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HOW THE 1 PERCENT PAYS TAXES, HOW THE 99 PERCENT COULD: THE SUBCHAPTER T WORKER COOPERATIVE TAX LOOPHOLE

*Michael Haber**

The ratification of the Sixteenth Amendment to the United States Constitution granted Congress the right to tax income “from whatever source derived.” Since its inception, the tax code has become long and complicated, filled with broad taxation rules and innumerable exceptions. Over time, the tax code has been amended with the stated purpose of promoting “fairness, efficiency, and enforceability.” However, the complexity of the tax code has led to abuse of “tax loopholes” by wealthy taxpayers who want to avoid paying their fair share of taxes. While abuse is likely to continue, as legislators remain intent on lowering taxes on the wealthy, there exists a “tax loophole” that can benefit the working class. Subchapter T of the Tax Code provides that worker cooperatives, businesses that are jointly owned by their workers, can pass through their income to their worker-owners in the form of patronage dividends, avoiding the entity level taxes that corporations are generally required to pay. However, the IRS has maintained that worker cooperatives must pay their worker-owners a “reasonable salary,” subject to payroll taxes, rather than allowing worker-owners to be paid their entire salaries as patronage dividends to circumvent payroll taxes. This Note argues that the IRS has incorrectly interpreted Subchapter T of the tax code, as Subchapter T allows worker cooperatives to avoid corporate taxes at the entity level and allows worker-owners to avoid payroll taxes on their entire income by structuring their salaries as patronage dividends. Further, this Note argues that, as a matter of policy, the IRS ought to endorse this understanding of Subchapter T, as offering tax incentives to worker cooperatives will benefit the working class.

INTRODUCTION

Subchapter T of the Internal Revenue Code (the “tax code”) addresses the tax treatment of worker cooperatives and their patrons.¹ Worker cooperatives are businesses that are jointly owned, operated, and governed by their workers.² Rather than profits being shared by a few wealthy partners, worker cooperatives divide profits between all of the cooperative’s workers in the form of patronage dividends, making each worker an owner of the worker cooperative (“worker-owners”).³ Worker cooperatives are more attractive than traditional business models to the average worker because they promote profit sharing, worker

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¹ I.R.C. § 1381 (2012). Though Subchapter T discusses the tax treatment of all cooperatives, this Note will focus on worker cooperatives because of the nexus between Subchapter T and payroll taxes. Since, by contrast to other forms of cooperatives, worker-owners of worker cooperatives provide labor for the cooperative, the issue of how much they are required to pay in payroll taxes is unique to their cooperative model. *See id.*

² Sustainable Economies Law Center & Eastbay Community Law Center, *Think Outside the Boss: How to Create a Worker-Owned Business*, CO-OPLAW 1 (7th ed., 2016), https://drive.google.com/file/d/0B_rgt0QdXUbycnprd3hhYzdWNnc/view [hereinafter *Think Outside the Boss*].

³ *See* Bianca Wythe, *A Fair Share: Worker Cooperatives and the Growth of Shared Capitalism*, COMMUNITY-WEALTH (Feb. 5, 2015), <https://community-wealth.org/content/fair-share-worker-cooperatives-and-growth-shared-capitalism> (discussing how worker cooperatives “have long been regarded by advocates as the most equitable, profit-sharing model”); *see also* I.R.C. § 1388 (a) (defining what constitutes a “patronage dividend”); *Patronage & Tax*, CO-OPLAW.ORG, http://www.co-oplaw.org/finances-tax/patronage/#Explanation_of_How_Money_Flows_Through_a_Cooperative (last visited Nov. 29, 2017) (noting that if there is any surplus at the end of an accounting period that “[u]nlike in a regular corporation, the surplus distributed is not based on ownership interest but on patronage.”).

protections, and democratic control.⁴ Recognizing the benefits of worker cooperatives, the tax code treats these entities more favorably than traditional businesses.⁵

Generally, patronage dividends received by worker-owners⁶ are exempt from entity-level taxes,⁷ also known as corporate taxes, allowing worker cooperatives to operate as “pass-through” business entities, passing the income of the company to worker-owners without an additional tax burden.⁸ However, the Internal Revenue Service (“IRS”), the government agency tasked with enforcing the tax code, has maintained that worker-owners acting as employees for worker cooperatives must be paid traditional salaries and pay payroll taxes on their salaries, rather than allowing worker-owners to treat their entire income as patronage dividends to avoid payroll taxes.⁹ Under the IRS’ interpretation of the tax

⁴ See *Think Outside the Boss*, *supra* note 2.

⁵ *IRC Section 521 Exempt Farmers’ Cooperatives*, IRS, https://www.irs.gov/irm/part4/irm_04-044-001.html (last visited Nov. 29, 2017); see Press Release, CICOPA, Worker and Social Cooperatives Fostering Equality by Putting Solidarity and Democracy in the Workplace (July 3, 2015), http://www.cicopa.coop/IMG/pdf/cicopa_pr_int_day_of_coops_2015_en_v02.pdf (discussing that worker cooperatives are a beneficial business structure as they allow all workers to have a say in the future of the company).

⁶ Patronage dividends are amounts paid to worker-owners for the value that they provide to their respective worker cooperatives. I.R.C. § 1388. The Code states that patronage dividends must be paid (1) to worker-owners “on the basis” of the amount of value that they provide to the cooperative, (2) under obligation from the worker cooperative that existed prior to receiving the income, and (3) from net earnings of the worker cooperative from work done with worker-owners. *Id.* Patronage dividends operate as a profit sharing mechanism, offering worker-owners a percentage of the worker cooperative’s annual net earnings, determined prior to the taxable year, based on the value that they provide to the worker cooperative. *See id.*

⁷ I.R.C. § 1381 (2012).

⁸ Bruce Mayer, *Patronage Dividends: A Primer*, COOPERATIVE GROCER NETWORK (July 14, 2009), <http://www.grocer.coop/articles/patronage-dividends-primer>.

⁹ Gregory R. Wilson, *Taxation of Patronage Dividends from Worker Cooperatives: Are They Subject to Employment Tax?*, GWILSON.COM 1 (2008), [http://www.gwilson.com/documents/Article4\(PatronageDivTax\).pdf](http://www.gwilson.com/documents/Article4(PatronageDivTax).pdf) [hereinafter Wilson, *Taxation of Patronage Dividends*]; Gregory Wilson, *Are Cooperative Patronage Dividends Subject to Employment Tax?*, CUTTING EDGE COUNSEL

code, worker-owners must receive a weekly salary, subject to payroll taxes and a separate annual patronage dividend, not subject to payroll taxes.¹⁰ This is problematic, as the IRS has inserted meaning into the tax code that is not otherwise present by forcing worker-owners to be paid a “reasonable salary,” subject to payroll taxes, thus compelling an unwarranted tax burden on worker cooperatives and their worker-owners.¹¹

The IRS’ insistence that worker-owners must pay payroll taxes on their weekly salaries, rather than allowing worker-owners to treat all of their income as patronage dividends,¹² is problematic. When read correctly, Subchapter T of the tax code does not prohibit the treatment of all worker-owner income as patronage dividends.¹³ To the contrary, a correct reading of Subchapter T allows worker-owners of worker cooperatives to treat their entire income earned through the worker cooperative as patronage dividends, as Subchapter T does not include a requirement that worker-owners be paid a salary.¹⁴ Subchapter T exempts patronage dividends paid to worker-owners of worker cooperatives from payroll taxes¹⁵ and does not restrict the amount of patronage dividends paid to them,¹⁶ creating an opportunity for worker-owners to be paid their entire salaries as patronage dividends.¹⁷

(June 30, 2009), <http://cuttingedgecounsel.com/patronage/> [hereinafter Wilson, *Are Cooperative Patronage Dividends Subject to Employment Tax?*].

¹⁰ See Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 3–6 (discussing self-employment tax and taxation of patronage dividends in the context of worker cooperatives and the IRS’ lack of clarity in its application to worker cooperatives); see also discussion *infra* Section II.C.

¹¹ Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 6 (discussing how where “an employee-member of a cooperative. . . is not paid market rate compensation separately from any patronage dividend” a claim, undue current law, that “his or her patronage dividends is not subject to self-employment tax” will be “weak” and the IRS is “challenging this position.”).

¹² *Id.* at 1.

¹³ See generally I.R.C. §§ 1381–1383, 1385 (2012) (making no mention of the prohibition of treating all income as patronage dividends).

¹⁴ See generally *id.* (making no mention of a reasonable salary requirement).

¹⁵ See I.R.C. 1385(c)(1)(A)(i).

¹⁶ See generally I.R.C. §§ 1381–1383, 1385 (offering no restriction on the amount of patronage dividends one can receive).

¹⁷ *Id.*; see discussion *infra* Part III.

Nevertheless, the IRS has refused to acknowledge this as a legitimate tax loophole.¹⁸ Instead, they have insisted that worker-owners must pay payroll taxes on their salaries,¹⁹ placing an undue burden²⁰ on worker-owners of worker cooperatives by prohibiting them from legally reducing their tax burden.²¹

This Note argues that the IRS has incorrectly interpreted Subchapter T of the tax code, as Subchapter T allows worker cooperatives to avoid corporate taxes at the entity level²² and allows worker-owners to avoid payroll taxes on their *entire income* by structuring their salaries as patronage dividends.²³ Further, this Note argues that, as a matter of policy, the IRS ought to endorse this understanding of Subchapter T, as offering tax incentives to worker cooperatives will undoubtedly benefit the working class by offering a tax haven for workers.²⁴

Part I of this Note discusses tax code policies and their impact on our taxation system, analyzing differences in the taxation of various types of businesses, employees, and income. Part II discusses worker cooperatives and why their benefits merit special tax treatment. This Part also explains Subchapter T of the tax code and discusses how the IRS and the United States Tax Court (“Tax Court”)²⁵ have interpreted Subchapter T, offering an alternative

¹⁸ Wilson, *Taxation of Patronage Dividends*, *supra* note 9; Wilson, *Are Cooperative Patronage Dividends Subject to Employment Tax?*, *supra* note 9.

¹⁹ Wilson, *Taxation of Patronage Dividends*, *supra* note 9; Wilson, *Are Cooperative Patronage Dividends Subject to Employment Tax?*, *supra* note 9.

²⁰ Forcing worker-owners to be paid a weekly salary requires them to pay payroll taxes on income that, if treated as a patronage dividend, would be exempt from payroll taxes. *See* Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 2.

²¹ *Id.*

²² Since patronage dividends “shall not be taken into account” in a worker cooperative’s gross income, paying all worker-owners in patronage dividends will result in the ability to avoid corporate taxes. I.R.C. § 1382 (b)(1) (2012).

²³ *See generally* Wilson, *Taxation of Patronage Dividends*, *supra* note 9; *see also* discussion *infra* Part III.

²⁴ *Think Outside the Boss*, *supra* note 2, at 81.

