all W-2s received by the K-1 recipient, including those from other employers. Furthermore, any Schedule SEs included with their 1040s also had to be accounted for. Only with all sources of compensation accounted for could we determine whether the total exceeded $118,500—the threshold at which the tax rate dropped from 15.3 percent to 2.9 percent in 2016—or the threshold for the Additional Medicare Tax. That calculation was done whether or not an owner filed a 1040.[14]

Reconciling Schedules K-1 with Form 1120S

For 88 percent of records in the sample, the K-1s were completely consistent with the information reported on the 1120S (meaning that the number of K-1s matched the reported number of owners and the "ordinary business income" distributed through the K-1s matched the ordinary business income on the 1120S). In the remaining cases, the number of K-1s issued by the S corporation did not match the number of owners reported on Form 1120S. In those cases, we attempted to reconcile the differences. Not all such attempts were successful.

One circumstance that resisted reconciliation was when no K-1s were attached. The absence of K-1s necessarily implied the absence of owners' W-2s which made it impossible to determine whether an incentive existed to underreport compensation of owners. Another such circumstance was when profits were reported on Form 1120S, but losses were reported on the K-1s and vice versa. That condition made it impossible to generate a reliable distribution of profits among owners to compare to the distribution of compensation. Either circumstance (which combined represented less than 7 percent of the nonmatches) resulted in the record being dropped from the sample.

In about 4 percent of nonmatches, the cumulative profits from the K-1s (*cumprf*) matched the profits from the 1120S (*repprf*) even though the number of K-1s (*nk1*) did not match the number of owners (*nown*). In those cases (and only those cases), we deemed the K-1s to be the more reliable source of information and changed the value of *nown* to equal *nk1*.

In roughly 13 percent of nonmatches, deleting one or more K-1s resolved not only the differences between *nk1* and *nown*, but also the differences between *cumprf* and *repprf*. Most of those cases involved multiple K-1s being issued to the same owner. When that happened, it generally was not limited to one owner—it was more common for multiple K-1s to be issued to most or all owners (for

[13] A nonzero amount of passive partnership or S corporation income or loss was used to identify owners to whom the marginal tax rate on passive S corporation profits would apply. That introduces some imprecision because the passive income could be attributable entirely to partnerships. Nevertheless, the source data do not distinguish between partnership and S corporation income, so that imprecision is unavoidable.

[14] The calculation for filers, however, required that Forms W-2 be reconciled to wages and salaries reported on Form 1040. That required accounting for all W-2s of each owner's spouse in addition to the owner's W-2s. Reconciliation was accomplished by identifying a set of W-2s that matched the amount reported on Form 1040 and deleting any W-2s outside of that set. If no such set could be identified, all W-2s were scaled up or down to hit the proper total. In the few cases in which more than one Schedule SE was attributed to an owner, the second was reattributed to the spouse. If the owner was not married, extra Schedules SE were disregarded.

example, to correct an error in the total amount distributed). Furthermore, it was usually the case that ignoring all but the first K-1 of each owner resolved the differences. Ignoring all but the second K-1 worked about 20 percent of the time.

In less than 2 percent of nonmatches, deleting excess K-1s did not result in full reconciliation. In 30 percent of those cases, the remaining differences were deemed to render the record unusable and those records were dropped. In the other 70 percent of cases, the records were retained because the ordinary business income from the K-1s was deemed to provide a distribution of profits among owners that could usefully be compared to the distribution of compensation despite the lack of reconciliation.

In most of the remaining nonmatches, *nk1* fell short of *nown* and the absolute value of *cumprf* fell short of absolute value of *repprf*. In those cases, additional K-1s were imputed, with the difference between *repprf* and *cumprf* being distributed equally among them. In a handful of cases, *nk1* fell short of *nown*, but the absolute value of *cumprf* exceeded the absolute value of *repprf*. No imputation of profits was made in such cases.

Because the compensation of owners tabulated from the W-2s (*cumcomp*) is a different concept than compensation of officers reported on the 1120S (*repcomp*), we did not attempt a full reconciliation of those differences (see Appendix A). However, when additional K-1s were imputed, we also imputed additional W-2s if *cumcomp* was less than *repcomp* (roughly 25 percent of nonmatches).

Quantifying the Incentive to Underreport Compensation of Owners

After reconciling the Schedules K-1 to the Forms 1120S, we proceeded to test each S corporation in the sample for conditions that would make either the LC or OS strategy viable. Tax data, however, reflect what is reported by S corporations and their owners (that is, after any mischaracterization of income), not the economic reality. It is not possible to know with certainty what each owner's reasonable compensation for labor services is. That being the case, the tests described above allow us only to identify S corporations in the *LC partial* and *OS partial* categories. S corporations in the *LC full* category report zero compensation and cannot be directly tested, and S corporations in the *OS full* category have at least one owner with zero compensation and thus appear to fail the OS viability test.

Furthermore, within the *OS partial* category there is no way to distinguish between firms that took partial advantage and firms that simply did not pursue the strategy. The same is true within the *LC partial* category, and that category has additional complications. The LC strategy, by definition, reduces each owner's compensation by the same percentage, meaning that the mismatch between ownership shares and labor contribution shares is not necessarily distorted for firms in the *LC partial* category. However, if the OS strategy was employed (whether fully or partially), the reported distribution of compensation will not reflect the underlying distribution of labor contribution. In such cases, some firms that belong in the *LC nonviable* category will be placed in the *LC partial* category. To estimate the extent to which the use of the OS strategy distorts the test for the viability of the LC strategy, we compare results of the LC viability test for two groups:

1. All multi-owner S corporations (the I series in the accompanying tables)
2. S corporations in the *OS nonviable* group (the III series in the accompanying tables).

For consistency, we also compare results of the OS strategy tests for all multi-owner S corporations (the II series in the accompanying tables) and S corporations in the *LC nonviable* group (also part of the III series in the accompanying tables).

In this note, results are broken down along two dimensions; specifically, the number of owners and whether the pool of net income out of which compensation would be paid is positive or negative. The five categories for number of owners—one, two, three, between four and seven, and eight or more—are the same as those used to create strata from which to draw the sample. The income pool is calculated as follows:

	Net business income as reported on Form 1120S
plus	any amounts deducted as compensation paid to owners
plus	net rental real estate income as reported on Form 8825
plus	other net rental income reported on Schedule K.

The concept of the income pool is the same as the $100,000 of earnings assumed in the illustrative scenarios shown above. It is not the same as the "presence of net income" criterion used to define strata from which to draw the sample. In that case, net income included only the first of the concepts listed above.

The accompanying tables also provide breakdowns by industry for single-owner and multi-owners S corporations.

Identifying and Comparing the *LC Partial* and *LC Full* Groups

The first step to identifying the *LC partial* group is to identify the preference of each owner. To do that, we calculated a measure of each owner's after-tax income under two scenarios:

1. The "as-reported" scenario, in which distributed profits and compensation subject to tax are as reported on the owner's K-1 and W-2 respectively (distinct from the "compliant" scenario described above in that it may incorporate some degree of noncompliance with the reasonable compensation standard), and
2. An "all-capital" scenario in which the total amount of owners' compensation paid by the firm is redistributed among owners in proportion to the reported distribution of profits and taxed accordingly (essentially the same as the "noncompliant" scenario described above).

The formulas used to calculate the two measures of after-tax income (ATI_{rep} for "as-reported" and ATI_{cap} for "all-capital") are as follows:

$$1)\ ATI_{rep} = C_{rep} * (1 - t_c) + W_{rep} * (1 - t_w - 0.5 * t_{fica})$$

$$2)\ ATI_{cap} = (C_{rep} + C_{redistrib}) * (1 - t_c)$$

where C_{rep} is the reported amount of business and rental income or loss from Schedule K-1,

$C_{redistrib}$ is the amount of additional profits that would be distributed to the owner if no wages and salaries were paid to any owner,

W_{rep} is the reported amount of wage and salary income subject the Medicare component of FICA from Form W-2,

t_C is the marginal income tax rate on passed-through profit or loss,

t_W is the marginal income tax rate on wages and salaries, and

t_{fica} is the marginal FICA tax rate on wages and salaries.[15]

$C_{redistrib}$, in turn, is determined by the following formula:

$$3)\quad C_{redistrib} = \sum_{i=1}^{nk1}\left[W_{rep,i}/\left(1 - 0.5 * t_{fica}\right)\right] * C_{rep}/\sum_{i=1}^{nk1} C_{rep,i}$$

Note that $t_C = t_W$ if the owner was actively involved in the business or had no passive losses with which to offset *C*. However, if the owner was not actively involved in the business and had passive losses from other businesses that could be used to offset *C*, then $t_C = 0$.

We then compared ATI_{rep} with ATI_{cap} for all owners. If ATI_{cap} was greater than ATI_{rep} for every owner, we categorized the S corporation as *LC partial*.

As for the *LC full* group, it is likely that many (if not most) owners who classify themselves as passive are not consciously pursuing an underreporting strategy—they believe that zero compensation is reasonable. In theory, the passive/nonpassive classification of owners can provide an alternative inferential test to identify firms in the *LC full* group.[16] With few exceptions, S corporations with at least one nonpassive owner cannot plausibly argue that zero represents reasonable compensation of its owners. Therefore, we placed in the *LC full* group any S corporation in which all owners report zero compensation and at least one is nonpassive.[17] Other S corporations paying zero owners' compensation are placed in the *LC irrelevant* group.

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[15] Tax rates are always those observed on the return. If implementing the LC strategy bumps an owner into a different tax bracket, that effect is not accounted for.

[16] In practice, the incentives to misclassify interfere with that identification as does the way profits and losses are reported on Schedule E and the way those data are captured in the Individual Returns Transaction File (IRTF), as explained in Appendix B. The discussion of results uses designations derived from separate tests for passivity and nonpassivity applied to each owner. In most cases, failing or passing one of the tests is sufficient to derive a designation. In some cases, however, neither designation is supported by the available data, so the owner's activity level is labelled "ambiguous." That label appears in the accompanying tables for the sake of transparency, but care should be taken about using those results to draw conclusions about the incentives.

[17] The exceptions suggest that this test probably overstates the size of the *LS full* group. For example, nonpassive owners who are so designated solely because they met the hours-worked threshold in five of the last ten years might legitimately receive no owners' compensation in the current year. That would not reflect utilization of the LC strategy, yet they would be placed in the *LC full* group. However, the data give no indication of the basis on which owners designate themselves passive or nonpassive. Furthermore, the aforementioned possibility that the FICA tax

In the case of S corporations with a negative income pool, the size of the *LC full* group is less reflective of the utilization of the LC strategy. Many such firms simply lack the cash to make compensation payments and assume that they are therefore excused from the reasonable compensation standard. Because such firms are very unlikely to make cash distributions of profits, they are, in fact, temporarily excused from the standard. Nevertheless, because enforcement of the standard is only deferred, not abandoned, we leave the classification as is.

Once S corporations have been placed in a group, we can compare the average compensation per compensated owner in each of the groups to estimate the extent to which the LC strategy is being used. The *LC full* group has average compensation of zero by definition, so comparisons to that group are not very useful. However, if average compensation in the *LC partial* group is lower than in the *LC nonviable* group, then we can conclude that the former group is probably making use of the LC strategy.

Relevance of the LC Strategy for S Corporations Paying Zero Owners' Compensation

Just under half (48 percent) of all S corporations report zero owners' compensation. According to the criteria laid out above, whether that places an S corporation in the *LC full* group depends on whether any of the owners are nonpassive. In the case of 7 percent of S corporations, all owners are passive and receive zero compensation. The LC strategy is presumably irrelevant to them. Another 31 percent of S corporations have nonpassive owners but nevertheless compensate none of them. Those are the S corporations placed in the *LC full* group. Another 10 percent of S corporations do not compensate any of their owners, but whether any of those owners are nonpassive cannot be determined, so they are classified as "ambiguous."

Those results differ most markedly based on whether the income pool is positive or negative. If it is positive (three-quarters of S corporations—see Figure 1A), 35 percent do not compensate any of their owners. If it is negative (one-quarter of S corporations—see Figure 1B), then 87 percent do not compensate any of their owners. In both cases, the share in the *LC irrelevant* group declines with the number of owners. Also in both cases, the share of S corporations for which the LC strategy is relevant (the *LC full* group) is highest in the eight-or-more owners category and second highest in the single-owner category.

Viability of the LC Strategy for Multi-Owner S Corporations Paying Nonzero Owners' Compensation

Of the 52 percent of S corporations that pay nonzero owners' compensation, 75 percent fall into the *LC partial* group and 25 percent fall into the *LC nonviable* group. However, those figures are distorted by the inclusion in the denominator of single-owner S corporations, none of which fall into the latter group. Considering only multi-owner S corporations paying nonzero owners' compensation, 31 percent fall into the *LC partial* group and 69 percent into the *LC nonviable* group.

About one-third of multi-owner S corporations with a positive income pool that compensate at least some of their owners would fall into the *LC partial* group. Of those with a negative income pool, the corresponding fraction is one-fifth. In both cases, that share declines sharply as the number of owners increases (see Figures 2A and 2B). To illustrate the sharpness of the decline, consider the over 1.2 million two-owner S corporations, 21 percent of which pay compensation to their owner and therefore

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liability of S corporation owners in this group is being permissibly deferred rather than avoided implies that the size of this group overstates the use of the LC strategy.

would fall into the *LC partial* group. In contrast, of the nearly 34,000 S corporations with eight or more owners, only about 2 percent (less than 700) would fall into that group.

Utilization of the LC Strategy by Multi-Owner S Corporations Paying Nonzero Owners' Compensation

Comparing the average compensation of the *LC partial* group with that of the *LC nonviable* group provides insight into the extent to which the strategy is actually used. Overall, owners in the *LC nonviable* group receive, on average, around $88,200 of compensation. Those in the *LC partial* group, in contrast, receive an average of $58,600—a gap of about 34 percent.

The dollar amounts are slightly higher and the gap roughly the same for multi-owner S corporations with a positive income pool. For S corporations with a negative income pool, however, the dollar amounts are roughly half of those with a positive income pool. The gap is smaller in both dollar terms ($14,700) and percentage terms (30 percent).

The gap also varies by number of owners. Whether the income pool is positive or negative, the gap is less than 5 percent for S corporations with two owners. When the income pool is positive, the gap increases in percentage terms as the number of owners increases, reaching 37 percent in the eight-or-more owners category (see Figure 3A). However, because the number of S corporations in that category that also fall into the *LC partial* group is so small, the total dollar amount associated with that gap is not particularly large (less than $50 million). When the income pool is negative, the gap is negligible in all but the eight-or-more category (see Figure 3B).