²⁵ “The United States Tax Court is a court of record established by Congress under Article I of the U.S. Constitution. When the Commissioner of Internal Revenue has determined a tax deficiency, the taxpayer may dispute the deficiency in the Tax Court before paying any disputed amount.” *About the*

explanation that will allow worker-owners to treat all their income as patronage dividends to avoid payroll taxes (the “Subchapter T tax loophole”). Part III provides policy support for the Subchapter T tax loophole, juxtaposing worker-owners with wealthy taxpayers and arguing that worker-owners deserve equitable tax treatment. Finally, Part IV addresses the counter argument that worker-owners are either employees or independent contractors and offers an alternative solution to the problem. This Note concludes with a plea to the IRS to recognize the Subchapter T tax loophole and to allow worker cooperatives to avoid payroll taxes.

I. THE TAX CODE: POLICY CONCERNS AND GENERAL PRINCIPLES

A. Policies Behind the Tax Code and How They Fail

The Sixteenth Amendment to the United States Constitution states that “Congress shall have power to lay and collect taxes on incomes, from whatever source derived.”²⁶ With this power, Congress enacted the Internal Revenue Code to govern federal tax law.²⁷ Although the tax code was a short and simple document when enacted in 1913,²⁸ it has become long and complicated over

Court, UNITED STATES TAX COURT, <https://www.ustaxcourt.gov/about.htm> (last updated Aug. 5, 2016).

²⁶ U.S. CONST. amend. XVI.

²⁷ *Tax Code, Regulations, and Official Guidance*, IRS, <https://www.irs.gov/tax-professionals/tax-code-regulations-and-official-guidance> (last updated Aug. 7, 2017).

²⁸ See *The Growing Complexity of the U.S. Federal Tax Code*, POLITICAL CALCULATIONS (Mar. 11, 2010), <http://politicalcalculations.blogspot.com/2010/03/growing-complexity-of-us-federal-tax.html#.WD244pMrJ-U> (noting that “[when the] U.S. implemented the income tax in 1913 “the entire federal tax could have been contained in a single 400 page textbook”, but as of 2010, “the code has ballooned to be 71,864 pages in length.”).

time.²⁹ As of April 2016, the tax code is comprised of 74,608 pages.³⁰

The tax code has become long and complicated because it is not simply a tool to raise revenue; the tax code's core purpose is to promote goals "including fairness, efficiency, and enforceability."³¹ However, due to its complexity, the tax code is filled with technicalities that allow individuals and businesses to "avoid the scope" of the tax law "without directly violating the law."³² Technicalities that allow individuals and businesses to legally avoid paying taxes are known as tax loopholes.³³ Though tax loopholes are not illegal, they are controversial because individuals and businesses that exploit tax loopholes are believed to be circumventing the spirit of tax law.³⁴ Tax loopholes are a highly divisive topic as they often benefit affluent taxpayers and large corporations, even when they were intended to benefit small

²⁹ See *id.*; see also Derek Thompson, *The Tax Code Is a Complicated, Horrible Mess Because We Like It That Way*, THE ATLANTIC (Apr. 18, 2012), <https://www.theatlantic.com/business/archive/2012/04/the-tax-code-is-a-complicated-horrible-mess-because-we-like-it-that-way/256094/> ("The irony is that the tax code is complicated because we want it to be complicated . . . [t]hat's democracy for you.").

³⁰ Jason Russell, *Look At How Many Pages are in the Federal Tax Code*, WASH. EXAMINER, (Apr. 15, 2016), <http://www.washingtonexaminer.com/look-at-how-many-pages-are-in-the-federal-tax-code/article/2563032>.

³¹ *Key Elements of the U.S. Tax System – Why are Taxes So Complicated?*, TAX POLICY CENTER, <http://www.taxpolicycenter.org/briefing-book/why-are-taxes-so-complicated> (last visited Nov. 29, 2017) [hereinafter *Key Elements of the U.S. Tax System*]; see *IRS Strategic Plan 2005–2009*, IRS 1, 4, https://www.irs.gov/pub/irs-utl/strategic_plan_05-09.pdf (last visited Nov. 29, 2017) (describing goals of the IRS in serving taxpayers including efficiency and fairness).

³² *Loophole*, INVESTOPEDIA, <http://www.investopedia.com/terms/l/loophole.asp> (last visited Nov. 29, 2017); see *The Problem With the Tax Code? Officially, There's Too Much of It.*, US TAX CENTER, <https://www.irs.com/articles/problem-tax-code-officially-theres-too-much-it> (last visited Nov. 29, 2017) (arguing that the complexity of the tax code yields perverse results).

³³ *Id.*

³⁴ Kay Bell, *Tax Loopholes that Mainly Benefit the Rich*, BANKRATE (Dec. 17, 2012), <https://www.bankrate.com/finance/taxes/tax-loopholes-mainly-benefit-rich-1.aspx>; see *Tax Loophole Law and Legal Definition*, USLEGAL, <http://definitions.uslegal.com/t/tax-loophole%20/> (last visited Nov. 29, 2017).

businesses and less-affluent taxpayers at the time they were enacted.³⁵ Thus, rather than promoting “fairness, efficiency, and enforceability,”³⁶ the tax code often has the reverse effect.³⁷

Though lawmakers claim that the complexity of the tax law is necessary to promote policy goals of fairness and equality,³⁸ the tax code is complex, in part, because special interest groups lobby lawmakers to amend the tax code in their favor.³⁹ Because politicians require funding to run political campaigns⁴⁰ and wealthy individuals and corporations readily donate to politicians who will serve their specific interests, politicians are often beholden to special interest groups.⁴¹ This system of political

³⁵ See Jonathan Berr, *How Big Businesses Get Tax Breaks Meant for Little Guys*, CBS NEWS (Aug. 16, 2016), <https://www.cbsnews.com/news/are-big-businesses-getting-tax-breaks-meant-for-small-firms/> (“[M]ore than 100,000 ‘big’ businesses reap billions in tax breaks designed to assist ‘small’ companies, costing Uncle Sam hundreds of billions in tax revenue.”).

³⁶ *Key Elements of the U.S. Tax System*, *supra* note 31.

³⁷ See Berr, *supra* note 35.

³⁸ See *Key Elements of the U.S. Tax System*, *supra* note 31 (“Most people believe taxes should be fair, conducive to economic prosperity, and enforceable, as well as simple . . . [however because] people who agree on these goals often disagree above the relative importance of each . . . policies usually represent a balance among [these] competing goals, and simplicity often loses out to other priorities.”).

³⁹ See *id.* (noting that “[i]nterest groups—and thus politicians—support tax subsidies for particular groups or activities” which “inevitably complicate the tax system . . .”).

⁴⁰ See Ed Hornick, *Why Do U.S. Elections Cost So Much?*, CNN POLITICS (Oct. 11, 2011), <http://www.cnn.com/2011/10/13/politics/us-election-costs/> (“Money drives a campaign, and fundraising is a signal of its strength.”).

⁴¹ Elias Isquith, “*The Interests of the Wealthy*”: *How the Rich Control Politicians — Even More Than You Think*, SALON (Feb. 27, 2015), http://www.salon.com/2015/02/27/the_interests_of_the_wealthy_how_the_rich_control_politicians_even_more_than_you_think/. A small group of wealthy voters contribute most of the funding for political campaigns. See Nicholas Confessore et al., *The Families Funding the 2016 Presidential Election*, NY TIMES: POLITICS (Oct. 10, 2015), <https://www.nytimes.com/interactive/2015/10/11/us/politics/2016-presidential-election-super-pac-donors.html> (noting, for example, that “[j]ust 158 families, along with companies they own or control, contributed \$176 million in the first phase of the [2016 presidential] campaign.”). Those who donate such large quantities of money to politicians generally support candidates who have pledged to serve their unique interests

campaign funding has led to many tax loopholes that are predominantly beneficial to wealthy taxpayers.⁴² For example, wealthy taxpayers are uniquely able to take advantage of the capital gains tax,⁴³ the home mortgage interest deduction,⁴⁴ and carried interest,⁴⁵ among others.⁴⁶

The capital gains tax rate allows taxpayers to pay a 0 to 20 percent tax rate on income from investments, as opposed to an ordinary personal income tax rate of 30 to 40 percent.⁴⁷ A commonly-cited reason for the capital gains tax loophole is that it encourages investment, which, in turn, stimulates economic growth.⁴⁸ However, taxpayers with lower income often spend most of their money paying their living expenses and do not have

such as “cut[ting] taxes on income, capital gains and inheritances; and shrink[ing] entitlement programs.” *Id.*

⁴² See Bell, *supra* note 34 (discussing how tax loopholes, such as the capital gains tax rate, enables the wealthy to “pay substantially lower overall tax rates”).

⁴³ Jay MacDonald, *5 Deductions That Favor the Rich*, BANKRATE, <http://www.bankrate.com/finance/taxes/tax-deductions-favor-rich-1.aspx> (last visited Nov. 29, 2017). “Capital gains” derive from the sale of investments such as stocks and bonds. *Id.*

⁴⁴ *Id.*

⁴⁵ See Judith Lewis Mernit, *How the Carried-Interest Loophole Makes the Super-Rich Super-Richer*, MOYERS & COMPANY (Jun. 23, 2016), <http://billmoyers.com/story/carried-interest-loophole-make-super-rich-super-richer/> (“The ‘carried-interest tax loophole’ allows managers of certain private-equity funds to treat the bulk of their earnings as long-term capital gains.”).

⁴⁶ MacDonald, *supra* note 43 (explaining that retirement savings and charitable deductions are other tax benefits that disproportionately aid the rich).

⁴⁷ *Id.*; *Tax Policy Center Briefing Book: Key Elements of the U.S. Tax System*, TAX POLICY CENTER, <http://www.taxpolicycenter.org/briefing-book/how-are-capital-gains-taxed> (last visited Nov. 29, 2017). See Rande Spiegelman, *Taxes: What’s New for 2017?*, CHARLES SCHWAB (Jan. 4, 2017), <https://www.schwab.com/resource-center/insights/content/taxes-whats-new> (referring to chart comparing taxes on ordinary income as opposed to tax rate on long term capital gains).

⁴⁸ See Chris Edwards, *Six Reasons to Keep Capital Gains Tax Rates Low*, CATO INSTITUTE (Dec. 27, 2012), <https://www.cato.org/publications/commentary/six-reasons-keep-capital-gains-tax-rates-low> (“Reduced capital gains taxes encourage entrepreneurship . . . [and] boost outside investment from angels and venture capitalist . . .”).

surplus money to invest,⁴⁹ resulting in tax treatment that is only beneficial to affluent taxpayers.⁵⁰ Tax loopholes that exclusively benefit the rich create a system at odds with stated policy goals such as fairness and efficiency. If the tax code is supposed to provide a fair and efficient system of taxation,⁵¹ the tax system must be fair and efficient for all Americans.

Though there has been a long national conversation about closing tax loopholes and changing policies that benefit wealthy taxpayers,⁵² and though many scholars and lobbyists argue for a

⁴⁹ See Bell, *supra* note 34 (noting that most people in the lower income tax brackets of 10 and 15 percent “don’t have a lot, if any, cash left over to invest after paying their bills.”). In fact, while approximately 51 percent of high income taxpayers report capital gains, only approximately 11 percent of taxpayers earning less than \$200,000 annually report any capital gains. These figures demonstrate that high income taxpayers disproportionately benefit from the capital gains tax loophole. Angie Drobnic Holan, *Mostly, Higher Incomes Pay Capital Gains Tax*, POLITIFACT (Jun. 11, 2008), <http://www.politifact.com/truth-o-meter/statements/2008/jun/11/republican-national-committee-republican/mostly-higher-incomes-pay-capital-gains-tax/>. These figures demonstrate that high income taxpayers disproportionately benefit from the capital gains tax loophole. *Id.*

⁵⁰ See Bell, *supra* note 34 (noting that the capital gains tax is largely beneficial to the “really rich” since “they tend to make most of their money via investments instead of standard paychecks” so unlike “ordinary taxpayers [who] pay tax on their earnings at ordinary income tax rates up to 35 percent . . . most of their money is [instead] taxed at 15 percent.”). In addition to the capital gains loophole, there are many similar tax loopholes that are uniquely beneficial to the rich. See also Noam Scheiber & Patricia Cohen, *For the Wealthiest, a Private Tax System That Saves Them Billions*, N.Y. TIMES (Dec. 29, 2015), <http://www.nytimes.com/2015/12/30/business/economy/for-the-wealthiest-private-tax-system-saves-them-billions.html> (describing how the rich have “used their influence to steadily whittle away at the government’s ability to tax them . . . [creating] a kind of private tax system, catering to only several thousand Americans” and that they benefit from many loopholes in the tax code).

⁵¹ See generally *IRS Strategic Plan 2005–2009*, *supra* note 31 (articulating the goals of the IRS in serving taxpayers including efficiency and fairness).

⁵² See, e.g., David Wessel, *In Obama’s Budget, a Case Study on Finding and Closing Tax Loopholes*, BROOKINGS (Feb. 9, 2016), <https://www.brookings.edu/opinions/in-obamas-budget-a-case-study-on-finding-and-closing-tax-loopholes/> (discussing Obama administration’s targeting of tax loophole that is being exploited by the rich); cf. Heather Long, *Trump’s Tax ‘Reform’ Looks Like Tax Cuts For the Rich*, WASH. POST (Sept. 25, 2017),

complete overhaul of the tax system,⁵³ the process required to close tax loopholes is complex and political.⁵⁴ More importantly, President Donald Trump does not seem to take middle class tax reform seriously.⁵⁵ During his 2016 presidential campaign, Mr.

https://www.washingtonpost.com/news/wonk/wp/2017/09/25/trumps-tax-reform-looks-like-tax-cuts-for-the-rich/?utm_term=.d2ee1c13e333 (noting that President Trump’s proposed tax plan is a “deal where most of the benefits go to the wealthy and large corporations.”); see also *Fact Sheet: President Donald J. Trump Tackles Our Broken Tax System*, THE WHITE HOUSE, (Aug. 30, 2017), <https://www.whitehouse.gov/briefings-statements/fact-sheet-president-donald-j-trump-tackles-broken-tax-system/> (“President Donald J. Trump is working hard to reform our tax system so that Americans are treated fairly, can keep more of their hard-earned money, and companies can bring jobs back to the United States.”).

⁵³ See, e.g., Eric Toder, *The U.S. Needs Tax Reform, Not Tax Cuts*, HARV. BUS. REV. (Aug. 22, 2017) <https://hbr.org/2017/08/the-u-s-needs-tax-reform-not-tax-cuts> (noting that the “tax system is badly in need of tax reform”); see also Naomi Jagoda, *Tax Reform Push Sparks Lobbying Frenzy*, THE HILL (Nov. 27, 2016) <http://thehill.com/policy/finance/307410-tax-reform-push-sparks-lobbying-frenzy> (noting that the “Republicans’ push for moving tax reform legislation in 2017 has set off a lobbying frenzy” and that some groups who “have long sought tax changes [] are excited to make the case for their priorities to be included in legislation.”); *Federal Tax System Seen in Need of an Overhaul*, PEWRESEARCHCENTER (Mar. 19, 2015), <http://www.people-press.org/2015/03/19/federal-tax-system-seen-in-need-of-overhaul/> (noting that “[t]he public sees the nation’s tax system as deeply flawed.”).

⁵⁴ See Chad Stone, *Pols Be Warned: Closing Tax Loopholes Will Be Tough*, U.S. NEWS (Oct. 18, 2012), <https://www.usnews.com/opinion/economic-intelligence/2012/10/18/closing-tax-loopholes-to-reduce-the-deficit-is-tough-but-necessary> (discussing the political, technical, and administrative challenges that will make it difficult to close tax loopholes).

⁵⁵ See Long, *supra* note 52; see also Mary Jordan, *When Donald Trump Said That Not Paying Taxes ‘Makes Me Smart,’ Undecided Voters in N.C. Gaped*, WASH. POST (Sep. 27, 2016), https://www.washingtonpost.com/politics/a-lean-toward-clinton-among-one-group-of-undecided-north-carolina-voters/2016/09/27/ff271b2e-8469-11e6-92c2-14b64f3d453f_story.html?utm_term=.0711a291aef3 (illustrating how President Trump alienated some middle-class voters when he commented that not paying federal taxes “makes [him] smart”). President Trump has proposed a tax plan that would lower the rate for the highest bracket and would end the Alternative Minimum Tax, providing even more benefits to rich taxpayers. Tom Anderson, *How Trump’s New Tax Reform Proposal May Affect Every Income Bracket*, CNBC (Apr. 27, 2017), <http://www.cnbc.com/2017>

Trump was criticized for using tax loopholes to avoid tax liability.⁵⁶ Mr. Trump responded that his ability to avoid tax liability made him smart, ignoring the notion that tax avoidance by wealthy individuals is inequitable and detrimental to our tax system.⁵⁷ Though the President supports legislative tax reform, the Tax Cuts and Jobs Act that he has signed into law focuses on comprehensive *corporate* tax cuts, rather than tax cuts for middle class individuals.⁵⁸ Based on the complex process needed to close tax loopholes,⁵⁹ the President's cavalier approach to tax loopholes,⁶⁰ and the new tax bill that will primarily benefit corporations,⁶¹ it is unlikely that loopholes that benefit wealthy taxpayers will change anytime soon. Therefore, finding a tax loophole that can help those who are less affluent—Americans who work hard and make a modest living, those who the tax code is “intended” to protect—is a noble task of paramount relevance.⁶² By utilizing the Subchapter T loophole, working-class Americans

/04/27/how-trumps-new-tax-reform-proposal-may-affect-every-income-bracket.html.

⁵⁶ See Jordan, *supra* note 55; Marissa Payne, *Mark Cuban Slams Donald Trump: Not Paying Taxes is Greedy Not 'Smart'*, WASH. POST (Sept. 27, 2016), https://www.washingtonpost.com/news/early-lead/wp/2016/09/27/mark-cuban-slams-donald-trump-not-paying-taxes-is-greedy-not-smart/?utm_term=.de0d9cc33757 (noting that “access to current tax laws that might benefit the wealthy . . . shouldn't preclude one from doing what's right.”).

⁵⁷ See *id.* In fact, President-elect Trump has indicated that he plans to lower the capital gains tax rate when he gains control of the oval office. Laura Saunders, *What to Do Now, Before the Tax on Capital Gains Is Cut*, WALL ST. JOURNAL (Nov. 25, 2016), <http://www.wsj.com/articles/what-to-do-now-before-the-tax-on-capital-gains-is-cut-1480087278?mod=e2fb>.

⁵⁸ See Dylan Matthews, *The House Republican Tax Bill, Explained*, VOX (Nov. 16, 2017), <https://www.vox.com/2017/11/2/16596896/house-republican-tax-reform-cuts-trump-ryan-explained> (demonstrating that the new tax bill is mainly focused on large corporate tax cuts).

⁵⁹ See Stone, *supra* note 54 (discussing the political, technical, and administrative challenges that will make it difficult to close tax loopholes).

⁶⁰ See Jordan, *supra* note 55 (discussing implications of Trump's comment that not paying federal taxes made him smart).

⁶¹ See Matthews, *supra* note 58.

⁶² See discussion *infra* Section IV.A (arguing that the tax code is abused by taxpayers it was not intended to benefit and that the IRS should allow lower income taxpayers to benefit from policies that were intended to benefit them).

can limit their tax liability by classifying their income as dividends not subject to payroll taxes.⁶³

B. Variations in Business Entity Taxation and Income

The United States government earns revenue through taxes imposed by the tax code.⁶⁴ The tax code can be described as having two separate buckets of revenue: the federal income tax bucket, which funds a vast array of government programs spanning “education to defense,”⁶⁵ and the payroll tax bucket, which funds “dedicated programs” including Medicare, social security, and unemployment, among others.⁶⁶ When employers pay their employees’ wages, the tax code mandates that they deduct a percentage of employee income for payroll taxes.⁶⁷ Similarly, those who work for themselves, rather than for an employer, must set aside self-employment taxes on their income.⁶⁸

Though the tax code’s buckets are easily defined, there are complicated rules and exceptions about who is required to pay taxes into each bucket and how much.⁶⁹ There is constant debate

⁶³ See discussion *infra* Part III.

⁶⁴ *Policy Basics: Where Do Federal Tax Revenues Come From?*, CENTER ON BUDGET AND POLICY PRIORITIES, <http://www.cbpp.org/research/policy-basics-where-do-federal-tax-revenues-come-from> (last updated Sept. 5, 2017).

⁶⁵ Thompson, *supra* note 29.

⁶⁶ *Id*; see *Payroll Taxes Explained*, ALL BUSINESS, <https://www.allbusiness.com/payroll-taxes-explained-672-1.html> (last visited Nov. 29, 2017) (providing a general explanation of how payroll taxes work).

⁶⁷ I.R.C. § 3103–3102; See *Payroll Taxes Explained*, *supra* note 66 (“Employers are responsible for withholding taxes from employees’ paychecks, sending them to the proper government agencies, and other employer tax obligations.”).

⁶⁸ See *Self-Employment Tax (Social Security and Medicare Tax)*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/self-employment-tax-social-security-and-medicare-taxes> (last updated Aug. 26, 2017) (describing self-employment taxes and how they work).