Identifying and Comparing the *OS Partial* and *OS Full* Categories

The *OS partial* group consists of all S corporations for which W_{rep} (reported wages) is greater than zero for all owners. That definition is independent of any owner's status as passive or nonpassive.

As explained above, S corporations that fall into the *OS full* group will always have at least one owner reporting zero compensation. On the other hand, any S corporation in which an owner actually contributes no labor will not benefit from the OS strategy. In this case, the passive/nonpassive designation can be helpful.[18] Because passive owners may legitimately contribute no labor, it is important that no S corporation in which any passive owner reports zero compensation be included in the *OS full* group. The uncompensated owner (or owners) who justifies placement in the *OS full* group, therefore, must be nonpassive.[19] If the uncompensated owners are passive, then the lack of compensation is unlikely to be attributable to the OS strategy and the S corporation can be placed in the *OS nonviable* group.[20]

The implications of viability and the extent of utilization can be tested by comparing average compensation per compensated owner. One might hypothesize that the highest average compensation

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[18] The same caveats noted in footnote 16 apply here.
[19] The same exceptions mentioned in footnote 17 apply here, meaning that this inferential test probably overstates the size of the *OS full* group.
[20] This inferential test unavoidably ignores the possibility that a passive owner may contribute labor—the data do not report labor contribution, only compensation paid (or not paid, as the case may be). That being the case, passive owners with zero compensation might actually be benefiting from the OS strategy. Thus, the size of the *OS nonviable* group is probably overstated, and that overstatement would be at the expense of the *OS full* group, offsetting some or all of the error mentioned in footnote 19.

would be observed in the *OS nonviable* group and the lowest average compensation would be observed in the *OS full* group. It is not obvious, however, that the *OS partial* group will necessarily have lower average compensation than the *OS nonviable* group. The inferential tests described above actually provides no evidence that the *OS partial* group is using the strategy at all—only that it is viable for them and that they could be using it more extensively. Furthermore, the strongest rationale for only partially using the LC strategy (that is, avoiding the attention of IRS auditors) does not apply to the OS strategy.

Viability of the OS Strategy

As reported in connection with the LC strategy, 48 percent of S corporations pay zero owners' compensation. The OS strategy is deemed viable for 49 percent, leaving only 3 percent of S corporations in either the *OS nonviable* group or with ambiguous viability.

The viability numbers differ significantly based on whether the income pool is positive or negative. For those with a positive income pool, the OS strategy is viable for 62 percent and not viable (or ambiguous) for 4 percent. For those with a negative income pool, the strategy is viable for 11 percent and not viable (or ambiguous) for 2 percent. In both cases, the remaining S corporations paid zero owners' compensation.

The share of multi-owner S corporations for which the OS strategy is viable declines with the number of owners, regardless of whether the income pool is positive or negative. For S corporations with a positive income pool, the share for which the OS strategy is viable decreases from 64 percent in the two-owner category to 13 percent in the eight-or-more-owners category (see Figure 4A). For multi-owner S corporations with a negative income pool, the corresponding share decreases from 12 percent in the two-owner category to 2 percent in the eight-or-more-owners category (see Figure 4B).

The impact of viability on average compensation per compensated owner is not clear. For multi-owner S corporations with a positive income pool, the average compensation in the *OC full* group is 43 percent less than in the *OS nonviable* group. However, that gap is not matched in any of the number-of-owner categories (see Figure 5A). In the two- and three-owner categories, the gap is only between 10 and 15 percent and in the eight-or-more-owners category, the average compensation is higher in the *OC full* group than in the *OC nonviable* group. Such a result indicates that the overall values for S corporations are distorted by the distribution among number-of-owners categories. S corporations in the *OS full* group have fewer owners than do S corporations in the *OS nonviable* group and average compensation per compensated owner is strongly correlated with number of owners. That drives the overall average for multi-owner S corporations down for the *OS full* group and up for the *OS nonviable* group, thereby making the difference between the two appear larger than it really is. A similar pattern occurs for those with a negative income pool (see Figure 5B).

Utilization of the OS Strategy by Multi-Owner S Corporations Paying Nonzero Owners' Compensation

Among all S corporations for which the OS strategy is deemed viable, 10 percent fall into the *OS full* group. However, that is distorted by the inclusion in the denominator of single-owner S corporations, none of which fall into that group. Considering only multi-owner S corporations, the percentage in the *OS full* group differs substantially based on whether the income pool is positive or negative. For those with a positive income pool, 31 percent for whom the OS strategy is viable make full use of it. For those with a negative income pool, the corresponding figure is 55 percent. In both cases, the share in the *OS full* group varies by number of owners, but not in a systematic way.

Interpreting the extent of utilization is not straightforward. Whether the income pool is positive or negative, the average compensation per compensated owner is lower in the *OS full* group (in which at least one nonpassive owner has zero compensation), than in the *OS partial* group (in which all owners receive compensation—see Figures 6A and 6B). However, in all but one of the number-of-owner categories the average compensation in the latter group also exceeds that in the *OS nonviable* group (in which at least one passive owner has zero compensation). That raises the possibility that the results reflect a higher underlying labor contribution per contributing owner when all owners contribute labor than when only some of them do, whether the noncontributors are passive or nonpassive. Note, however, that this concern does not carry over to the above evaluation of the effect of viability. In that case, both the *OS full* and *OS nonviable* groups have uncompensated owners and there is no reason to expect differences that do not reflect the impact of the strategy's viability.

Interaction Between the Two Strategies

Because it is possible for both the LC and OS strategies to be viable for a multi-owner S corporation, it is necessary to determine whether the above results for each strategy might, to some extent, actually reflect the impact of the other strategy. Also of concern is that use of the OS strategy distorts the distribution of compensation relative to the distribution of labor contribution, rendering the test for LC viability less reliable. To isolate each strategy, results have been generated for each combination of viability and nonviability of the two strategies. However, doing so reduces the sample size enough that the eight-or-more-owners category must be combined with the between-four-and-seven-owners category to avoid disclosing tax return data.

The LC Strategy When the OS Strategy is Not Viable

Considering only S corporations in the *OS nonviable* group significantly ensures that only the effects of the LC strategy are being captured, but it also reduces not only the number, but also the percentage of returns in the *LC partial* group. Of those with a positive income pool, the *LC partial* group contains 32 percent of multi-owner S corporations reporting nonzero owners' compensation. When considering only the *OS nonviable group*, however, that share drops to 13 percent (see Figure 7A). Both figures are lower when the income pool is negative (see Figure 7B).

Nevertheless, the question of interest is whether average compensation per compensated owner differs between S corporations in the *LC partial* and *LC nonviable* groups. For all multi-owner S corporations with a positive income pool, the former was 34 percent lower than the latter. Considering only S corporations in the *OS nonviable* group, that gap increases to 56 percent. Among those with a negative income pool, the change is even greater with the gap increasing from 30 percent to 64 percent. At the very least, those results demonstrate that the gap observed for all S corporations is not an artifact of interaction between strategies.

Breaking those results down by number of owners sheds additional light. Whether the income pool is positive or negative, there was virtually no gap in average compensation between two-owner S corporations in the *LC partial* and *LC nonviable* groups (see Figures 8A and 8B). That result does not change when considering only S corporations in the *OS nonviable* group. The same phenomenon occurs for three-owner S corporations with a negative income pool. For three-owner S corporations with a positive income pool, there is an average compensation gap, but that difference is very similar whether considering all S corporations or only those in the *OS nonviable* group. In the four-or-more-owners category, however, the gap is significantly larger when considering only those in the *OS nonviable* group, whether the income pool is positive or negative. That might indicate that the size of the gap is being obscured by including those for which both strategies are viable, or it might be an artifact of a greatly reduced sample size when only those in the *OS nonviable* group are considered.

The OS Strategy When the LC Strategy is Not Viable

Considering only S corporations in the *LC nonviable* group has very little effect on the results because that group includes most multi-owner S corporations that report nonzero owners' compensation. Among two-owner S corporations (with a positive or negative income pool), dropping those for which the LC strategy is viable puts a smaller percentage in the *OS partial* group and a larger percentage in the *OS full* group (see Figures 9A and 9B).In the other number-of-owners categories, the changes associated with narrowing the analysis are minor.

Comparisons between average compensation in the *OS full* group with those in the *OS nonviable* group by number of owners are not significantly affected by dropping S corporations in the *LC partial* group (see Figures 10A and 10B). Comparisons between S corporations in the *OS full* group and the *OS partial* group show a slightly bigger difference after dropping S corporations in the LS partial group (see Figures 11A and 11B). Thus, the results reported above for the OS strategy do not seem to be overstated because of interaction with the LC strategy.

Appendix A. The Relationship Between Compensation of Owners and Compensation of Officers

Form 1120S draws a distinction between the compensation of corporate officers and the compensation of nonofficers. The distinction is made to facilitate the enforcement of the reasonable compensation standard. Unfortunately, because not all officers are owners (for example, an expert nonowner could be hired to serve as chief financial officer) and not all owners are officers (in particular, passive investors), that distinction is not useful for evaluating whether an S corporation has an incentive to underreport the compensation of owners.[21] For that, we need the actual compensation of owners, which we define as compensation of K-1 recipients that is reported on a W-2.

Comparing the compensation received by K-1 recipients with the compensation of officers reported on Form 1120S allows us to determine how closely the concepts overlap. For almost three-quarters of S corporations, the two concepts are identical—43 percent report zero for both concepts and another 31 percent report the same positive amount for each. For another 18 percent of S corporations, compensation of owners falls short of compensation of officers. For the remaining S corporations, compensation of owners exceeds compensation of officers.

The relationship between the two concepts differs significantly between S corporations with positive and negative income pools. Among those with a positive income pool, only 29 percent report zero for both concepts while 39 percent report the same positive amounts. Of those with a negative income pool, fully 83 percent of S corporations report zero for both concepts while only 7 percent report the same positive amounts. For 21 percent of S corporations with a positive income pool, compensation of owners falls short of compensation of officers; for those with a negative income pool, the corresponding figure is 7 percent. For 11 percent of S corporations with a positive income pool, compensation of owners exceeds compensation of officers; for those with a negative income pool, the corresponding figure is 3 percent.

The percentage of S corporations reporting zero for both concepts does not vary systematically by number of owners. Similarly, the percentage for which compensation of owners falls short of compensation of officers shows little variation by number of owners. The percentage reporting the same positive amount for both, however, declines as the number of owners increases. Of single-owner S corporations with a positive income pool, 41 percent fall into that category compared to only 13 percent of S corporations with 8 or more owners (see Figure A-1A). The percentage in which compensation of owners exceeds compensation of officers shows the opposite pattern. Only 9 percent of single-owners S corporations fall into that category, compared to 32 percent of S corporations with eight or more owners. Those general patterns hold—at much lower levels—for S corporations with a negative income pool (see Figure A-1B).

Additional data can be found in the tables accompanying this note (each with an IV prefix). For example, the tables present the average amount of compensation deducted by S corporations when compensation of officers equals compensation of owners and when each exceeds the other. Furthermore, compensation paid when the two are not equal is broken down into the overlap, the

[21] There is no incentive to underreport the compensation of nonowner officers. They would not receive any of the increased distribution of profits and would therefore insist on receiving full compensation subject to the FICA tax.

excess of owners' over officers' compensation, and the excess of officers' over owners' compensation. The tables disaggregate the data as follows:

A. By the sign of the income pool (positive or negative) and number-of-owners class (one, two, three, between four and seven, and eight or more), and
B. By industry.

Appendix B. Identifying the Activity Level of Owners

There are no data fields from Schedule K-1, Form 1040, or its accompanying schedules that allow for the definitive classification of S corporation owners as either passive or nonpassive, even if those owners engage in no mischaracterization of their activity level. The only data that addresses the distinction at all are the following fields from Schedule E relating to partnership and S corporation income:

1. Passive partnership and S corporation income
2. Nonpassive partnership and S corporation income
3. Passive partnership and S corporation losses
4. Nonpassive partnership and S corporation losses

Thus, even though the database links those four fields to the K-1s of each S corporation owner, the fields cannot be definitive because they do not distinguish between partnership and S corporation income. Even if the fields were limited to S corporations, they might cover S corporations other than the one issuing the K-1.

Nevertheless, we devised rules for comparing Schedule E income with K-1 income that allow the distinction to be made for over 85 percent of owners' compensation. The process tests for passivity and nonpassivity separately, then makes an assignment based on the outcome of both tests. The tests below apply to nonpassive and passive income, but a parallel set of rules applies to passive and nonpassive losses:

Nonpassivity test

• Nonpassive Schedule E income = 0	Strongly fails
• 0 < Nonpassive Schedule E income < K-1 income	Weakly fails
• Nonpassive Schedule E income = K-1 income	Strongly passes
• Nonpassive Schedule E income > K-1 income	Inconclusive

Passivity test

• Passive Schedule E income = 0	Strongly fails
• 0 < Passive Schedule E income < K-1 income	Weakly fails
• Passive Schedule E income = K-1 income	Strongly passes
• Passive Schedule E income > K-1 income	Inconclusive

Evaluating the two tests on each owner together yields the following assignments:

Result of nonpassivity test	Result of passivity test	Assignment
Strongly pass	Strongly fail	Nonpassive
Strongly pass	Weakly fail	Nonpassive
Strongly pass	Inconclusive	Nonpassive
Weakly fail	Strongly fail	Nonpassive
Inconclusive	Strongly fail	Nonpassive
Inconclusive	Weakly fail	Nonpassive
Strongly fail	Strongly pass	Passive
Weakly fail	Strongly pass	Passive
Inconclusive	Strongly pass	Passive
Strongly fail	Weakly fail	Passive
Strongly fail	Inconclusive	Passive
Weakly fail	Inconclusive	Passive
Strongly fail	Strongly fail	*See below*
Weakly fail	Weakly fail	Ambiguous
Strongly pass	Strongly pass	Ambiguous
Inconclusive	Inconclusive	Ambiguous

Most of the above assignments should be uncontroversial. Results of “strongly pass” or “strongly fail” are definitive unless they are in direct contradiction to one another (the double “strongly fail” case is discussed below). Those involving the “weakly fail” outcome, however, require some illustration.

Consider an owner with $10,000 of K-1 income and $5,000 of nonpassive Schedule E income. That owner weakly fails the nonpassivity test because there is not enough nonpassive Schedule E income to account for the entire K-1 amount. The assignment then depends on the amount of passive Schedule E income. If that amount is zero, then the only Schedule E income is nonpassive and, despite that income’s insufficiency, it seems reasonable to make the “nonpassive” assignment. If, however, passive Schedule E income was also $5,000, it would weakly fail both tests, there would be no basis for distinguishing between them, and the assignment would be “ambiguous.” If passive Schedule E income were $10,000 (the same as the K-1 amount), then the owner would strongly pass the passivity test and the assignment clearly would be “passive.” Finally, if passive Schedule E income were in excess of $10,000, the result of the passivity test would be inconclusive because there is clearly passive income from other entities being included. Nevertheless, the assignment would be “passive” because there is enough passive Schedule E income to account for the entire K-1 amount, while the same is not true of nonpassive Schedule E income.