⁶⁹ See *Understanding Employment Taxes*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/understanding-employment-taxes> (last updated Sept. 15, 2017) (providing general explanation of what an employer is required to withhold as payroll tax for the various dedicated programs). The IRS’ website has many links and articles discussing who must pay payroll taxes

regarding the amount that corporations should contribute to government revenues, some arguing that the government should only tax natural persons and keep out of the zone of business.⁷⁰ However, the tax code requires businesses to pay their “fair share” of taxes, though different business entities are taxed at distinctive rates and are offered varying benefits based on their social costs and benefits.⁷¹ For example, ordinary corporations are taxed at the entity level, meaning that their profits are taxed prior to being distributed to shareholders,⁷² and are then taxed when shareholders report the profits as income.⁷³ By contrast, small businesses are often entitled to pass all their income to shareholders,⁷⁴ thereby

and when they must pay, as the tax code is complicated. *See, e.g., Employment Taxes*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/employment-taxes> (last updated Sept. 15, 2017) (providing a list of resources covered employment taxes); *see also Employment Tax Exceptions and Exclusions for Exempt Organizations*, IRS, <https://www.irs.gov/charities-non-profits/charitable-organizations/employment-tax-exceptions-and-exclusions-for-exempt-organizations> (last updated Aug. 12, 2017) (providing a list of resources on who may be exempt from employment taxes).

⁷⁰ *See* Christopher Beam, *Why Do We Tax Corporations?*, SLATE (Oct. 17, 2017), http://www.slate.com/articles/news_and_politics/explainer/2008/10/why_do_we_tax_corporations.html (presenting arguments for and against the corporate tax).

⁷¹ *See Business Structures*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/business-structures> (last updated Aug 3, 2017) (“Your form of business determines which income tax return form you have to file.”); *see also Choose a Business Structure*, SBA, <https://www.sba.gov/business-guide/launch/choose-business-structure-types-chart> (last visited Nov. 29, 2017) (describing the differences in the taxation of various business entities).

⁷² *Key Elements of the U.S. Tax System*, *supra* note 31; *see also* I.R.C. § 11 (2012) (“A tax is hereby imposed for each taxable year on the taxable income of every corporation.”); *Corporate and LLC Taxation Compared*, LLC MADE EASY (Aug. 28, 2016), <http://llc-made-easy.com/llc-and-corporate-tax.html> (noting that “[a] corporation is subject [to] what is called an ‘entity level’ tax . . . [which] means that the corporation pays taxes itself, as if it were a person”).

⁷³ *See Key Elements of the U.S. Tax System*, *supra* note 31.

⁷⁴ *Subchapter S Corporations*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations> (last updated Oct. 6, 2017) (“S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes.”). Specifically, the tax code provides pass through status to businesses that qualify for Subchapter S tax treatment. *Id.* Subchapter S companies must: (1) “[b]e a

avoiding paying taxes separately from their shareholders.⁷⁵ Similarly, Subchapter T worker cooperatives are generally allowed to pass their surplus income⁷⁶ to worker-owners in the form of patronage dividends, in order to avoid most entity-level taxes.⁷⁷ These distinctions between business entities are important, as they affect the amount of money that companies, shareholders, and employees must pay in income taxes.⁷⁸

Similarly, confusion arises regarding payroll taxes when defining who is an employee and the type of income that is subject to payroll or self-employment taxes. While income earned through one's job is generally subject to payroll taxes,⁷⁹ there are various forms of income that one can earn that are exempt from payroll or self-employment taxes.⁸⁰ For example, interest income is exempt from self-employment taxes unless it is received in the course of business.⁸¹ Specifically, “[d]ividends on securities aren’t self-employment income unless you’re a dealer in securities.”⁸² With reference to self-employment taxes, the tax code states, “there shall

domestic corporation,” (2) “[h]ave only allowable shareholders” such as “individuals, certain trusts, and estates” and “[n]ot be partnerships, corporations or non-resident alien shareholders,” (3) “[h]ave no more than 100 shareholders,” (4) “[h]ave only one class of stock,” and (5) “[n]ot be an ineligible corporation (i.e. certain financial institutions, insurance companies, and domestic international sales corporations).” *Id.*

⁷⁵ See *id.*; *Choose a Business Structure*, *supra* note 71 (noting that S corps allow profits, and some losses, to be passed through directly to owners’ personal income without ever being subject to corporate tax rates).

⁷⁶ See *Patronage & Tax*, *supra* note 3 (noting that at the end of an accounting period a “cooperative’s accountant determines whether there is any surplus”, and, if so, the board has the option of “distribut[ing] the surplus to the members” of the cooperative). This Note argues that worker-owners should not be paid salaries, rather they should be paid their income as patronage dividends, causing their salaries to be part of the cooperative’s surplus income and allowing more income to pass through. See discussion *infra* Part III.

⁷⁷ Mayer, *supra* note 8.

⁷⁸ *Selecting a Business Structure*, *supra* note 71; *Choose a Business Structure*, *supra* note 71.

⁷⁹ I.R.C. § 3102 (2012).

⁸⁰ *Tax Trails—Self-Employment Income*, IRS, <https://www.irs.gov/individuals/tax-trails-self-employment-income-9> (last updated Aug. 17, 2017).

⁸¹ *Id.*

⁸² *Id.*

be excluded dividends on any share of stock, and interest on any bond, debenture, note, or certificate . . . in registered form by any corporation . . . unless such dividends and interest are received in the course of a trade or business as a dealer in stocks or securities.”⁸³ These exceptions to payroll and self-employment taxes raise questions about what sort of dividends are “received in the course of a trade or business”⁸⁴ and about what sort of income can be treated as a dividend to avoid payroll and self-employment taxes.⁸⁵ The need to resolve this perplexity becomes increasingly relevant as the controversy over how to define employees and contractors becomes more complicated.

Based on general tax policy, it would seem that patronage dividends earned by worker-owners of worker cooperatives in the ordinary course of business ought to be subject to payroll taxes.⁸⁶ However, since the tax code exempts taxable income from worker cooperatives,⁸⁷ the IRS has conceded that they are exempt from payroll taxes,⁸⁸ and the tax code strongly implies that they are exempt from payroll taxes,⁸⁹ patronage dividends are, at least at times, exempt. Though other portions of the tax code suggest that dividends “received in the ordinary course of business” are subject to self-employment taxes,⁹⁰ Subchapter T specifically exempts patronage dividends earned by worker-owners from payroll taxes,⁹¹ allowing for the formation of the Subchapter T loophole.

⁸³ I.R.C. § 1402 (2012).

⁸⁴ *See id.*

⁸⁵ *Tax Treatment of Dividend Income*, WELLS FARGO ADVISORS, <https://www.wellsfargoadvisors.com/tax-center/dividend-income-tax.html> (last visited Nov. 29, 2017).

⁸⁶ *See Tax Trails—Self Employment Income*, *supra* note 80.

⁸⁷ I.R.C. § 1382 (2012).

⁸⁸ Wilson, *Taxation of Patronage Dividends*, *supra* note 9.

⁸⁹ *See* I.R.C. § 1388 (c)(1)(B) (2011) (suggesting that the effective tax rate of patronage dividends will not exceed 20%).

⁹⁰ I.R.C. § 1402 (2012).

⁹¹ *See* discussion *infra* Part III.

II. WORKER COOPERATIVES AND THEIR TAX TREATMENT

A. Worker Cooperatives Explained

The confusion that arises in the worker cooperative tax environment can partially be explained by examining the ways in which worker cooperatives differ from publicly-traded companies and other corporations. Stock in publicly-traded companies is available for purchase on the open market and may be freely traded by individuals and enterprises alike.⁹² Publicly-traded companies are primarily concerned with profit maximization,⁹³ as investors hope to receive a financial return. By contrast, worker cooperatives are business entities owned, operated, and governed by their own workers.⁹⁴ Members of worker cooperatives “gain admission [to a worker cooperative] through a buy-in” and become shareholders and employees of the company.⁹⁵ In addition to maximizing profits, worker cooperatives try to ensure that their business meets the needs of its workers⁹⁶ by “paying fair wages, providing a sustainable livelihood, investing in the local community, and promoting a healthy environment” for worker-owners.⁹⁷ Based on their diverse goals and humanistic approach to conducting

⁹² See *What's the Difference Between Publically- and Privately-Held Companies*, INVESTOPEDIA, <http://www.investopedia.com/ask/answers/162.asp?lgl=rira-baseline-vertical> (last updated May 10, 2017) (noting that “[a] public company [] is a company that has sold all or a portion of itself to the public [] meaning shareholders have claim to part of the company’s assets and profits . . . [and] its trading on a U.S. stock exchange.”).

⁹³ See *The Goals of a Business*, LUMEN, <https://courses.lumenlearning.com/boundless-business/chapter/what-is-a-business/> (last visited Nov. 29, 2017) (noting that “the main purpose of a business is to maximize profits for its owners, and in the case of a publicly-traded company, the stockholders are its owners.”).

⁹⁴ *Think Outside the Boss*, *supra* note 2; Alana Semuels, *Getting Rid of Bosses*, THE ATLANTIC (Jul. 8, 2015), <http://www.theatlantic.com/business/archive/2015/07/no-bosses-worker-owned-cooperatives/397007/>.

⁹⁵ Nina Misuraca Ignaczak, *It Takes an Ecosystem: The Rise of Worker Cooperatives in the US*, SHAREABLE (Jul. 16, 2014), <https://www.shareable.net/blog/it-takes-an-ecosystem-the-rise-of-worker-cooperatives-in-the-us>.

⁹⁶ *Think Outside the Boss*, *supra* note 2.

⁹⁷ *Id.*

business,⁹⁸ worker cooperatives provide a superior business model to that of corporations focused on profits at the expense of socially-responsible goals.⁹⁹

Businesses that operate as worker cooperatives provide many social benefits to their communities.¹⁰⁰ First, worker cooperatives offer their workers economic independence.¹⁰¹ Rather than simply working for a paycheck at the end of the week, worker-owners are incentivized to add value to their worker cooperative by working hard and being productive, as they are all owners of the company that they work for.¹⁰² While worker-owners receive a paycheck for their work, surplus earnings of the worker cooperative are split between worker-owners based on a patronage system.¹⁰³ When a worker cooperative determines its surplus for the year, surplus earnings are split equitably between worker-owners, or *patrons*, “based on factors such as hours worked or value of work provided.”¹⁰⁴

Worker cooperatives usually determine a worker-owner’s patronage dividend by calculating the percentage of his hours worked in relation to the total hours worked by all worker-owners, and multiplying that percentage by the total surplus earnings of the

⁹⁸ *Id.*

⁹⁹ See Bruce Bartlett, *Is the Only Purpose of a Corporation to Maximize Profits?*, THE BIG PICTURE (May 13, 2015), <http://ritholtz.com/2015/05/corp-purpose-maximize-profit/>.

¹⁰⁰ *Worker Ownership*, UNITED STATES FEDERATION OF WORKER COOPERATIVES, <https://usworker.coop/what-is-a-worker-cooperative/> (last visited Nov. 29, 2017).

¹⁰¹ *Id.*

¹⁰² Semuels, *supra* note 94.

¹⁰³ *How Worker Co-ops Decide to Share Profits*, COOPERATIVE DEVELOPMENT INSTITUTE (Jul. 30, 2015), <http://cdi.coop/profit-sharing-in-worker-coops/>.

¹⁰⁴ *Think Outside the Boss*, *supra* note 2, at 1. Individual worker cooperatives can choose to split profits equitably, reinvest the surplus to grow the business, or spend the surplus on other things. *Worker Cooperatives*, CULTIVATE.COOP, http://cultivate.coop/wiki/Worker_Cooperatives (last updated Mar. 2, 2016, 9:00 AM). The important factor to consider is that whatever a worker cooperative decides to do with its surplus is decided by a vote of the worker-owners, giving them the economic independence that traditional workers are not afforded. *Id.*

worker cooperative.¹⁰⁵ Figure 2.1 illustrates an example of this equation using a worker cooperative with a total surplus of \$1 million and 80,000 total hours worked by all worker-owners.¹⁰⁶ It also demonstrates the difference in the patronage dividends received by two different worker-owners, one of whom worked 2,000 hours and the other 1,500 hours.

Figure 2.1

Total Surplus	Total Hours Worked By all Worker-owners	Individual Hours Worked	Patronage Dividend = (Individual's Hours/Total Hours) X Total Surplus	Individual's Patronage Dividend
\$1,000,000	80,000	2,000	(2,000 /80,000) X \$1,000,000	<u>\$25,000</u>
\$1,000,000	80,000	1,500	(1,500 /80,000) X \$1,000,000	<u>\$18,750</u>

As shown above, the patronage dividend that worker-owners receive is directly related to their worker cooperative's success in the past year and the value that each worker-owner adds to the worker cooperative.¹⁰⁷ This process encourages worker-owners to work hard and care about their jobs, as they stand to benefit immensely from their cooperative's financial success.¹⁰⁸

Furthermore, the worker cooperative business model can limit the wage gap between members of society.¹⁰⁹ As opposed to

¹⁰⁵ *How Worker Co-ops Decide to Share Profits*, *supra* note 103.

¹⁰⁶ See generally *id.* (providing example of "a common ration that many worker cooperatives use to distribute [patronage dividends]").

¹⁰⁷ See *id.*

¹⁰⁸ *Why Form Worker Cooperatives?*, CO-OP LAW.ORG, <http://www.co-oplaw.org/co-op-basics/types/worker-cooperatives/> (last visited Nov. 29, 2017); see Sarah Jaffe, *Can Worker Cooperatives Alleviate Income Inequality?*, ALJAZEERA AMERICA (Jan. 15, 2015), <http://america.aljazeera.com/articles/2015/1/13/worker-run-cooperatives.html> (discussing potential of worker cooperatives to alleviate income inequality).

¹⁰⁹ See Jaffe, *supra* note 108.

traditional corporations where the ratio between the highest and lowest paid workers can be as vast as 600:1, the pay ratio between the highest- and lowest-paid worker-owners in worker cooperatives is often between 3:1 and 5:1.¹¹⁰ The limited wage gap of the worker cooperative business model can help create a work environment in which everyone feels valued, thus fostering a positive workplace culture.¹¹¹ Further, worker cooperatives foster a more positive workplace culture by offering employment security to their worker-owners.¹¹² Because worker cooperatives are established to protect workers, they often choose to maintain their workers rather than maximize profits.¹¹³ Finally, because worker-owners are shareholders in their companies, worker cooperatives operate on a democratic basis.¹¹⁴ This democracy allows worker-owners to participate in company decision-making,¹¹⁵ allowing for a system in which the workers of a company can determine how they are to be treated.¹¹⁶

B. Subchapter T: Taxation of Worker Cooperatives

When an ordinary corporation distributes a dividend to its shareholders, they pay what is often referred to as a “double tax.”¹¹⁷ First, the corporation is required to pay taxes on its year-

¹¹⁰ *Id.*

¹¹¹ See *Think Outside the Boss*, *supra* note 2, at 1–3.

¹¹² *Why Form Worker Cooperatives?*, *supra* note 108.

¹¹³ *Id.*

¹¹⁴ *The Benefits of Worker Cooperatives*, DEMOCRACY AT WORK INSTITUTE, <http://institute.coop/benefits-worker-cooperatives> (last visited Nov. 29, 2017) (“[W]orkers at worker cooperatives participate in the profits, oversight, and often management of the organization using democratic practices . . . [and] own the majority of the equity in the business, and control the voting shares.”).

¹¹⁵ Semuels, *supra* note 94.

¹¹⁶ See *Think Outside the Boss*, *supra* note 2 (“When faced with a tradeoff between pursuing profits and maintaining employment, worker coops often choose the latter.”).

¹¹⁷ Jean Murray, *What is Double Taxation?*, THE BALANCE (Jun. 8, 2016), <https://www.thebalance.com/what-is-double-taxation-398210> (noting that “[d]ouble taxation is a term to describe the way taxes are imposed on corporate shareholders and on corporations” and that “[t]he corporation is taxed on its earnings (profits), and the shareholders are taxed again on the dividends they

end earnings.¹¹⁸ After paying taxes on year-end earnings, corporations may elect to distribute dividends to their shareholders.¹¹⁹ When shareholders receive dividends from the corporation, the shareholders must include those dividends in their personal taxable income.¹²⁰ Thus, the dividend is taxed twice, once at the *entity level* and once on the *personal level* of the shareholders.¹²¹

In contrast to ordinary corporations, Subchapter T of the tax code provides worker cooperatives with their own tax status.¹²² The IRS defines a cooperative as “a type of organization formed for the purpose of providing goods or services for its patron-owners, or selling their products.”¹²³ Businesses that qualify for Subchapter T tax status include farmers’ cooperatives,¹²⁴ retailers’ cooperatives,¹²⁵ cooperative housing corporations,¹²⁶ and urban

receive from those earnings.”); see also *What Is the Double Taxation of Dividends?*, INVESTOPEDIA, <http://www.investopedia.com/ask/answers/03/102203.asp> (last visited Nov. 29, 2017) (providing an example of double taxation).

¹¹⁸ *Id.*

¹¹⁹ Murray, *supra* note 117.

¹²⁰ *Id.*

¹²¹ *Id.*; *What Is the Double Taxation of Dividends?*, *supra* note 117.

¹²² See I.R.C. § 1381 (2012); see also *Worker Cooperatives and Tax (Subchapter T)*, CO-OP LAW.ORG, <http://www.co-oplaw.org/finances-tax/worker-cooperatives-and-tax/> (last visited Nov. 29, 2017) (noting that the tax benefits imposed by Subchapter T are “available to ‘any cooperation operating on a cooperative basis’ . . . [and that] [t]his broad language is evidence that Congress intended subchapter T to apply to a wide variety of entities.”).

¹²³ *IRC Section 521 Exempt Farmers’ Cooperatives*, *supra* note 5.

¹²⁴ See *id.* (discussing farmer’s cooperatives as Subchapter T cooperatives). “Farmers cooperatives are businesses owned and controlled by farmers, ranchers or growers. Through their cooperatives, farmers are empowered, as elected board members, to make decisions affecting the current and future activities of the cooperative.” *What is a Farmer Cooperative?*, DFA (May 2011), http://www.dfainfo.com/dfamilk/whatisacoop_web05.11.pdf.

¹²⁵ See I.R.C. § 1381 (noting that qualifying for Subchapter T tax status includes “any cooperation operating on a cooperative basis” absent the specified exception listed in the statute); see also *Types of Cooperatives*, NEBRASKA COOPERATIVE DEVELOPMENT CENTER, <http://ncdc.unl.edu/typescooperatives.shtml> (last visited Nov. 29, 2017) (“Retail Cooperatives are a type of ‘consumer cooperative’ which help create retail stores . . . [that] allow consumers the opportunity to supply their own needs, gain bargaining power, and share

consumer cooperatives.¹²⁷ In order to qualify for Subchapter T tax treatment, a business must operate on a cooperative basis in its “subordination of capital, democratic control, and operation at cost.”¹²⁸ Cooperatives that meet the strict requirements laid out by the tax code and related IRS guidance are able to benefit from taxation under Subchapter T.¹²⁹

The tax treatment of dividends paid by worker cooperatives differs from the “double tax” paid by ordinary corporations.¹³⁰ Subchapter T of the tax code states, in relevant part, “[i]n determining the taxable income of an organization to which this part applies, *there shall not be taken into account* amounts paid during the payment period for the taxable year . . . as *patronage dividends* . . . in money or other property.”¹³¹ Worker cooperatives can deduct patronage dividends paid to their worker-owners from the cooperative’s gross income, avoiding paying taxes on the cooperative’s earnings that are paid out as patronage dividends.¹³² A patronage dividend is an amount paid to a patron by a worker cooperative “on the basis of quantity or value of business done with or for such patron . . . under an obligation of such an organization to pay such amount . . . which is determined by reference to the net earnings of the organization from business done with or for its patrons.”¹³³ According to the IRS, a patron is “any person . . . with whom or for whom the cooperative does

earnings . . . [and] are organized as communities, or other ‘local groups’, owning their own retail stores.”)

¹²⁶ *Types of Cooperatives*, *supra* note 125 (“Housing cooperatives are a type of service cooperative which provide . . . home owners the opportunity to share costs of home ownership (or building) . . . [and] are organized as an incorporated business formed by people who wish to provide and jointly own their housing.”).

¹²⁷ *IRC Section 521 Exempt Farmers’ Cooperatives*, *supra* note 5.

¹²⁸ *Id.*

¹²⁹ *See id.*

¹³⁰ *Patronage & Tax*, CO-OPLAW.ORG, <http://www.co-oplaw.org/finances-tax/patronage/> (last visited Nov. 29, 2017).

¹³¹ I.R.C. § 1382 (2012) (emphasis added).

¹³² *Id.*

¹³³ I.R.C. § 1288 (2012).

business on a cooperative basis . . . who bears some risk of loss from dealings with the cooperative.”¹³⁴

The deduction for patronage dividends allows worker cooperatives to operate as a “pass-thru entity where profits” are considered to be a surplus and are returned to worker-owners, thereby avoiding entity level taxes.¹³⁵ With the ability to avoid double taxation,¹³⁶ the worker cooperative surplus for the year is higher, allowing for a higher payout of patronage dividends to worker-owners.¹³⁷ Thus, the benevolent worker cooperative model receives beneficial tax treatment, satisfying the purpose of the tax code.¹³⁸

C. Taxation on the Receipt of Patronage Dividends: How the IRS and Tax Court Have Interpreted Subchapter T

Though allocating patronage dividends to worker-owners allows worker cooperatives to avoid paying entity level taxes,¹³⁹ the IRS has been indecisive as to whether the patronage dividends *received by worker-owners* of worker cooperatives are subject to payroll or self-employment taxes.¹⁴⁰ Generally, employers are

¹³⁴ IRC Section 521 Exempt Farmers' Cooperatives, *supra* note 5.

¹³⁵ Mayer, *supra* note 8.

¹³⁶ *Worker Cooperatives and Tax (Subchapter T)*, *supra* note 122.

¹³⁷ Mayer, *supra* note 8.