A result of “strongly fail” for both tests occurs when there is no income of either type reported on Schedule E. That can occur under four broad conditions:

1. The owner is noncompliant and is not reporting the S corporation income despite the existence of a K-1;
2. The owner is a legitimate individual nonfiler;
3. The owner is a compliant individual filer, but there is some bureaucratic reason why Schedule E is not showing up in the IRTF; or
4. The owner is a nonprofit organization.

Of those conditions, the last is not actually ambiguous—those owners are unambiguously passive. We identify them by the absence of both a 1040 and a W-2. That necessarily includes some S corporation owners meeting the other three conditions (probably all who meet the second condition), but the misidentified number should be small. Of the rest, simply removing from the analysis owners who are noncompliant or associated with bureaucratic errors would seem to be the preferred solution. However, there is no way to do so without invalidating the tests for the viability of the LC and OS strategies, so those owners are retained with the "ambiguous" label.

Overall, around 68 percent of owners were designated as nonpassive and 8 percent as passive, with 19 percent left as ambiguous. The remaining 5 percent were deemed to be nonprofit organizations or individual nonfilers. The ambiguous share generally increases with the number of owners and is higher for S corporations with a negative income pool (see Figures B-1A and B-1B).

The tables accompanying this note include the following three (each beginning with V) that present data by activity by level (nonpassive, passive, ambiguous, and nonprofit):

i) Percentage of S corporations and average owner's S corporation income from Schedule K-1 (which excludes labor income),
ii) Percentage of owners receiving labor compensation on Form W-2 and average compensation per compensated owner,
iii) Percentage of owners receiving each type of S corporation and partnership income or loss (excluding labor) reported on Schedule E (nonpassive income, nonpassive loss, passive income, passive loss).

Each of those tables disaggregates the data as follows:

A. By the sign of the income pool (positive or negative) and number-of-owners class (one, two, three, between four and seven, and eight or more), and
B. By industry.

Tables

Table 1.
The Taxation of Different Forms of Business Organization

	Direct Taxation of Profits	**Taxation of Owners' Compensation[a]**
C corporations	Corporate income tax[b]	FICA[c]
S corporations	Individual income tax	FICA[c]
Limited Liability Companies	Individual income tax and (for some members) SECA[d,e]	SECA[d]
Limited Partnerships	Individual income tax and (for some partners) SECA[d,f]	SECA[d]
General Partnerships	Individual income tax and SECA[d,f]	SECA[d]
Sole Proprietorships	Individual income tax and SECA[d]	SECA[d]

Notes:

Net investment income tax liability is not covered in this table.

a. All owners' compensation is subject to individual income tax in addition to the Social Security taxes shown.
b. C Corporation profits are also subject to indirect taxation through the individual income tax on dividends and realized capital gains.
c. FICA = Federal Insurance Contributions Act
d. SECA = Self-Employment Contributions Act
e. Members of limited liability companies who actively participate in the business must pay SECA tax on their distributive share of profits.
f. Partners who do not receive full liability protection must pay SECA tax on their distributive share of profits.

Table 2.
Illustration of the Proportional-to-Labor-Contribution Strategy for Increasing After-Tax Income

(Dollars)

	Proper Characterization of Income		Proportional-to-Labor-Contribution Strategy	
	Mary	John	Mary	John
	Scenario 1: Owners' Labor Contribution Shares Are the Same as Their Ownership Shares			
Pre-tax income				
…from wages (owners' compensation)	23,223	23,223	0	0
…employer's share of FICA	1,777	1,777	0	0
…from passed-through profits	25,000	25,000	50,000	50,000
Total pre-tax income	50,000	50,000	50,000	50,000
Individual income tax				
…on wages	5,806	5,806	0	0
…on passed-through profits	6,250	6,250	12,500	12,500
FICA tax (employer & employee shares)	3,553	3,553	0	0
Total tax liability	15,609	15,609	12,500	12,500
After-tax income	34,391	34,391	37,500	37,500
Benefit of mischaracterizing			3,109	3,109
	Scenario 2: Owners' Labor Contribution Shares Differ Significantly from Their Ownership Shares			
Labor contribution shares	0.20	0.80		
Ownership shares	0.80	0.20		
Pre-tax income				
…from wages (officers' compensation)	9,289	37,157	0	0
…employer's share of FICA	711	2,843	0	0
…from passed-through profits	40,000	10,000	80,000	20,000
Total pre-tax income	50,000	50,000	80,000	20,000
Individual income tax				
…on wages	2,322	9,289	0	0
…on passed-through profits	10,000	2,500	20,000	5,000
FICA tax (employer & employee shares)	1,421	5,685	0	0
Total tax liability	13,744	17,474	20,000	5,000
After-tax income	36,256	32,526	60,000	15,000
Benefit of mischaracterizing			23,744	-17,526

Notes: Assumes a 25 percent income tax rate and no other income or deductions.
FICA = Federal Insurance Contributions Act
Numbers may not sum to totals because of rounding.
Source: Author's calculations

Table 3a.
Two Different Strategies for Increasing After-Tax Income—Scenario 2

(Dollars)

	Proper Characterization of Income		Proportional-to-Ownership-Shares Strategy		Proportional-to-Labor-Contribution Strategy	
	Mary	John	Mary	John	Mary	John
Labor contribution shares	0.20	0.80				
Ownership shares	0.80	0.20				
Pre-tax income						
...from wages (owners' compensation)	9,289	37,157	0	34,835	0	0
...employer's share of FICA	711	2,843	0	2,665	0	0
...from passed-through profits	40,000	10,000	50,000	12,500	80,000	20,000
Total pre-tax income	50,000	50,000	50,000	50,000	80.000	20,000
Individual income tax						
...on wages	2,322	9,289	0	8,709	0	0
...on passed-through profits	10,000	2,500	12,500	3,125	20,000	5.000
FICA tax (employer & employee shares)	1,421	5,685	0	5,330	0	0
Total tax liability	13,744	17,474	12,500	17,164	15,308	14,356
After-tax income	36,256	32,526	37,500	32,836	60.000	15,000
Benefit of mischaracterizing			1,244	311	23,744	-17,526

Assumes a 25 percent income tax rate and no other income or deductions.
FICA = Federal Insurance Contributions Act
Numbers may not sum to totals because of rounding.
Source: Author's calculations

Table 3b.
Two Different Strategies for Increasing After-Tax Income—Scenario 3

(Dollars)

	Proper Characterization of Income		Proportional-to-Ownership-Shares Strategy		Proportional-to-Labor-Contribution Strategy	
	Mary	John	Mary	John	Mary	John
Labor contribution shares	0.4548	0.5452				
Ownership shares	0.5452	0.4548				
Pre-tax income						
…from wages (owners' compensation)	21,124	25,323	0	7,701	0	0
…employer's share of FICA	1,616	1,937	0	589	0	0
…from passed-through profits	27,260	22,740	50,000	41,709	54,520	45,480
Total pre-tax income	50,000	50,000	50,000	50,000	54,520	45,480
Individual income tax						
…on wages	5,281	6,331	0	1,925	0	0
…on passed-through profits	6,815	5,685	12,500	10,427	11,630	11,370
FICA tax (employer & employee shares)	3,232	3,874	0	1,178	0	0
Total tax liability	15,328	15,890	12,500	13,531	11,630	11,370
After-tax income	34,672	34,110	37,500	36469	40,890	34,110
Benefit of mischaracterizing			2,828	2,359	6,218	0

Assumes a 25 percent income tax rate and no other income or deductions.
FICA = Federal Insurance Contributions Act
Numbers may not sum to totals because of rounding.
Source: Author's calculations

Table 3c.
Two Different Strategies for Increasing After-Tax Income—Scenario 4

(Dollars)

	Proper Characterization of Income		Proportional-to-Ownership-Shares Strategy		Proportional-to-Labor-Contribution Strategy	
	Mary	John	Mary	John	Mary	John
Labor contribution shares	0.0000	1.0000				
Ownership shares	0.1658	0.8342				
Pre-tax income						
…from wages (owners' compensation)	0	46,447	0	46,447	0	0
…employer's share of FICA	0	3,553	0	3,553	0	0
…from passed-through profits	8,290	41,710	8,290	41,710	16,580	83,420
Total pre-tax income	8,290	91,710	8,290	91,710	16,580	83,420
Individual income tax						
…on wages	0	11,612	0	11,612	0	0
…on passed-through profits	2,073	10,428	2,073	10,428	4,145	20,855
FICA tax (employer & employee shares)	0	7,106	0	7,106	0	0
Total tax liability	2,073	29,146	2,073	29,146	4,145	20,855
After-tax income	6,218	62,564	6,218	62,564	12,435	62,565
Benefit of mischaracterizing			0	0	6,218	1

Assumes a 25 percent income tax rate and no other income or deductions.
FICA = Federal Insurance Contributions Act
Numbers may not sum to totals because of rounding.
Source: Author's calculations

Table 4a: Average Sampling Rates by Industry (Percent)

Agriculture: Crop Farming	13.1	Transportation: Water	49.8
Agriculture: Livestock	28.5	Transportation: Truck	5.8
Agriculture: Forestry	23.2	Transportation: Passenger	12.5
Agriculture: Fishing & Hunting	22.8	Transportation: Pipeline	99.7
Agriculture: Support Activities	16.8	Transportation: Support Activities	9.7
Mining: Oil and Gas Extraction	21.8	Transportation: Warehousing & Storage	35.8
Mining: All Other Extraction	44.0	Information: Publishing	24.6
Mining: Support Activities	22.3	Information: Movies & Records	15.5
Utilities	49.5	Information: Broadcasting	37.2
Construction: Buildings	4.5	Information: Telecommunications	24.0
Construction: Heavy	15.8	Information: Internet Services	24.2
Construction: Specialty	2.3	Information: Other	26.7
Manufacturing: Food	30.3	Finance: Depository Credit Intermediation	59.6
Manufacturing: Beverage & Tobacco	45.0	Finance: Nondepository Credit Intermediation	22.5
Manufacturing: Textile Mills	57.3	Finance: Securities & Commodities	16.9
Manufacturing: Apparel	25.4	Finance: Insurance	6.2
Manufacturing: Leather Products	62.8	Finance: Funds, Trusts & Other	36.7
Manufacturing: Wood Products	19.3	Real Estate: Lessors of Buildings	5.5
Manufacturing: Paper	63.7	Real Estate: Agents & Brokers	4.6
Manufacturing: Printing	16.1	Real Estate: Property Managers	6.4
Manufacturing: Petroleum Products	66.2	Real Estate: Non-Real Estate Rental	17.8
Manufacturing: Chemicals	31.2	Real Estate: Lessors of Intangibles	57.4
Manufacturing: Plastic & Rubber	31.8	Services: Legal	3.7
Manufacturing: Nonmetallic Minerals	29.6	Services: Accounting	7.4
Manufacturing: Primary Metals	41.6	Services: Architectural & Engineering	8.6
Manufacturing: Fabricated Metals	10.1	Services: Specialized Design	8.5
Manufacturing: Machinery	17.2	Services: Computer Systems Design	6.7
Manufacturing: Computers & Electronics	35.0	Services: Management Consulting	8.8
Manufacturing: Electrical Equipment	34.0	Services: Scientific	10.0
Manufacturing: Transportation Equipment	36.1	Services: Advertising & Marketing	13.2
Manufacturing: Furniture	25.7	Services: Other Professional	10.8
Manufacturing: Miscellaneous	14.3	Holding Companies	29.6
Wholesale Trade: Durables	6.7	Services: Administrative & Support	6.1
Wholesale Trade: Nondurables	11.1	Services: Waste Management	24.2
Wholesale Trade: Other	16.0	Services: Educational	11.5
Retail Trade: Motor Vehicles	6.3	Services: Physicians	3.0
Retail Trade: Home Furnishings	14.3	Services: Dentists	2.5
Retail Trade: Electronics & Appliances	20.0	Services: Other Health Practitioners	4.8
Retail Trade: Home & Garden Improvement	11.2	Services: Other Ambulatory Health	11.2
Retail Trade: Food & Beverage	8.8	Services: Hospitals & Nursing Homes	22.5
Retail Trade: Personal Care	11.1	Services: Social	9.3
Retail Trade: Gasoline	11.9	Services: Arts & Sports	20.4
Retail Trade: Clothing	12.4	Services: Artists, Writers & Performers	8.9
Retail Trade: Recreational	14.7	Services: Amusement & Gambling	10.7
Retail Trade: General Merchandise	18.1	Services: Accommodation	11.2
Retail Trade: Other Stores	8.4	Services: Food & Drink	3.4
Retail Trade: Nonstore	9.1	Services: Repair	3.2
Transportation: Air	35.4	Services: Personal	3.3
Transportation: Rail	90.8	Services: Nonprofit	36.9
		All Industries	8.5

Source: Internal Revenue Service

Table 4b:
Average Sampling Rates by Profitability and Number of Owners (Percent)

	With Net Income	Without Net Income
One owner	5.3	8.0
Two owners	7.0	10.9
Three owners	19.0	24.8
Four to seven owners	23.1	28.5
Eight or more owners	51.1	52.3
All classes	7.1	11.1

Source: Internal Revenue Service

FIGURE 1A
RELEVANCE OF THE LC STRATEGY TO S CORPORATIONS WITH A POSITIVE INCOME POOL BUT PAYING ZERO OWNERS' COMPENSATION, BY NUMBER OF OWNERS

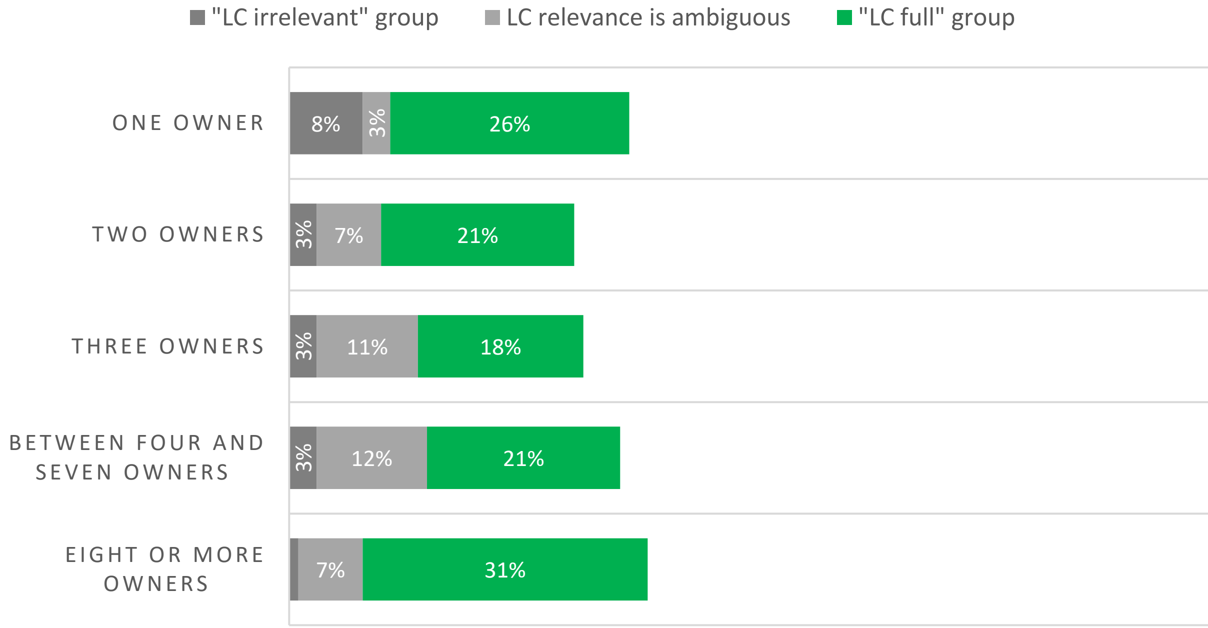


FIGURE 1B
RELEVANCE OF THE LC STRATEGY TO S CORPORATIONS WITH A NEGATIVE INCOME POOL BUT PAYING ZERO OWNERS' COMPENSATION, BY NUMBER OF OWNERS

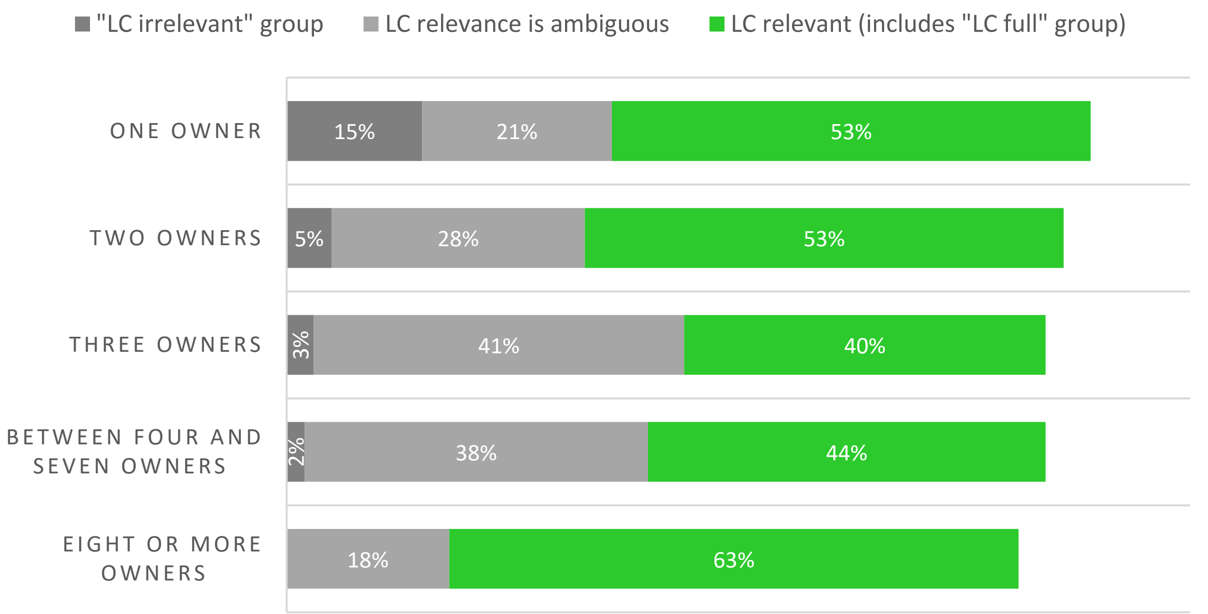


FIGURE 2A
VIABILITY AND UTILIZATION OF THE LC STRATEGY FOR S CORPORATIONS WITH A POSITIVE INCOME POOL, BY NUMBER OF OWNERS

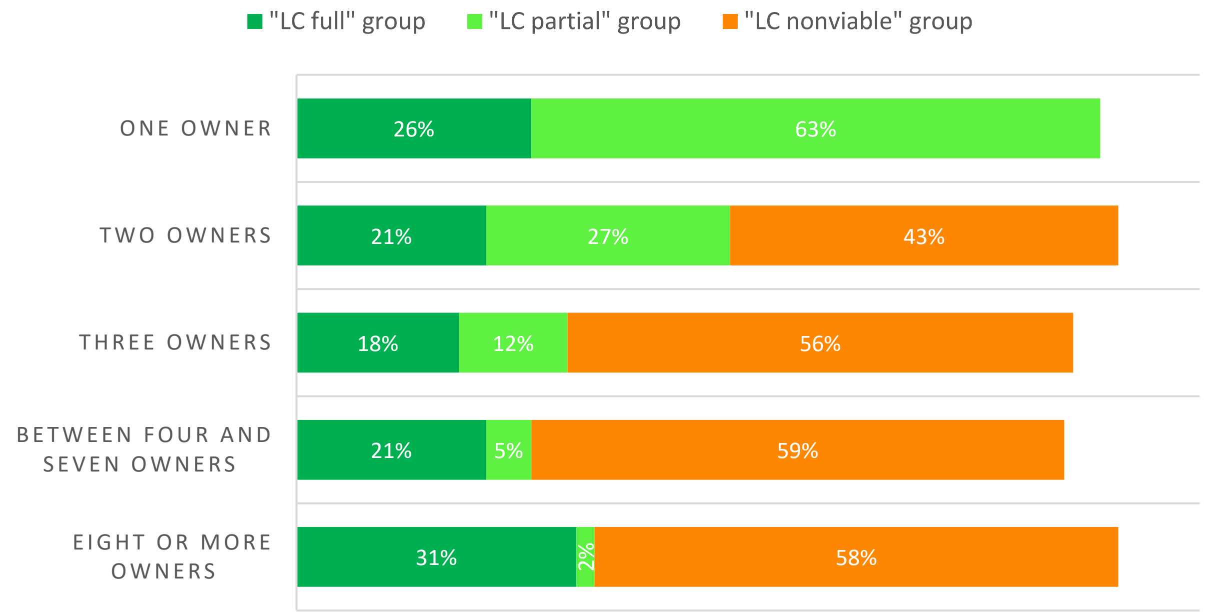
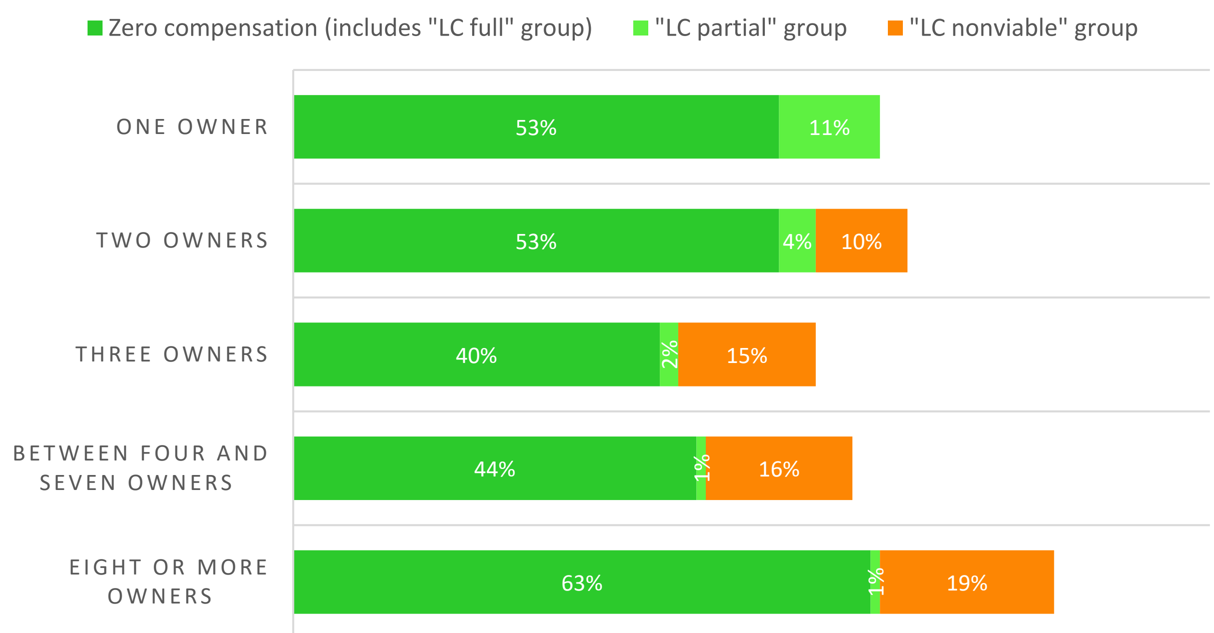


FIGURE 2B
VIABILITY AND UTILIZATION OF THE LC STRATEGY FOR S CORPORATIONS WITH A NEGATIVE INCOME POOL, BY NUMBER OF OWNERS



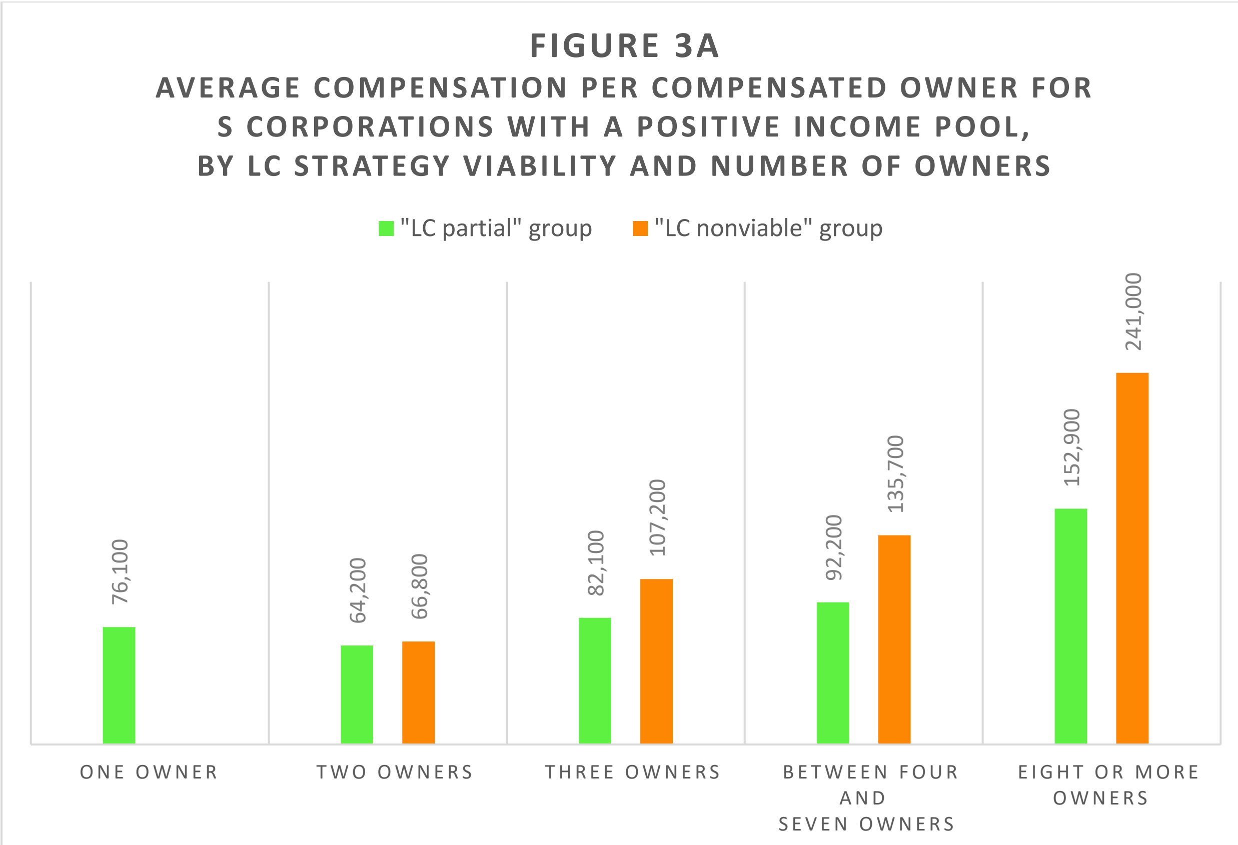


FIGURE 3A
AVERAGE COMPENSATION PER COMPENSATED OWNER FOR
S CORPORATIONS WITH A POSITIVE INCOME POOL,
BY LC STRATEGY VIABILITY AND NUMBER OF OWNERS
"LC partial" group
"LC nonviable" group
76,100
64,200
66,800
82,100
107,200
92,200
135,700
152,900
241,000
ONE OWNER
TWO OWNERS
THREE OWNERS
BETWEEN FOUR AND SEVEN OWNERS
EIGHT OR MORE OWNERS