¹³⁸ See generally *Key Elements of the U.S. Tax System – Why are Taxes So Complicated?*, *supra* note 31 (highlighting the tax codes goals of “fairness, efficiency, and enforceability” and noting that “Congress has used the tax system to influence social policy as well as to deliver benefits to specific groups and industries”). However, the tax code does not elaborate on the definition of surplus in the context of Subchapter T, begging the question of whether worker-owners must be paid a weekly salary for their services to the cooperative, or if they can receive their entire income as a patronage dividend.

¹³⁹ *Worker Cooperatives and Tax (Subchapter T)*, *supra* note 122.

¹⁴⁰ Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 1, 3–4. “Self-employment tax is tax consisting of Social Security and Medicare taxes primarily for individuals who work for themselves.” *Self-Employment Tax (Social Security and Medicare Taxes)*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/self-employment-tax-social-security-and-medicare-taxes> (last updated Aug. 26, 2017). Traditionally, standard dividends paid by ordinary corporations are not subject to self-employment taxes. Mike Piper, *Types of Taxable Income: Dividends, Salary, Etc.*, OBLIVIOUS INVESTOR (June 7,

required to withhold payroll taxes on the income of their employees.¹⁴¹ However, “there are various forms of income that one can earn that are exempt from payroll or self-employment taxes,” including certain types of dividends.¹⁴²

The Tax Court addressed the issue of whether patronage dividends paid to a shareholder of a cooperative were subject to payroll taxes in *Fultz v. Commissioner*.¹⁴³ The court in *Fultz* held that “patronage dividends received by cooperative members who are doing business with/through the cooperative are subject to self-employment tax” and required the member to pay payroll taxes on the patronage dividend that he received.¹⁴⁴ The court reasoned that the taxpayer in *Fultz* did not bear the risks of ownership, as he conducted business as a corn farmer independently of the cooperative.¹⁴⁵ The fact that the taxpayer had a contract with the cooperative to provide corn for them was insufficient to prove that he endured the risks of ownership of the cooperative, and therefore his patronage dividend was subject to self-employment taxes.¹⁴⁶ Figure 2.2 illustrates the tax liability, according to the Tax Court, of a member of a cooperative who operates a business independently of the cooperative and receives a \$100,000 patronage dividend.¹⁴⁷

2009), <http://www.obliviousinvestor.com/types-of-taxable-income-dividends/>. By contrast, regarding patronage dividends, the IRS has been indecisive as to whether they are subject to payroll or self-employment taxes. See Wilson, *Taxation of Patronage Dividends*, *supra* note 9.

¹⁴¹ See discussion *supra* Section I.B.

¹⁴² *Id.*

¹⁴³ *Fultz v. C.I.R.*, T.C.M (RIA) 2005-045. 1, 2 (T.C. 2005).

¹⁴⁴ Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 3 (citing *Fultz*, T.C.M (IRA) 2005-045).

¹⁴⁵ *Fultz*, T.C.M (RIA) 2005-045, at 12-13. Even though the taxpayer was a member of the cooperative, his business as a corn farmer was independent of his membership to the cooperative, and therefore the Tax Court treated him as a non-employee, subjecting his patronage dividend to self-employment taxes. *Id.*

¹⁴⁶ See *id.* at 11-13. The argument that the court applied in *Fultz*, that the risks of ownership are required to avoid paying payroll taxes on patronage dividends, is similar to the IRS's statement that patrons must bear “some risk of loss from dealings with the cooperative” in order to qualify for Subchapter T tax treatment. See *IRC Section 521 Exempt Farmers' Cooperatives*, *supra* note 3.

¹⁴⁷ See Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 5-6 (providing a similar chart pertaining to tax liability of coop member).

Figure 2.2

Payment	Amount	Income Tax	Employment Tax	Self-employment Tax
Wages	\$0	N/A	N/A	N/A
Non-Employee Patronage Dividend	\$100,000	YES	NO	YES

Though the Tax Court concluded that shareholders of worker cooperatives who do not bear the risks of the worker cooperative are required to pay self-employment taxes on the patronage dividends that they receive, as they conducted business with the cooperative, the IRS remained uncertain.¹⁴⁸

Gregory R. Wilson, a recognized expert on Subchapter T,¹⁴⁹ distinguished the holding in *Fultz*, arguing that worker-owners who are active employees of worker cooperatives should not be required to pay payroll taxes on the patronage dividends that they receive.¹⁵⁰ He reasoned that simply being an employee of a worker cooperative can be distinguished from the ruling in *Fultz*, since *Fultz* involves “a farmer receiving money from a cooperative through which he sells his crop.”¹⁵¹ When a farmer who happens to be a shareholder of a cooperative is paid by his cooperative for his crop, the payments that the farmer receives relate to his trade or business with the cooperative “no differently than if the farmer

¹⁴⁸ *Id.*

¹⁴⁹ *Patronage & Tax*, *supra* note 1. Gregory R. Wilson, Esq. is a tax lawyer in San Francisco, California. *Attorney Profile*, GREGORY R. WILSON, <http://www.gwilson.com/profile.htm> (last visited Nov. 29, 2017). He received his L.L.M. in tax, with distinction, from Georgetown University Law Center in 1996. *Id.* Wilson was instrumental in convincing the IRS to exempt patronage dividends from self-employment taxes, fighting the cases that were involved in the process. *Patronage & Tax*, *supra* note 130.

¹⁵⁰ Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 3.

¹⁵¹ *Id.*

sold his crop independent of the cooperative.”¹⁵² Therefore, because the farmer conducted business *with the cooperative*, the patronage dividend he received was subject to self-employment taxes.¹⁵³

By contrast, an employee of a worker cooperative who works for the cooperative on a daily basis does not operate a trade or business independently of the cooperative.¹⁵⁴ The employee does not conduct business *with the cooperative*, as the employee’s trade is solely “being an employee.”¹⁵⁵ Therefore, Wilson reasoned, if a member of a worker cooperative is an employee of the cooperative and does not conduct business independently of the cooperative, the patronage dividend that the worker-owner is paid should not be subjected to payroll taxes, as he incurs the risks of ownership.¹⁵⁶

After many years of correspondence, the IRS accepted Wilson’s argument and determined that employee members of worker cooperatives are not required to pay self-employment taxes on the patronage dividend that they receive, as their only trade or business is being an employee of the cooperative.¹⁵⁷ The IRS reasoned that “in cases where members of a worker cooperative are employees, employees generally do not receive both employment income and self-employment income from the same entity.”¹⁵⁸

Though the IRS has allowed worker-owners who are active employees to avoid payroll taxes on the patronage dividends that they receive, the IRS has maintained that when worker-owners are active employees, their weekly salaries are subject to payroll taxes, similar to the employees of ordinary corporations.¹⁵⁹ Thus, according to the current IRS interpretation, worker-owners who are employees of their worker cooperatives are required to pay payroll taxes on their income earned as employees, but any patronage

¹⁵² *Id.*

¹⁵³ *Id.* at 4.

¹⁵⁴ *Id.* at 3.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 4.

¹⁵⁷ *Patronage & Tax*, *supra* note 130.

¹⁵⁸ *Id.*

¹⁵⁹ See Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 4 (discussing that the IRS wanted to treat all income of worker-owners as subject to payroll taxes, but has only conceded that patronage dividends are not subject to payroll taxes when worker-owners are employees).

dividends that they receive can be reported as dividend income, avoiding the extra 15 percent self-employment tax.¹⁶⁰ Figure 2.3 illustrates the tax savings of an employee member of a worker cooperative who earns \$75,000 in annual salary and a \$25,000 patronage dividend.¹⁶¹

Figure 2.3

Payment	Amount	Income Tax	Employment Tax	Self-employment Tax
Wages	\$75,000	YES	YES	NO
Employee Patronage Dividend	\$25,000	YES	NO	NO

Figure 2.3 demonstrates that the IRS requires members of worker cooperatives that are also employees to pay payroll taxes on their wages, but not on the patronage dividends that they receive.¹⁶² The IRS reasons that because worker-owners are employees, they are required to pay payroll taxes on their salaries, and cannot be both employees and independent contractors of the same company.¹⁶³

The IRS's determination that worker-owners who are employees do not have to pay self-employment tax on their patronage dividends,¹⁶⁴ coupled with the court's holding that shareholders conducting business independent of the cooperative must pay self-employment tax on patronage dividends,¹⁶⁵ leaves little room for debate. Worker-owners that are employees of their worker cooperative must pay self-employment taxes on their wages, but can avoid self-employment taxes on the patronage

¹⁶⁰ *Id.* at 3, 6; *Patronage & Tax*, *supra* note 130.

¹⁶¹ See Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 4–6.

¹⁶² *Id.*

¹⁶³ *Patronage & Tax*, *supra* note 130.

¹⁶⁴ Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 4.

¹⁶⁵ *Fultz v. C.I.R.*, T.C.M (RIA) 2005-045. 1, 4 (T.C. 2005).

dividends received from the cooperative.¹⁶⁶ Shareholders of worker cooperatives not acting as employees of the worker cooperative must pay self-employment payroll taxes on any patronage dividend that they receive from the worker cooperative with which they conduct business.¹⁶⁷ Either way, according to the IRS and the Tax Court, shareholders of worker cooperatives cannot avoid payroll taxes on all of their income.¹⁶⁸

D. The IRS and the Tax Court are Wrong: The Subchapter T Tax Loophole

Contrary to the analyses by the IRS and Tax Court, an accurate reading of Subchapter T allows worker-owners of worker cooperatives to avoid paying payroll and self-employment taxes on their entire income. Based on the holdings of the IRS and the Tax Court, Gregory Wilson concluded that worker-owners who are employees can avoid payroll taxes, provided that they are paid “reasonable compensation” in salary for the services that they provide to their worker cooperative.¹⁶⁹ Wilson likens worker-owners of worker cooperatives to “employee-shareholders of corporations” who do not have to pay self-employment taxes on stock dividends provided that they are paid a “reasonable compensation and not attempt to characterize too much of the corporation’s income as dividends (in order to avoid employment taxes).”¹⁷⁰ Wilson argues that akin to employee-shareholders receiving a stock dividend, employees of worker cooperatives that are paid “reasonable compensation” for their services are likely to

¹⁶⁶ I.R.C. § 3101–3102 (discussing payroll tax on employees); see Payroll Taxes Explained, *supra* note 67; see also Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 6 (“Under current law, an employee-member of a worker cooperative (formed as a corporation) certainly has reasonable basis to take the position that his or her patronage dividend is not subject to self-employment tax.”).

¹⁶⁷ Fultz, T.C. Memo. 2005–45, at 13; see Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 3.

¹⁶⁸ Fultz, T.C. Memo. 2005–45, at 13; see Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 3; *Patronage & Tax*, *supra* note 130 (discussing employment and self-employment tax).

¹⁶⁹ Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 4.