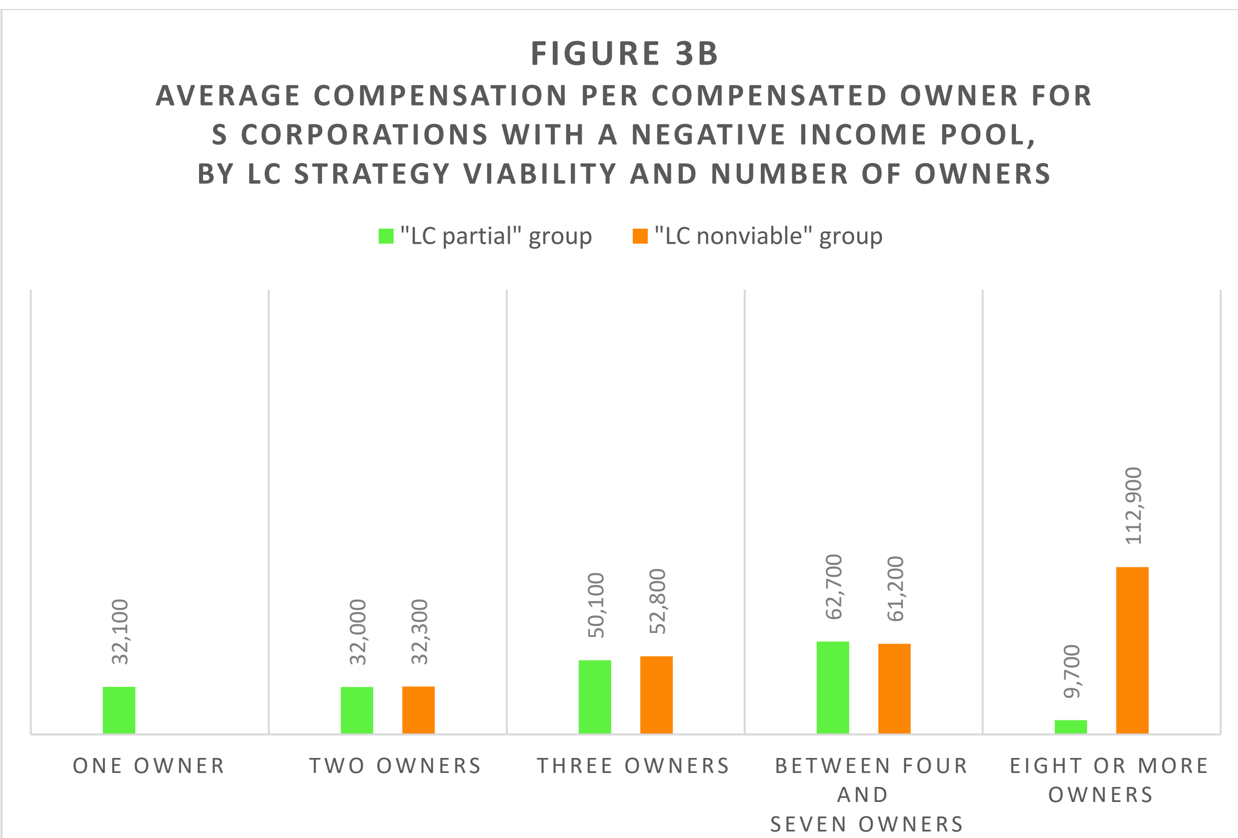


FIGURE 3B
AVERAGE COMPENSATION PER COMPENSATED OWNER FOR
S CORPORATIONS WITH A NEGATIVE INCOME POOL,
BY LC STRATEGY VIABILITY AND NUMBER OF OWNERS
"LC partial" group
"LC nonviable" group
32,100
32,000
32,300
50,100
52,800
62,700
61,200
9,700
112,900
ONE OWNER
TWO OWNERS
THREE OWNERS
BETWEEN FOUR AND SEVEN OWNERS
EIGHT OR MORE OWNERS

FIGURE 4A
VIABILITY AND UTILIZATION OF THE OS STRATEGY FOR S CORPORATIONS WITH A POSITIVE INCOME POOL AND PAYING NONZERO OWNERS' COMPENSATION, BY NUMBER OF OWNERS

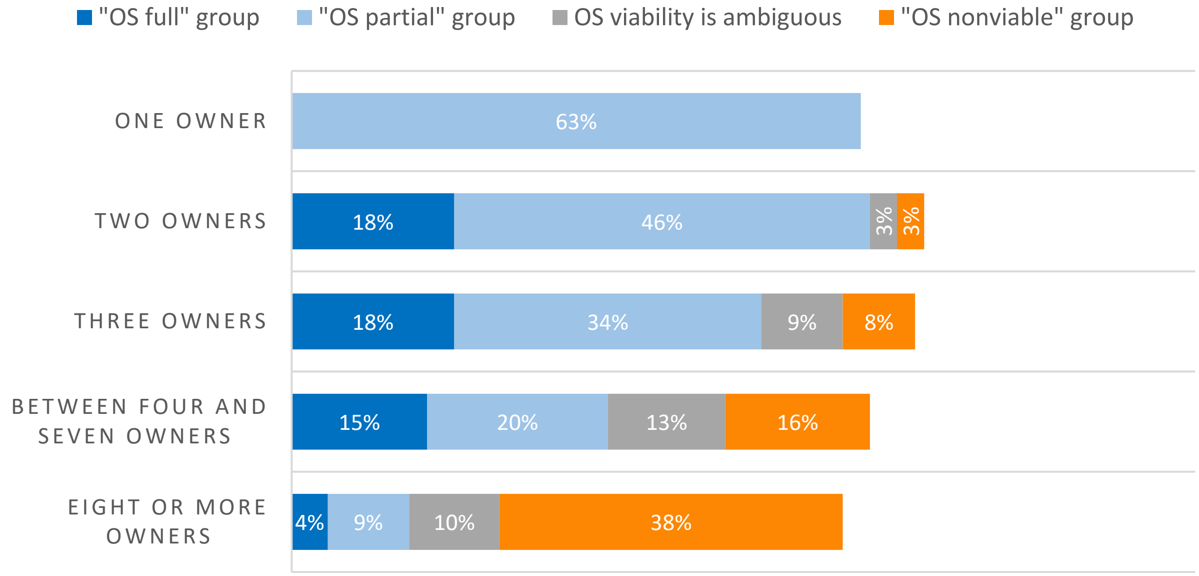


FIGURE 4B
VIABILITY AND UTILIZATION OF THE OS STRATEGY FOR S CORPORATIONS WITH A NEGATIVE INCOME POOL AND PAYING NONZERO OWNERS' COMPENSATION, BY NUMBER OF OWNERS

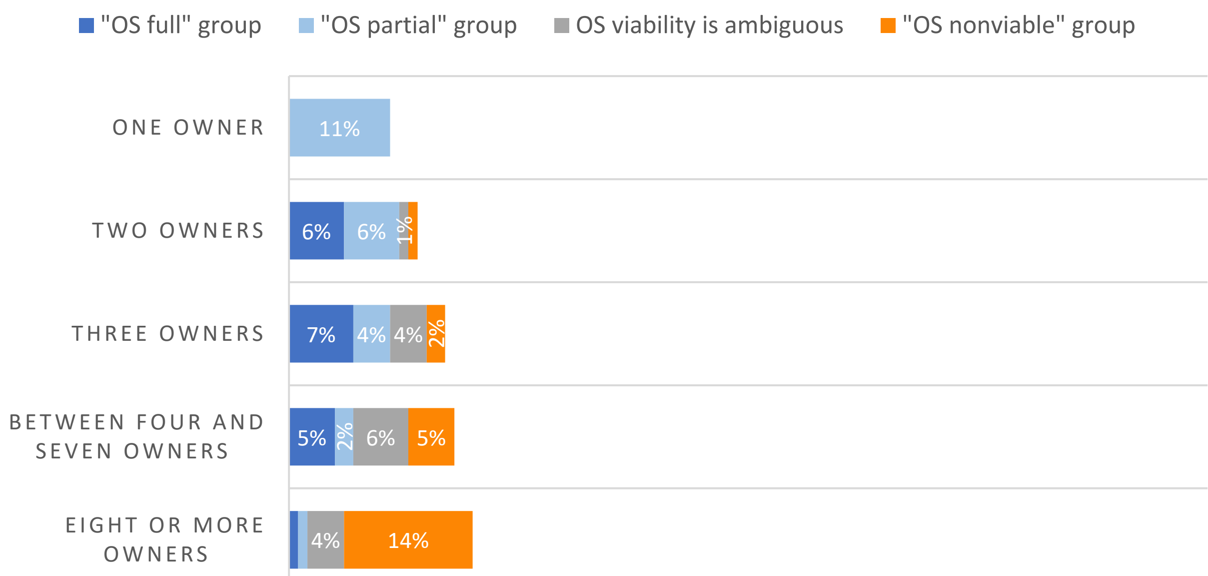


FIGURE 5A
AVERAGE COMPENSATION PER COMPENSATED OWNER FOR S CORPORATIONS WITH A POSITIVE INCOME POOL, BY OS STRATEGY VIABILITY AND NUMBER OF OWNERS

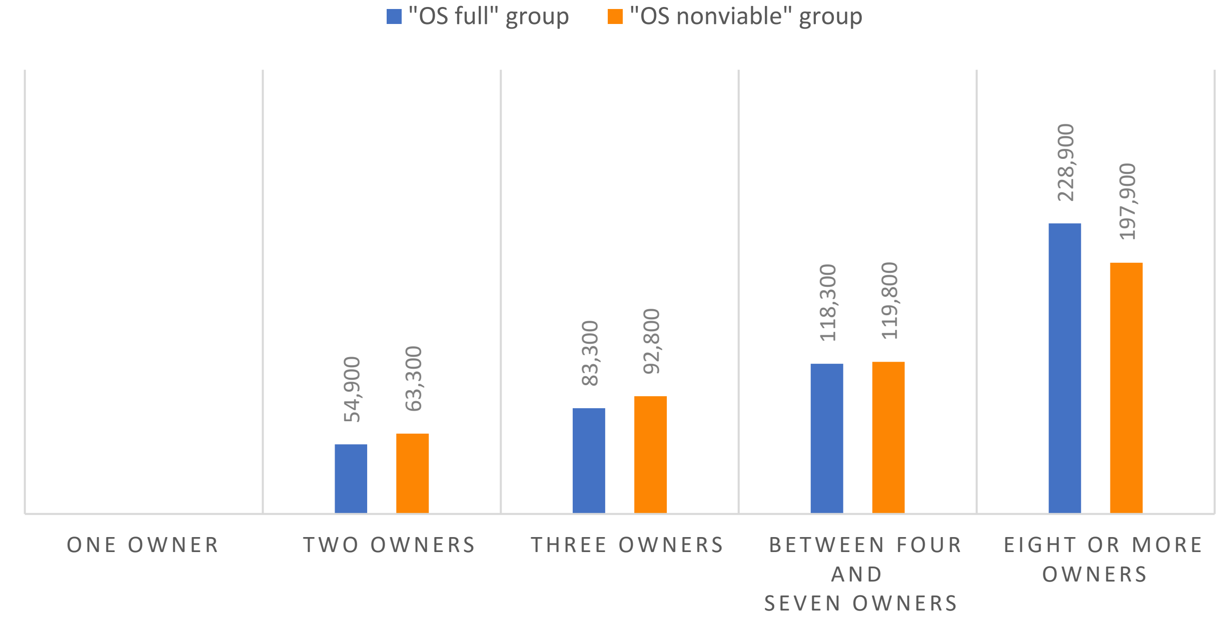
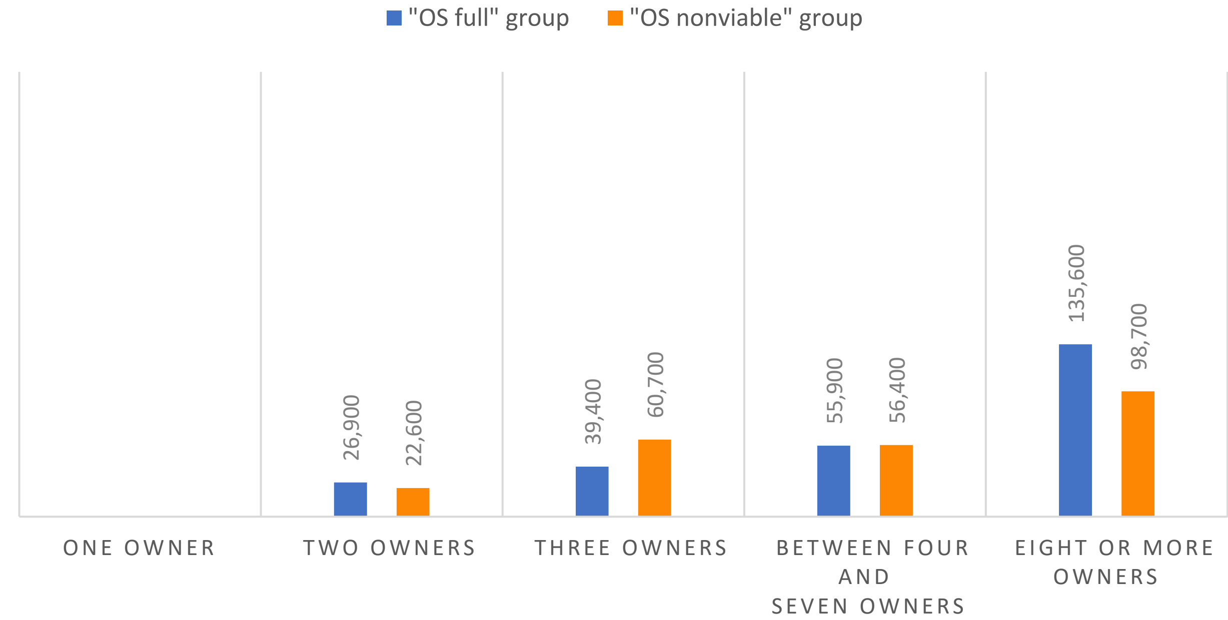


FIGURE 5B
AVERAGE COMPENSATION PER COMPENSATED OWNER FOR S CORPORATIONS WITH A NEGATIVE INCOME POOL, BY OS STRATEGY VIABILITY AND NUMBER OF OWNERS



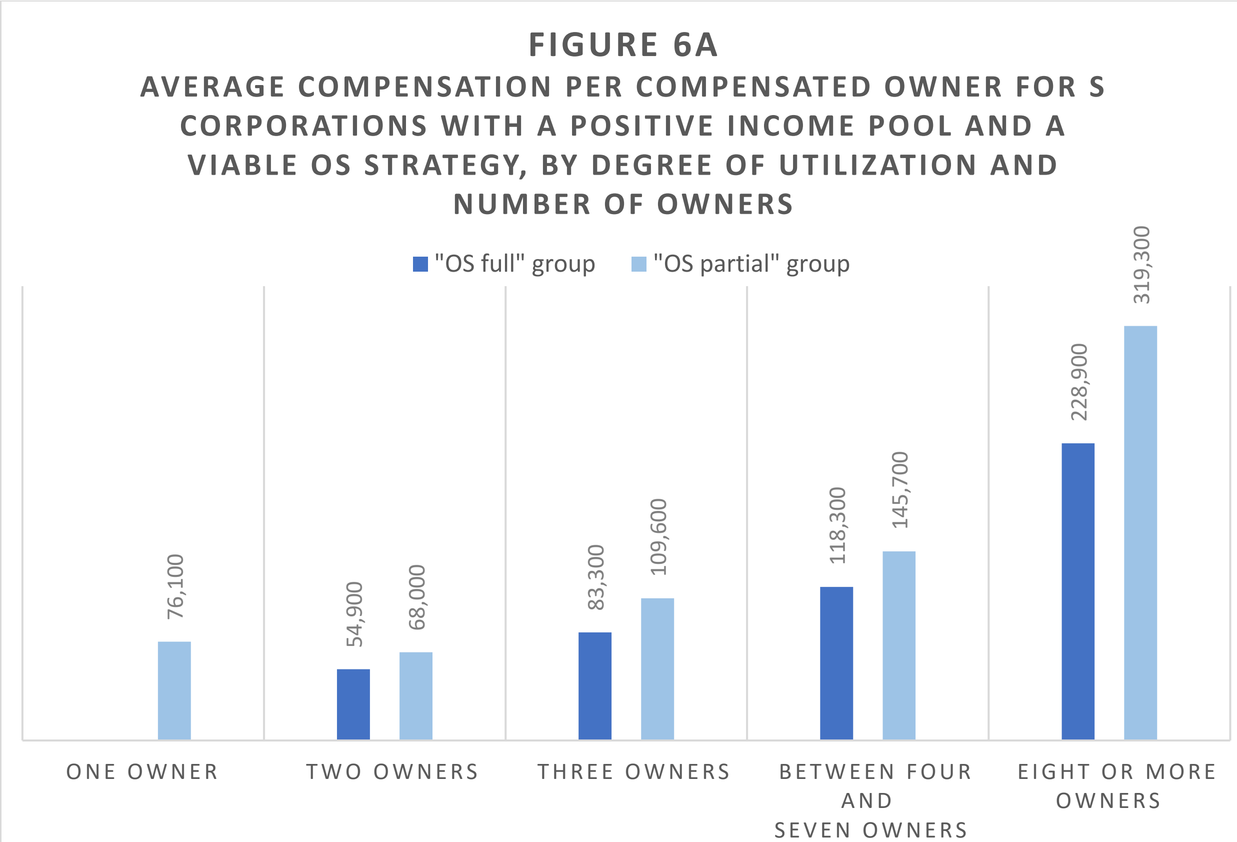


FIGURE 6A
AVERAGE COMPENSATION PER COMPENSATED OWNER FOR S CORPORATIONS WITH A POSITIVE INCOME POOL AND A VIABLE OS STRATEGY, BY DEGREE OF UTILIZATION AND NUMBER OF OWNERS
"OS full" group
"OS partial" group
76,100
54,900
68,000
83,300
109,600
118,300
145,700
228,900
319,300
ONE OWNER
TWO OWNERS
THREE OWNERS
BETWEEN FOUR AND SEVEN OWNERS
EIGHT OR MORE OWNERS

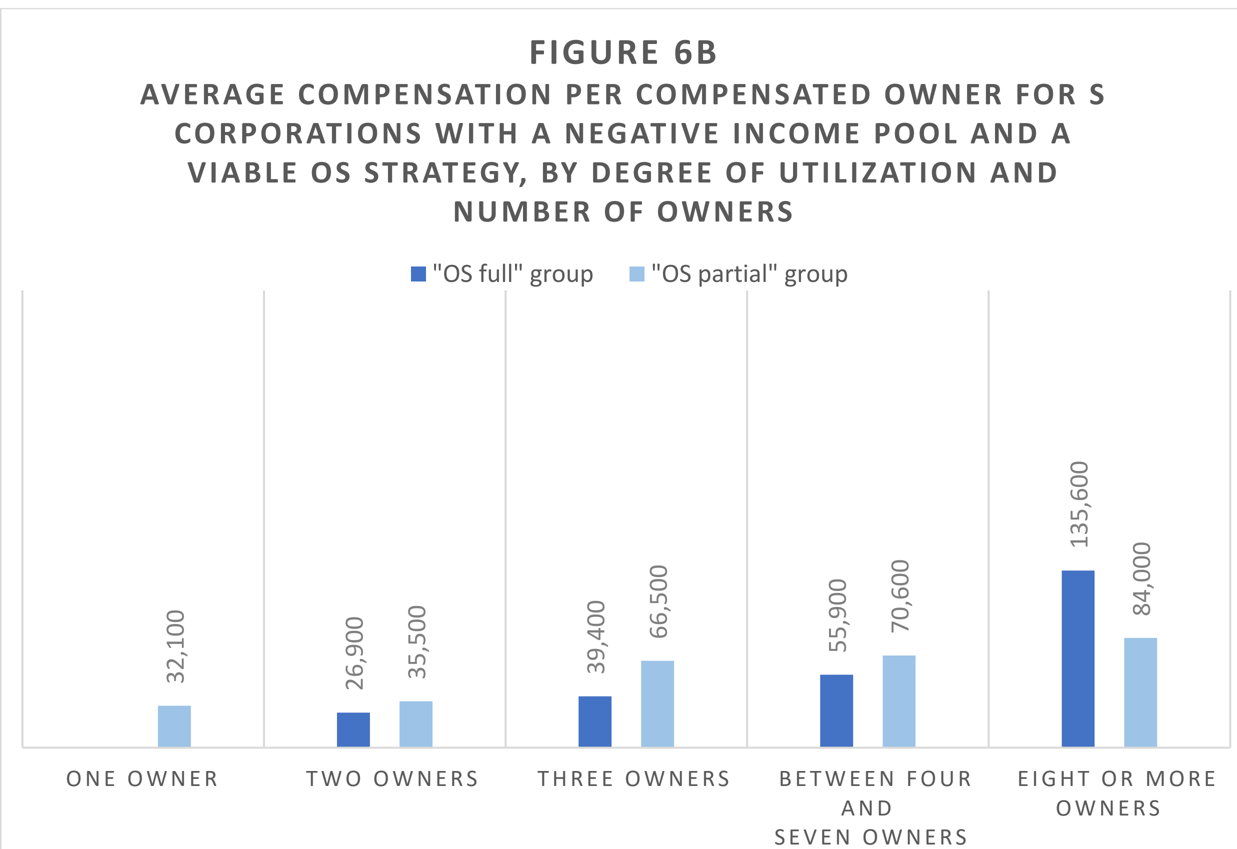


FIGURE 6B
AVERAGE COMPENSATION PER COMPENSATED OWNER FOR S CORPORATIONS WITH A NEGATIVE INCOME POOL AND A VIABLE OS STRATEGY, BY DEGREE OF UTILIZATION AND NUMBER OF OWNERS
"OS full" group
"OS partial" group
32,100
26,900
35,500
39,400
66,500
55,900
70,600
135,600
84,000
ONE OWNER
TWO OWNERS
THREE OWNERS
BETWEEN FOUR AND SEVEN OWNERS
EIGHT OR MORE OWNERS

FIGURE 7A
LC STRATEGY VIABILITY FOR S CORPORATIONS WITH A POSITIVE INCOME POOL AND PAYING NONZERO OWNERS' COMPENSATION, BY NUMBER OF OWNERS AND INTERACTION WITH THE OS STRATEGY

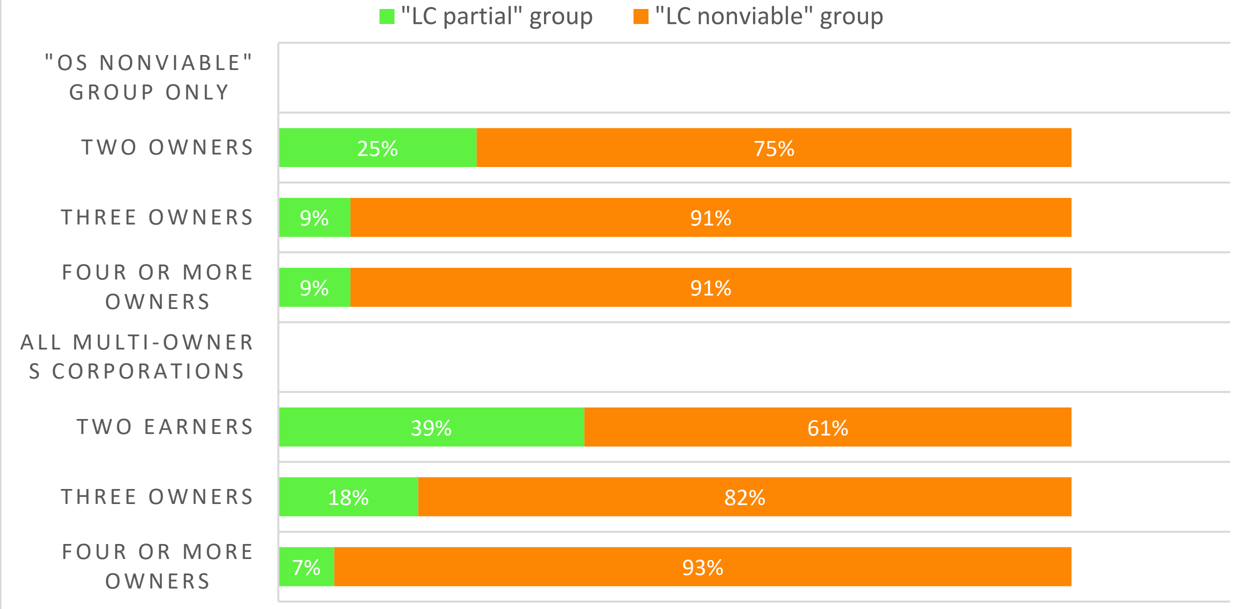


FIGURE 7B
LC STRATEGY VIABILITY FOR S CORPORATIONS WITH A NEGATIVE INCOME POOL AND PAYING NONZERO OWNERS' COMPENSATION, BY NUMBER OF OWNERS AND INTERACTION WITH THE OS STRATEGY

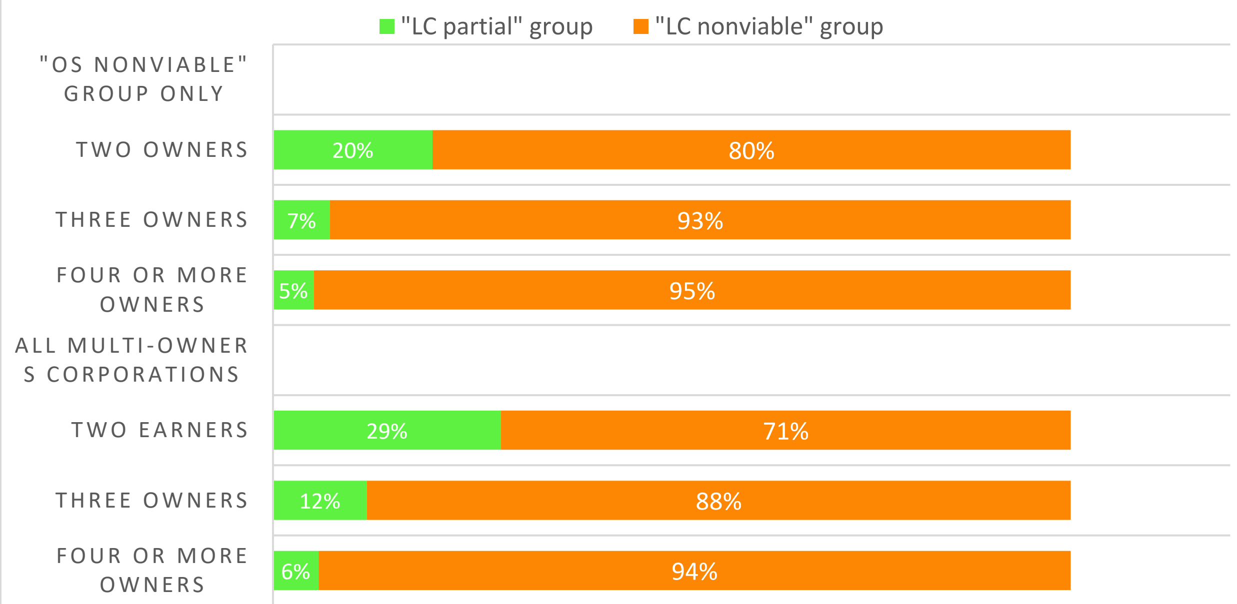


FIGURE 8A
AVERAGE COMPENSATION PER COMPENSATED OWNER FOR S CORPORATIONS WITH A POSITIVE INCOME POOL, BY NUMBER OF OWNERS AND INTERACTION WITH THE OS STRATEGY

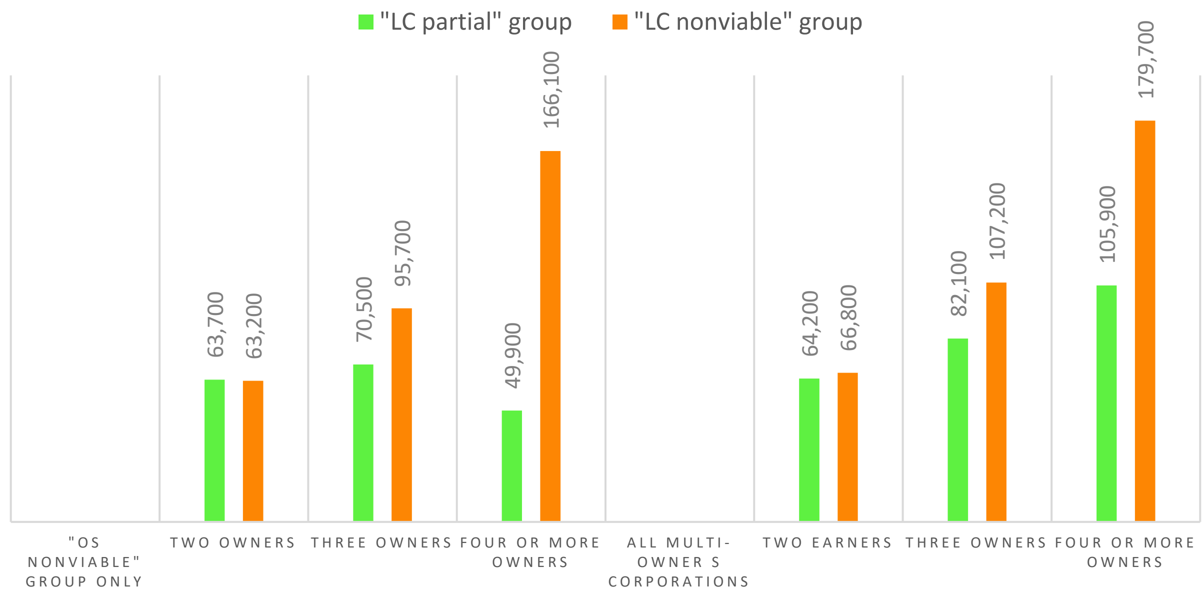


FIGURE 8B
AVERAGE COMPENSATION PER COMPENSATED OWNER FOR S CORPORATIONS WITH A NEGATIVE INCOME POOL, BY NUMBER OF OWNERS AND INTERACTION WITH THE OS STRATEGY