¹⁷⁰ *Id.*

be able to avoid paying self-employment taxes on any patronage dividend that they receive.¹⁷¹

However, Wilson's conclusion that employees of worker cooperatives must be paid "reasonable compensation" for their services¹⁷² is ill-founded. Though it is true that employees of worker cooperatives do not need to pay self-employment taxes on the patronage dividends that they receive,¹⁷³ there is no requirement that they must receive "reasonable compensation" for their services, as Wilson suggests.¹⁷⁴

Subchapter S of the tax code demonstrates that the "reasonable compensation" requirement does not apply to Subchapter T worker cooperatives.¹⁷⁵ Subchapter S states, in relevant part, "[i]f an individual who is a member of the family . . . of one or more shareholders of an S corporation renders services for the corporation . . . without receiving reasonable compensation therefor, the Secretary shall make such adjustments in the items taken into account by such individual."¹⁷⁶ This provision exists in Subchapter S in order to prevent corporations and their shareholders from avoiding payroll taxes.¹⁷⁷ By contrast to the "reasonable compensation" requirement mentioned in Subchapter S, Subchapter T makes *no mention* of a "reasonable compensation"

¹⁷¹ *Id.* Wilson reasons that the "reasonable compensation" requirement will prove to the IRS that worker-owners of patronage dividends are not attempting to avoid employment taxes. *Id.*

¹⁷² *Id.*

¹⁷³ *Id.*; see Wilson, *Are Cooperative Patronage Dividends Subject to Employment Tax?*, *supra* note 9 (noting that "[i]t appears that the IRS National Office concluded that patronage dividends paid by worker cooperatives are indeed not subject to SE [Self-Employment] tax.").

¹⁷⁴ *See id.*

¹⁷⁵ *See* I.R.C. § 1366 (2012) (specifically requiring Subchapter S shareholders to earn a reasonable salary for their work).

¹⁷⁶ § 1366 (e).

¹⁷⁷ *See* Tony Nitti, *Tax Geek Tuesday: Reasonable Compensation in the S Corporation Arena*, FORBES (Feb. 4, 2014), <https://www.forbes.com/sites/anthony-nitti/2014/02/04/tax-geek-tuesday-reasonable-compensation-in-the-s-corporation-arena/#5c1b9eed4790> (discussing the IRS' attempts to prevent S Corporations from reducing their employees' compensation to lower their payroll taxes).

requirement for patronage dividends.¹⁷⁸ In fact, when discussing the taxable income of patrons of worker cooperatives, Subchapter T merely states that patrons must include patronage dividends in their gross income, but makes no mention of worker-owners receiving a salary at all.¹⁷⁹

Though the IRS and the Tax Court have consistently maintained that members of worker cooperatives are either employees, subject to employment tax, or non-employees, subject to self-employment tax,¹⁸⁰ they have interpreted the tax code incorrectly based on an analysis of “reasonable compensation” that is not present in Subchapter T. Whereas other sections of the tax code address the issue of disguising employment compensation as a dividend to avoid payroll taxes by requiring that employees must be paid “reasonable compensation” for their work,¹⁸¹ Subchapter T leaves out the provision.¹⁸² Because the language of Subchapter T does not require worker-owners to be paid “reasonable compensation” for their work, the tax code leaves open the possibility that worker cooperatives can structure the *entire compensation* of their worker-owners as patronage dividends, rather than as wages, thereby avoiding payroll taxes entirely.¹⁸³ Additionally, because worker-owners are simply employees, and do not conduct business *with or through* the worker cooperative, their patronage dividends will not be subject to self-employment taxes, as the IRS and the Tax Court have already conceded.¹⁸⁴

¹⁷⁸ See generally I.R.C. §§ 1381–1383, 1285 (2012) (making no mention of a “reasonable compensation” requirement).

¹⁷⁹ I.R.C. § 1385 (2012).

¹⁸⁰ See Wilson, *Taxation of Patronage Dividends*, *supra* note 9.

¹⁸¹ See I.R.C. § 1366 (2007) (discussing the “reasonable compensation” requirement for S corporations).

¹⁸² See generally I.R.C. § 1385.

¹⁸³ See *id.*

¹⁸⁴ See Wilson, *Taxation of Patronage Dividends*, *supra* note 9 (discussing that the IRS wanted to treat all income of worker-owners as subject to payroll taxes, but has conceded that patronage dividends are not subject to payroll taxes when worker-owners are employees); see also Wilson, *Are Cooperative Patronage Dividends Subject to Employment Tax?*, *supra* note 9 (noting that the IRS’ determination that “patronage dividends paid by worker cooperatives are indeed not subject to SE [Self-Employment] tax” was based on determination that “worker/members are employees of the cooperative and employees

Although the IRS is likely to respond that the new patronage dividend is a disguised salary for worker-owner employees, they have already conceded that patronage dividends paid to worker-owners who are employees should be treated as a dividend for tax purposes, and should therefore be exempt from payroll and self-employment taxes.¹⁸⁵ Because there is no “reasonable salary” requirement in Subchapter T,¹⁸⁶ the IRS should concede that worker-owners who are employees are exempt from payroll and self-employment taxes on any money that they are paid as patronage dividends, even if worker-owners receive their entire compensation as patronage dividends.

III. WORKER COOPERATIVES DESERVE BETTER TAX TREATMENT: PROMOTING A MORE BALANCED SYSTEM OF TAX LOOPHOLES

Though a plain reading of Subchapter T of the tax code allows for worker-owners to treat their entire income as patronage dividends, the IRS has not interpreted the tax code in that way.¹⁸⁷ However, the IRS should reverse its policy. If the tax code is supposed to promote fairness and equality,¹⁸⁸ there cannot be two sets of rules. If the IRS refuses to close loopholes that uniquely benefit wealthy taxpayers,¹⁸⁹ they ought to turn a blind eye to a loophole that will benefit the working class—the class that it was intended to benefit.¹⁹⁰

generally cannot receive both employment and self-employment compensation from the same entity.”).

¹⁸⁵ See Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 4 (noting that the “IRC and case law clearly state that stock dividends paid to employee-shareholders of corporations are not subject to self-employment tax”).

¹⁸⁶ See generally I.R.C. § 1385 (discussing what is included in the calculation of gross income).

¹⁸⁷ Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 3.

¹⁸⁸ See *Key Elements of the U.S. Tax System – Why are Taxes So Complicated?*, *supra* note 31.

¹⁸⁹ Berr, *supra* note 35.

¹⁹⁰ See *IRC Section 521 Exempt Farmers’ Cooperatives*, *supra* note 5 (laying out the criteria for Subchapter T tax status).

A. Abuse of the "Small Business" Designation

Wealthy corporations, politicians, and citizens alike have historically abused our complicated tax system.¹⁹¹ As a prime example, prior to joining the Senate in 1999, John Edwards was a successful trial attorney, earning more than \$26 million for his services in 1997 alone.¹⁹² A savvy taxpayer, Edwards reported personal income of \$360,000 for the same year, an amount so disproportionate to his true earnings, due to the tax loophole contained in Subchapter S of the tax code, that it is now referred to as the "Gingrich/Edwards" loophole.¹⁹³ To accomplish this, Edwards established his business as an S corporation, a small business corporation that elects to pass its "corporate income, losses, deductions and credits through to its investors and shareholders for federal tax purposes."¹⁹⁴ Under Subchapter S, profits earned by employee shareholders of an S corporation can be treated as gains of the corporation, rather than as personal income to employees, as long as shareholders are salaried "reasonable compensation" for their services.¹⁹⁵ Using this tax loophole, Edwards was able to treat most of his income as earnings of his S corporation, thereby avoiding nearly \$600,000 in payroll taxes from 1995 to 1999.¹⁹⁶ Similarly, Newt Gingrich, the former speaker of the House, reported \$444,327 in personal income for

¹⁹¹ Paul Bucheit, *Tax Avoidance Saves Wealthiest Americans \$3 Trillion Each Year*, HUFFINGTON POST (Jan. 7, 2013), http://www.huffingtonpost.com/2013/01/07/tax-avoidance_n_2426754.html.

¹⁹² Mark Koba, *How the Gingrich-Edwards Tax Loophole Works*, CNBC (Mar. 5, 2014), <http://www.cnbc.com/2014/03/05/cnbc-explains-the-gingrich-edwards-tax-loophole.html>; Michael Moss & Kate Zernike, *The 2004 Campaign: The North Carolina Senator; Campaign Releases Edwards's Earnings*, N.Y. TIMES (July 10, 2014), <http://www.nytimes.com/2004/07/10/us/2004-campaign-north-carolina-senator-campaign-releases-edwards-s-earnings.html>.

¹⁹³ See sources cited *supra* note 192.

¹⁹⁴ Koba, *supra* note 192; IRS, *Subchapter S Corporations*, *supra* note 74.

¹⁹⁵ I.R.C. § 1366 (2007).

¹⁹⁶ Moss & Zernike, *supra* note 192; see Koba, *supra* note 192.

2010, while his S corporations reported earnings of \$2.4 million.¹⁹⁷ Gingrich's use of Subchapter S of the Internal Revenue Code allowed him to avoid approximately \$69,000 in Medicare payroll taxes.¹⁹⁸ The salaries that both Edwards and Gingrich reported were considered "reasonable compensation,"¹⁹⁹ an utter exploitation of our tax system. Indeed, the "Gingrich/Edwards" tax loophole has severe tax implications; in 2009, the Government Accountability Office reported that "people who used the loophole underreported about \$23.6 billion in compensation in 2003 and 2004."²⁰⁰

The tax status of an S Corporation was created by Congress under President Dwight Eisenhower during a time when the corporate tax rate was so high that it was difficult for entrepreneurs and small businesses to survive.²⁰¹ Though Congress intended for Subchapter S to help small businesses avoid double taxation,²⁰² proponents of tax reform argue that the original intention of Congress is not being fulfilled, as big businesses and wealthy individuals are the ones that truly benefit.²⁰³ In 2006, "only 2.2% of all S corps . . . received 51.9 percent of the total business profits for S corporations," demonstrating that large companies with vast resources use Subchapter S to avoid paying corporate taxes.²⁰⁴ Though Subchapter S was not created to help wealthy business

¹⁹⁷ Koba, *supra* note 192; see Andrea Coombes, *Gingrich Avoided \$69,000 in Medicare Tax in 2010: source*, MARKET WATCH (Jan. 23, 2012), <http://blogs.marketwatch.com/capitolreport/2012/01/23/gingrich-avoided-69000-in-medicare-tax-in-2010-source/>.

¹⁹⁸ Koba, *supra* note 192.

¹⁹⁹ See *id.*

²⁰⁰ *Id.* (citing U.S. GOV'T ACCOUNTABILITY OFF., GAO-10-195, ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES 25 (2009)).

²⁰¹ *The History and Challenges of America's Dominant Business Structure*, S-CORP, <http://s-corp.org/our-history/> (last visited Nov. 29, 2017).

²⁰² See *id.*

²⁰³ See Berr, *supra* note 35; Alexandra Thornton, *Ending the Pass-Through Tax Loophole for Big Business*, CENTER FOR AMERICAN PROGRESS (Aug. 10, 2016), <https://www.americanprogress.org/issues/economy/reports/2016/08/10/139261/ending-the-pass-through-tax-loophole-for-big-business/>.