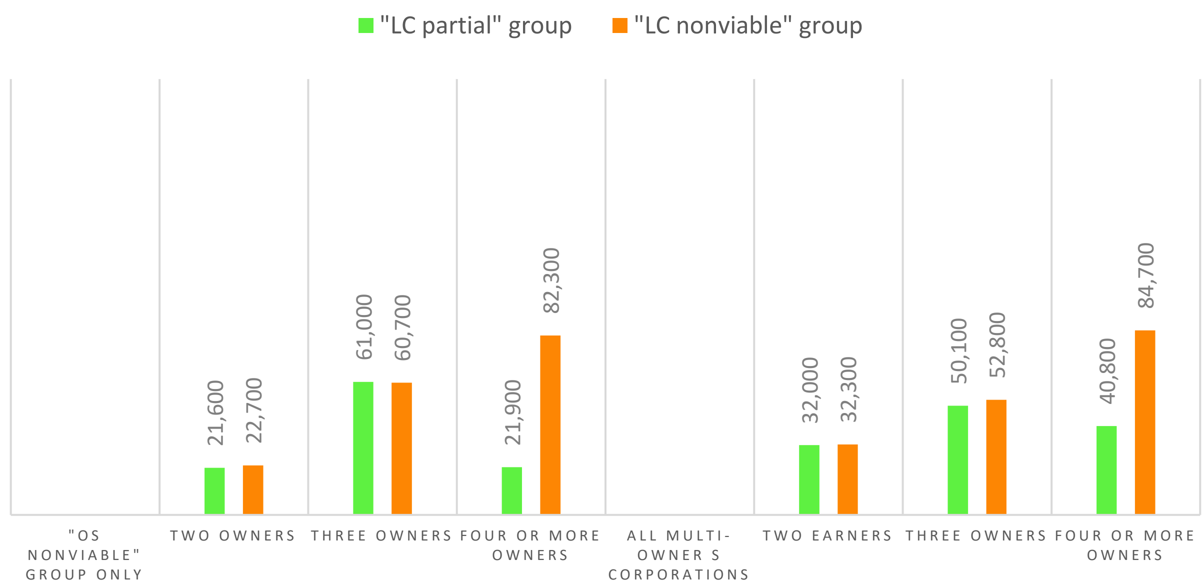


FIGURE 9A
VIABILITY AND UTILIZATION OF THE OS STRATEGY FOR S CORPORATIONS WITH A POSITIVE INCOME POOL AND PAYING NONZERO OWNERS' COMPENSATION, BY NUMBER OF OWNERS AND INTERACTION WITH THE LC STRATEGY

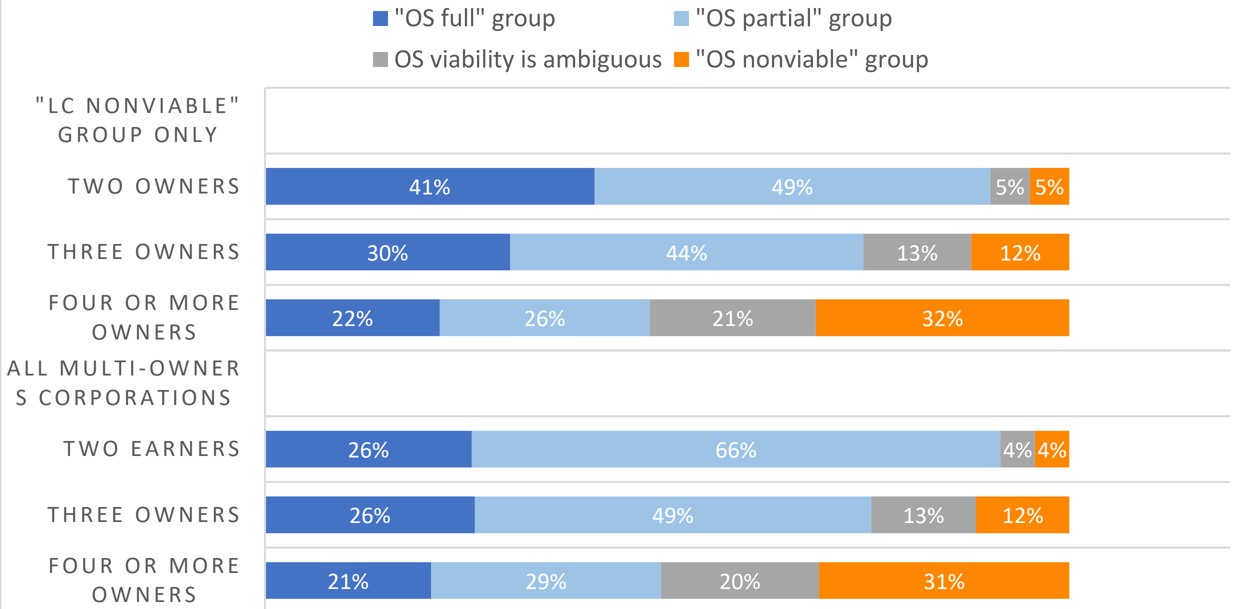
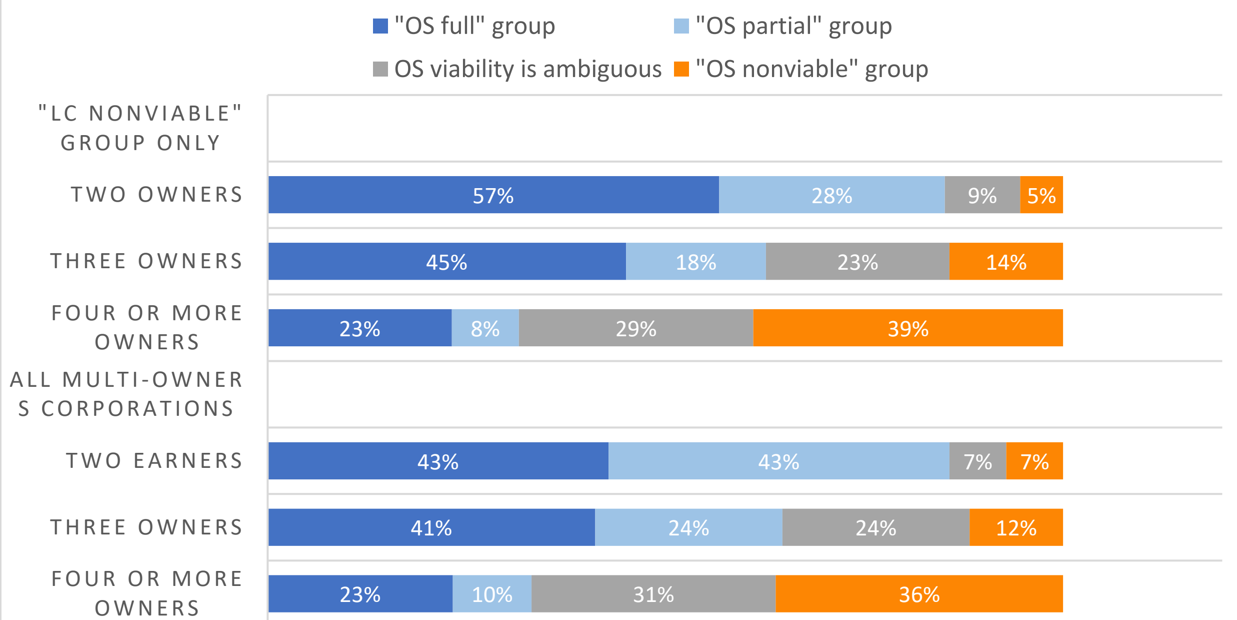


FIGURE 9B
VIABILITY AND UTILIZATION OF THE OS STRATEGY FOR S CORPORATIONS WITH A NEGATIVE INCOME POOL AND PAYING NONZERO OWNERS' COMPENSATION, BY NUMBER OF OWNERS AND INTERACTION WITH THE LC STRATEGY



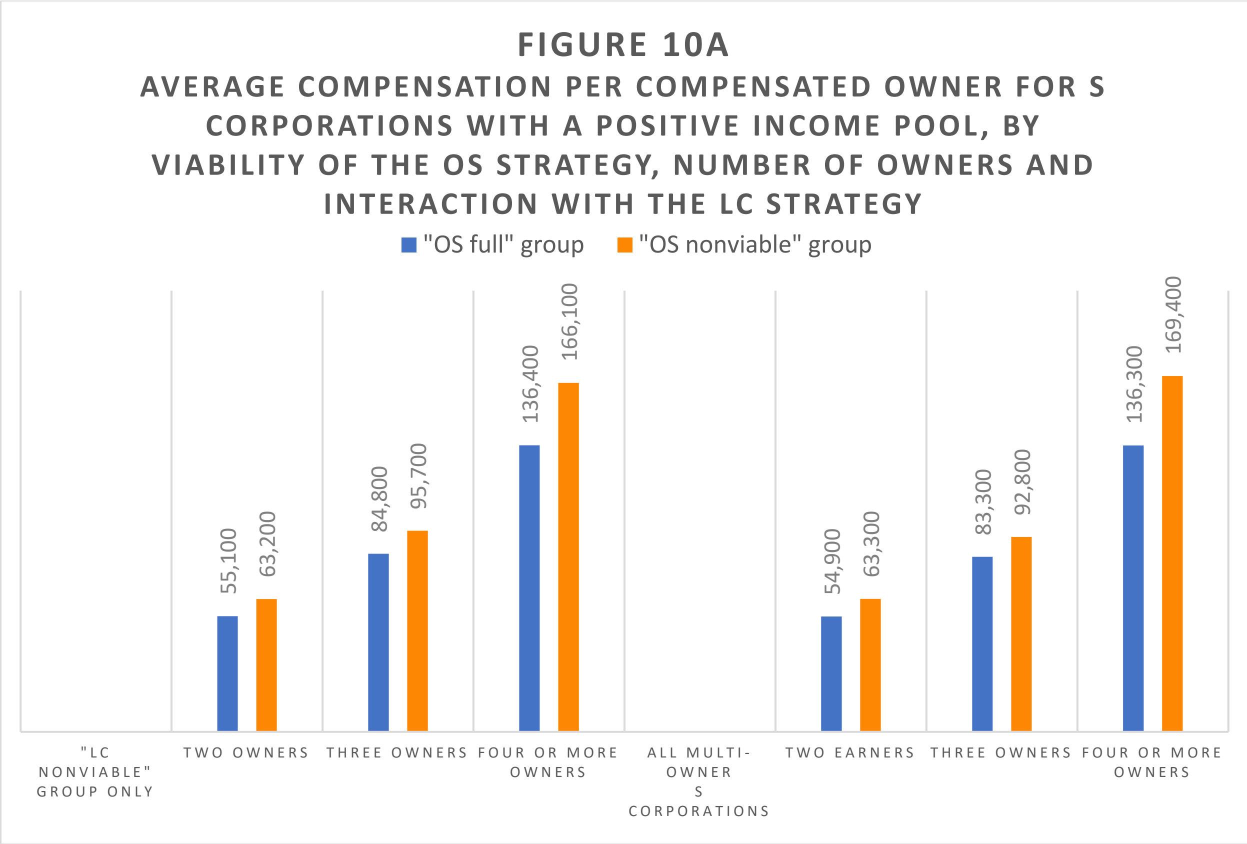


FIGURE 10A
AVERAGE COMPENSATION PER COMPENSATED OWNER FOR S CORPORATIONS WITH A POSITIVE INCOME POOL, BY VIABILITY OF THE OS STRATEGY, NUMBER OF OWNERS AND INTERACTION WITH THE LC STRATEGY
"OS full" group
"OS nonviable" group
55,100
63,200
84,800
95,700
136,400
166,100
54,900
63,300
83,300
92,800
136,300
169,400
"LC NONVIABLE" GROUP ONLY
TWO OWNERS
THREE OWNERS
FOUR OR MORE OWNERS
ALL MULTI-OWNER S CORPORATIONS
TWO EARNERS
THREE OWNERS
FOUR OR MORE OWNERS

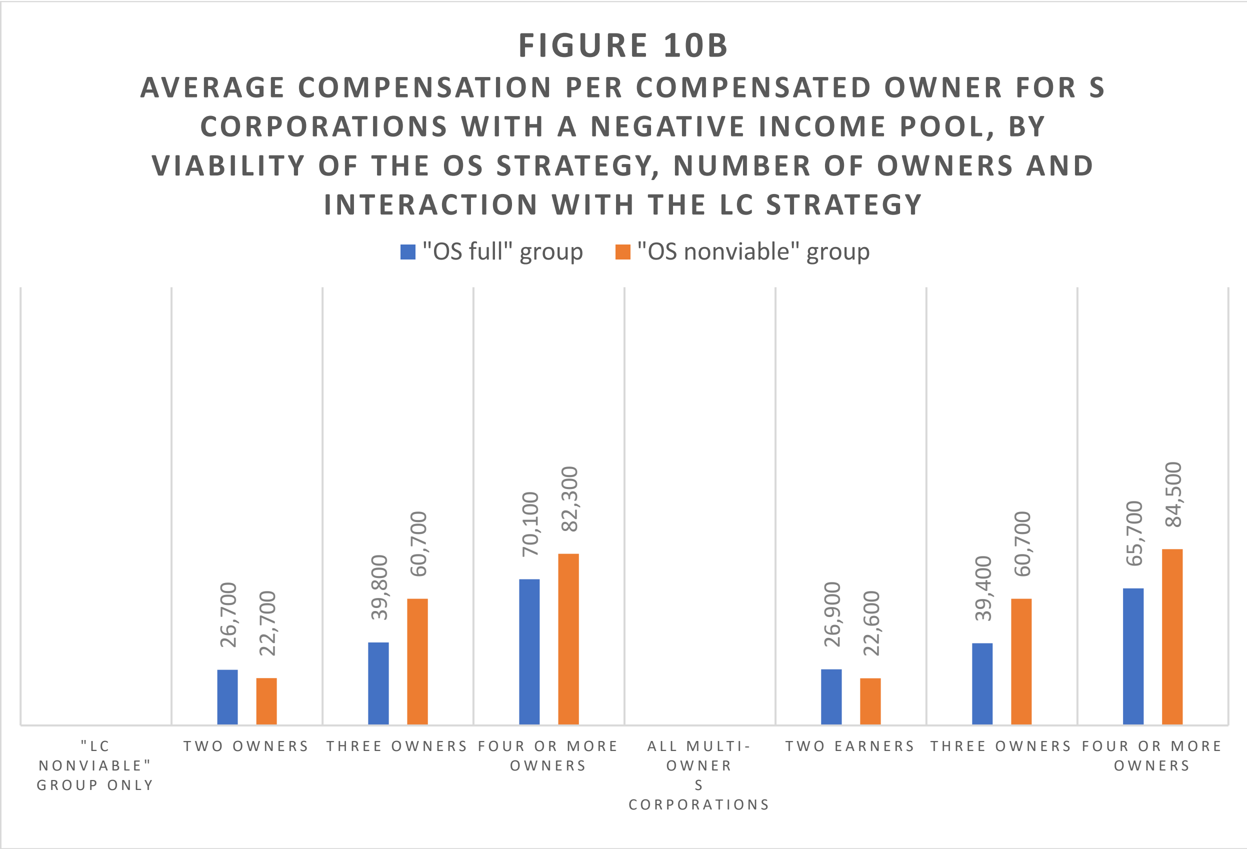


FIGURE 10B
AVERAGE COMPENSATION PER COMPENSATED OWNER FOR S CORPORATIONS WITH A NEGATIVE INCOME POOL, BY VIABILITY OF THE OS STRATEGY, NUMBER OF OWNERS AND INTERACTION WITH THE LC STRATEGY
"OS full" group
"OS nonviable" group
26,700
22,700
39,800
60,700
70,100
82,300
26,900
22,600
39,400
60,700
65,700
84,500
"LC NONVIABLE" GROUP ONLY
TWO OWNERS
THREE OWNERS
FOUR OR MORE OWNERS
ALL MULTI-OWNER S CORPORATIONS
TWO EARNERS
THREE OWNERS
FOUR OR MORE OWNERS

FIGURE 11A

AVERAGE COMPENSATION PER COMPENSATED OWNER FOR S CORPORATIONS WITH A POSITIVE INCOME POOL AND A VIABLE OS STRATEGY, BY DEGREE OF UTILIZATION, NUMBER OF OWNERS AND INTERACTION WITH THE LC STRATEGY

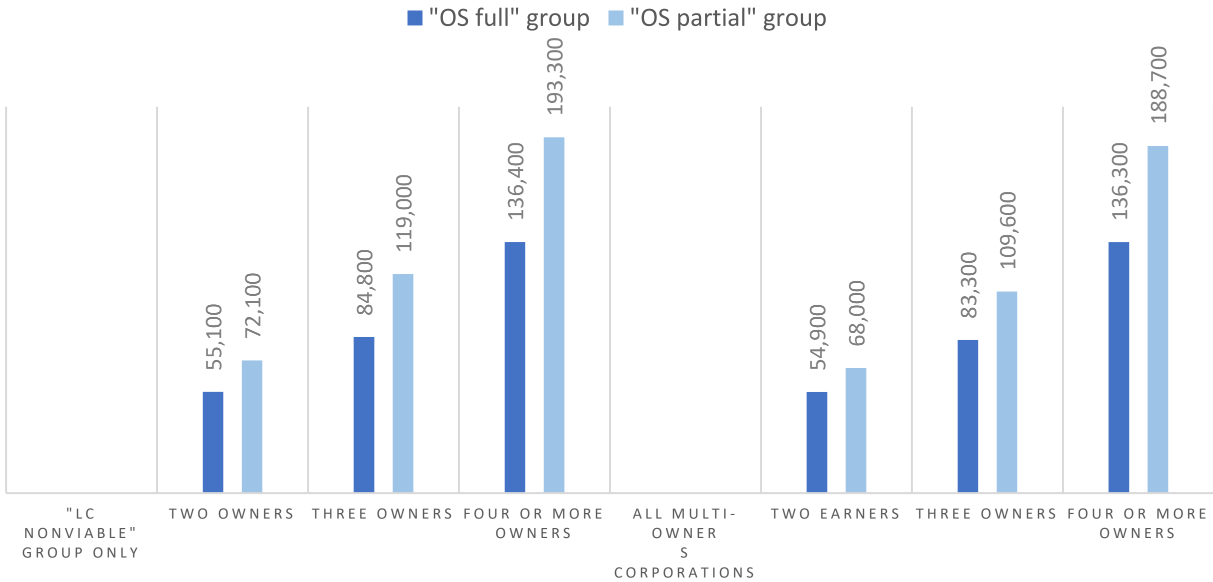


FIGURE 11B

AVERAGE COMPENSATION PER COMPENSATED OWNER FOR S CORPORATIONS WITH A NEGATIVE INCOME POOL AND A VIABLE OS STRATEGY, BY DEGREE OF UTILIZATION, NUMBER OF OWNERS AND INTERACTION WITH THE LC STRATEGY

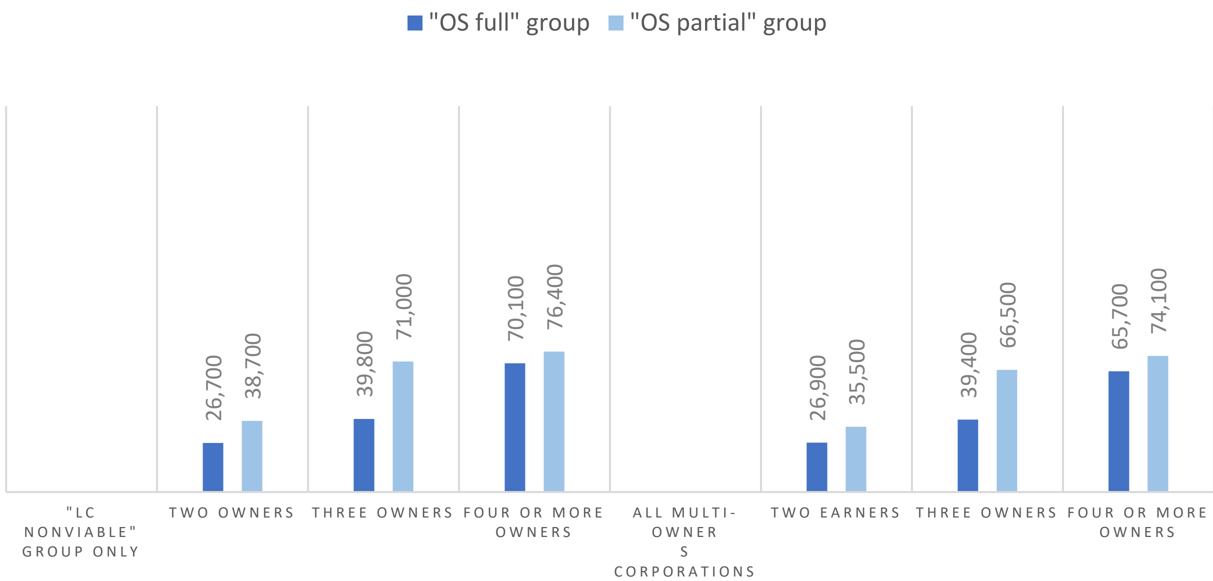


FIGURE A_1A
RELATIONSHIP BETWEEN COMPENSATION OF OFFICERS AND COMPENSATION OF OWNERS FOR S CORPORATIONS WITH A POSITIVE INCOME POOL, BY NUMBER OF OWNERS

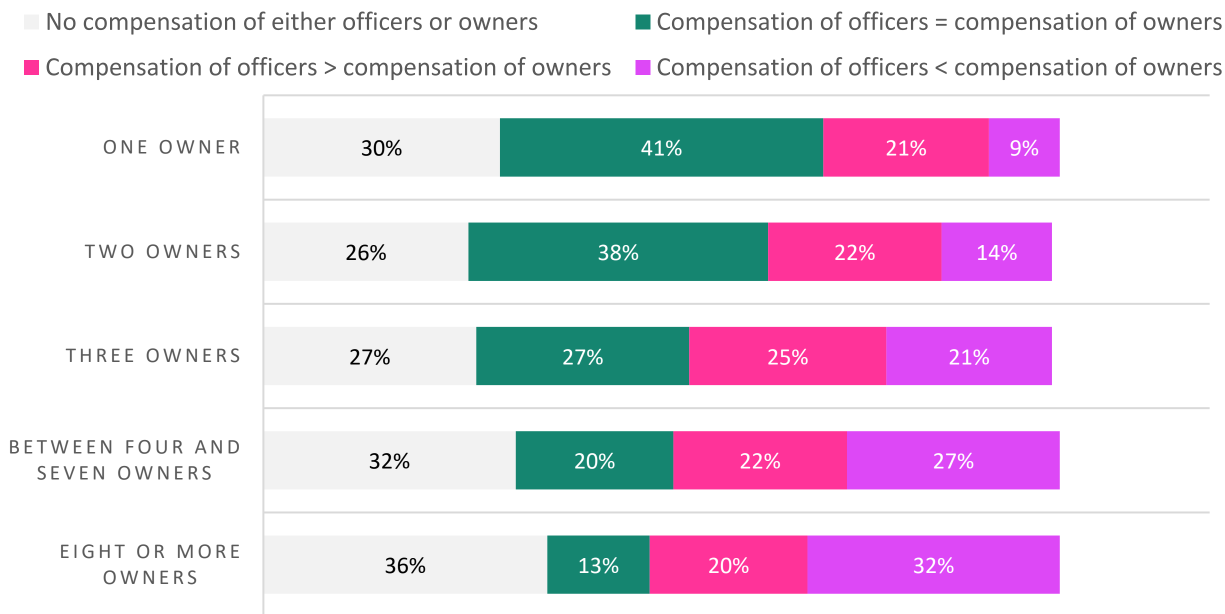


FIGURE A_1B
RELATIONSHIP BETWEEN COMPENSATION OF OFFICERS AND COMPENSATION OF OWNERS FOR S CORPORATIONS WITH A NEGATIVE INCOME POOL, BY NUMBER OF OWNERS

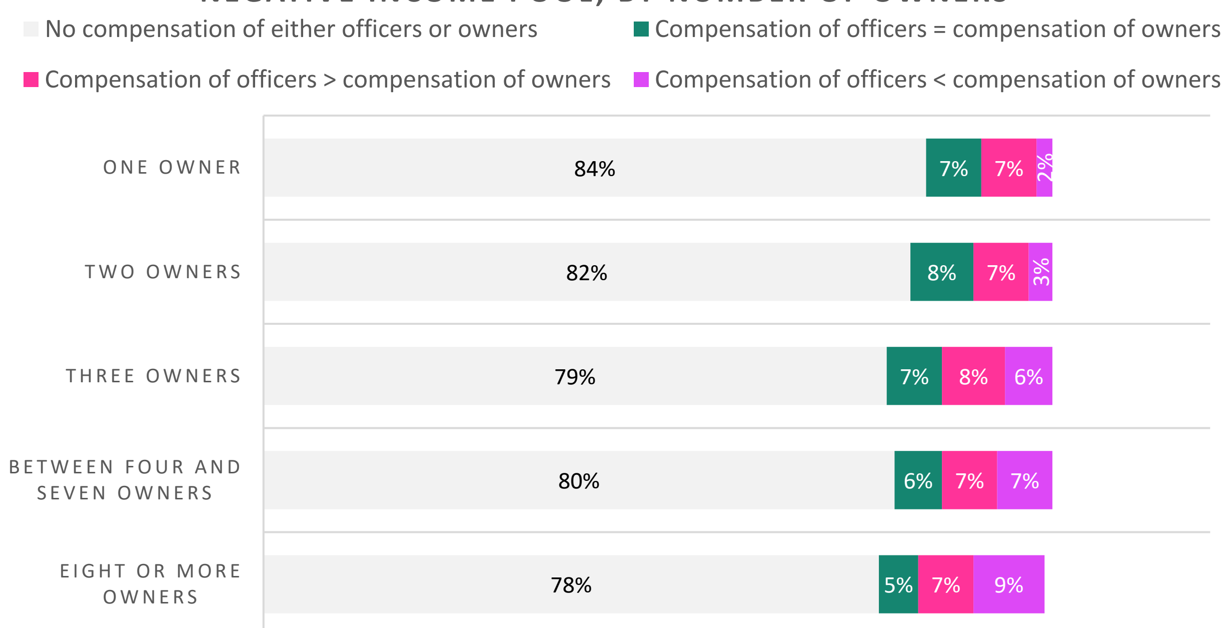


FIGURE B_1A
DISTRIBUTION OF OWNERS BY ACTIVITY LEVEL FOR S CORPORATIONS WITH A POSITIVE INCOME POOL, BY NUMBER OF OWNERS

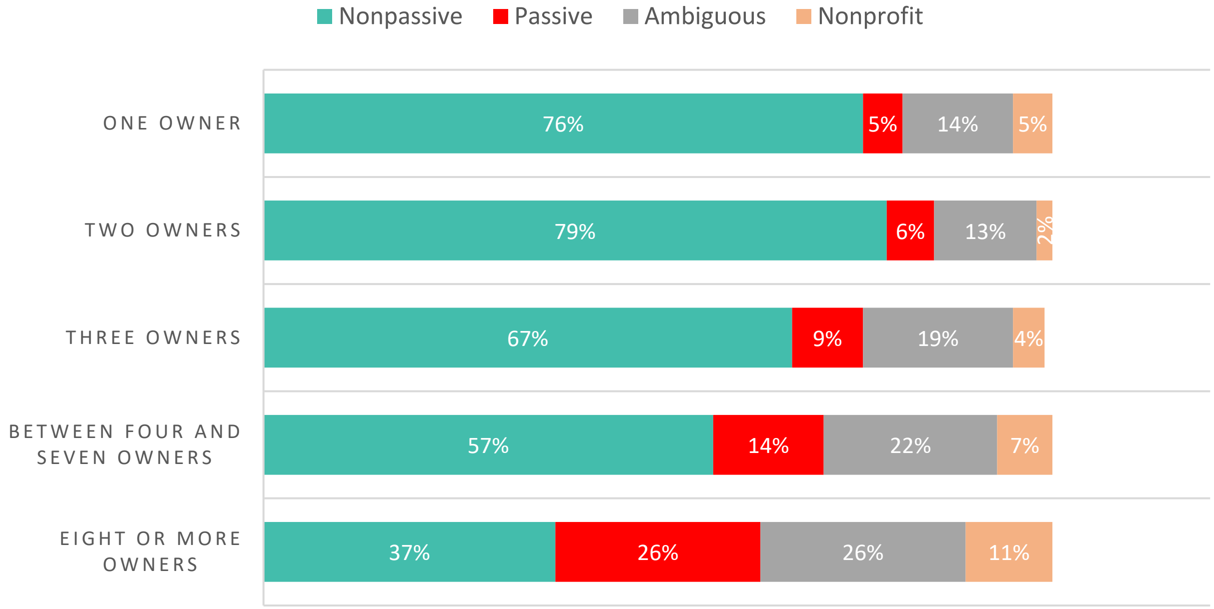


FIGURE B_1B
DISTRIBUTION OF OWNERS BY ACTIVITY LEVEL FOR S CORPORATIONS WITH A NEGATIVE INCOME POOL, BY NUMBER OF OWNERS