²⁰⁴ *Loopholes for Wealthy Owners of "Subchapter S Corporations" Will Not Help "Small Businesses"*, CITIZENS FOR TAX JUSTICE (Apr. 22, 2010), <http://ctj.org/pdf/scorps.pdf>.

owners and large corporations, the IRS has allowed people like John Edwards and Newt Gingrich to take advantage of Subchapter S.²⁰⁵ This abuse is a failure of our tax system,²⁰⁶ and supports the idea that the IRS ought to allow middle class workers to take advantage of tax loopholes like the one found in Subchapter T, rather than leaving loopholes open for the rich and closing them off to everyone else.

Using the loophole found in Subchapter T is sure to benefit the class of its intended benefit, the working class.²⁰⁷ Allowing worker-owners who are employees to avoid payroll taxes is socially beneficial and draws a strong distinction between those tax loopholes that are able to be abused and those that are used to properly benefit those that deserve it.²⁰⁸ While the IRS turns a blind eye to the plethora of tax abuse executed by wealthy taxpayers,²⁰⁹ the middle-class worker is left behind.²¹⁰ The Subchapter T tax loophole, if allowed by the IRS, will benefit businesses that provide better opportunities for their workers.²¹¹ If the IRS wants to enforce the tax code, as its charter proclaims,²¹² it will allow worker cooperative owners to take advantage of the Subchapter T tax loophole, allowing workers to take equal advantage of our tax system.

²⁰⁵ Koba, *supra* note 192.

²⁰⁶ See Jake Blumgart, *4 Ways Government Policy Favors the Rich and Keeps the Rest of Us Poor*, ALTERNET (Sep. 2, 2011), http://www.alternet.org/story/152284/4_ways_government_policy_favors_the_rich_and_keeps_the_rest_of_us_poor (arguing that the government lets wealthy taxpayers “keep their earnings . . . tax free”).

²⁰⁷ See *IRC Section 521 Exempt Farmers’ Cooperatives*, *supra* note 5 (laying out the criteria for Subchapter T tax status).

²⁰⁸ *Think Outside the Boss*, *supra* note 2, at 15.

²⁰⁹ See Blumgart, *supra* note 206.

²¹⁰ See Sean Colarossi, *Millions Of Middle-Class Families Will See Tax Increases Under The Trump Plan*, POLITICUSUSA (Nov. 25, 2016), <http://www.politicususa.com/2016/11/25/millions-middle-class-families-tax-increases-trump-plan.html> (describing how taxes on the middle class are going to increase).

²¹¹ *Think Outside the Boss*, *supra* note 2, at 15.

²¹² *IRS Strategic Plan*, *supra* note 31.

B. Hedge Fund Managers and Capital Gains

The Subchapter T tax loophole mirrors the *IRS-sanctioned* “carried interest” tax loophole that allows hedge fund managers to avoid payroll taxes.²¹³ Hedge funds are “alternative investment vehicle[s],”²¹⁴ that are managed by sophisticated investors who earn a fee for their management, which is subject to employment taxes and payroll taxes.²¹⁵ However, most income of the income that hedge fund managers are paid is categorized as “carried interest,” taxable at the capital gains tax rate, a maximum rate of 20 percent of what the fund earns.²¹⁶ This categorization allows hedge fund managers to avoid payroll taxes on most of their income and allows them to pay a significantly lower tax rate than the rate they would normally be required to pay.²¹⁷ Defenders of this tax loophole have argued that “carried interest” payments to hedge fund managers are a reward for their fund’s successful year.²¹⁸ They argue that since hedge fund managers bear the risks of their fund’s investments, as their salaries are contingent on the fund’s performance, hedge fund managers are more like entrepreneurs than they are employees, and thus, they should be taxed a lower rate.²¹⁹

Since the IRS allows the wealthiest to skirt their responsibility based on enduring the risk of ownership, they ought to do the same for hard-working worker-owners, whose salaries are dependent on

²¹³ Dean Baker, *The Hedge Fund Managers Tax Break: Because Wall Streeters Want Your Money*, TRUTHOUT (Apr. 14, 2014), <http://www.truthout.org/opinion/item/23074-the-hedge-fund-managers-tax-break-because-wall-streeters-want-your-money>.

²¹⁴ *What is a Hedge Fund?*, BARCLAYHEDGE, <https://www.barclayhedge.com/research/educational-articles/hedge-fund-strategy-definition/what-is-a-hedge-fund.html> (last visited Nov. 29, 2017).

²¹⁵ *Id.*; see Baker, *supra* note 213 (discussing “the hedge fund manager’s tax break”).

²¹⁶ Baker, *supra* note 213.

²¹⁷ *Id.*

²¹⁸ Matthew Johnston, *Carried Interest: A Loophole in America’s Tax System*, INVESTOPEDIA (Sept. 22, 2017), <http://www.investopedia.com/articles/investing/102515/carried-interest-loophole-americas-tax-code.asp>.

²¹⁹ *Id.*

their worker cooperative's annual performance.²²⁰ Since worker-owners are paid patronage dividends that are directly based on their own cooperative's financial success,²²¹ they are more like entrepreneurs than they are employees, and thus, like hedge fund managers, they deserve to be taxed at a lower rate.²²² Like capital gains, patronage dividends received by worker-owners are a reward for a successful year²²³ and deserve to be treated as such.

Furthermore, Subchapter T of the tax code suggests that worker-owners are more like owners than they are employees.²²⁴ Subchapter T allows worker cooperatives to offer their worker-owners a patronage dividend in the form of a "written notice of allocation" as long as patrons are paid 20 percent of the patronage dividend in cash.²²⁵ Worker-owners can collectively choose to reinvest the money that would be paid to them as patronage dividends, provided that they are paid 20 percent in cash in order to be able to pay taxes on their patronage dividends.²²⁶ This provision is telling, as it requires worker cooperatives to pay worker-owners 20 percent in cash,²²⁷ the maximum rate of the capital gains tax,²²⁸ suggesting that the authors of the tax code intended for patronage dividends to be excluded from payroll and self-employment taxes.²²⁹

The authors of Subchapter T intended to treat worker-owners of worker cooperatives as owners, rather than as employees.²³⁰ First, not only did the authors of the code fail to include a provision requiring worker-owners to be paid "reasonable compensation," they did not even go as far as to comment on

²²⁰ See *id.*; cf. *Think Outside the Boss*, *supra* note 2, at 17.

²²¹ *Think Outside the Boss*, *supra* note 2, at 17

²²² See *id.* at 8.

²²³ See I.R.C. § 1381 (2012).

²²⁴ See *id.*

²²⁵ I.R.C. § 1388 (c)(1)(B).

²²⁶ See *id.*; see also *Think Outside the Boss*, *supra* note 2, at 77, 81.

²²⁷ See I.R.C. § 1388 (c)(1)(B); Baker, *supra* note 213.

²²⁸ Kay Bell, *Capital Gains Tax: Your Income Helps Determine What You Pay*, BANKRATE (Sept. 22, 2017), <http://www.bankrate.com/finance/taxes/capital-gains-tax-rates-1.aspx>.

²²⁹ See I.R.C. § 1381 (c)(1)(B).

²³⁰ See *id.*

whether worker-owners should be paid any salary at all.²³¹ The absence speak volumes, indicating that the authors of the tax code intended for Subchapter T to be treated differently than other sections of the tax code.²³² Second, the authors of the code required that, in the event of reinvestment, worker-owners must be paid at least 20 percent of their patronage dividend in cash in order to pay taxes on their patronage dividend.²³³ This clearly demonstrates that the authors of the tax code considered the effective tax rate of the patronage dividends, and determined that it would not exceed 20 percent, the maximum tax rate for capital gains tax.²³⁴ The result is the Subchapter T tax “loophole,” the notion that the authors of the code intended for worker-owners to avoid paying payroll taxes on their entire income.

While the tax treatment of hedge fund managers is controversial, it has not yet been changed.²³⁵ Though many politicians have come out in favor of closing the “carried interest” tax loophole, stating that the tax system is making the rich richer,²³⁶ it is doubtful that ordinary Americans would be similarly outraged about worker cooperative owners receiving a similar tax break, as worker cooperatives allow for the creation of a larger middle class²³⁷ by offering ownership to all workers at each level of the cooperative.²³⁸

Based on the language of the tax code, the intent of the legislators who enacted Subchapter T,²³⁹ and the common desire

²³¹ See generally I.R.C. § 1381–1383, 1385, 1388 (making no mention of a reasonable salary requirement, nor prohibiting treating all income as a patronage dividend).

²³² See *id.*

²³³ I.R.C. § 1388 (c)(1)(B).

²³⁴ See *id.*

²³⁵ See Baker, *supra* note 213 (discussing how the “carried interest” loophole is just making hedge fund managers richer).

²³⁶ *Kill the Hedge Fund Tax Break: Our View*, USA TODAY (Sep. 15, 2015), <http://www.usatoday.com/story/opinion/2015/09/15/hedge-fund-carried-interest-donald-trump-jeb-bush-editorials-debates/72268922/>.

²³⁷ See Jaffe, *supra* note 108 (discussing how worker cooperatives help combat the problem of income inequality).

²³⁸ See *Think Outside the Boss*, *supra* note 2, at 4, 8, 17.

²³⁹ See I.R.C. § 1381 (2012).

for a larger middle class,²⁴⁰ the IRS ought to offer worker-owners the similar tax loophole to the one used by hedge fund managers to avoid payroll taxes.²⁴¹ As depicted in Figure 3.1, based on the Subchapter T tax loophole, worker-owners earning \$100,000 annually should be able to treat their income as follows:

Figure 3.1

Payment	Amount	Income Tax	Employment Tax	Self-employment Tax
Wages	\$0	N/A	N/A	N/A
Patronage Dividend	\$100,000	YES	NO	NO

This tax treatment would allow worker-owners to save approximately 15 percent on payroll taxes²⁴² and creates a loophole for workers who incur the risks of ownership.²⁴³ While a small portion of a hedge fund manager's salary is treated as ordinary income, most of their income is treated in the same way as the chart above illustrates, and they earn substantially more than the average working-class American.²⁴⁴ Until the system is

²⁴⁰ See Ronald Brownstein, *Meet the New Middle Class: Who They Are, What They Want, and What They Fear*, THE ATLANTIC (Apr. 25, 2013), <https://www.theatlantic.com/business/archive/2013/04/meet-the-new-middle-class-who-they-are-what-they-want-and-what-they-fear/275307/>.

²⁴¹ See *id.*

²⁴² See Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 3 (noting that the employment tax is approximately 15 percent); see also *Federal Tax Information*, PAYROLL TAXES, <http://www.payroll-taxes.com/federal-tax> (last visited Nov. 29, 2017) (providing Federal tax withholding formula, including for employment tax).

²⁴³ See *Worker Cooperatives: Performance and Success Factors*, CO-OP LAW.ORG, <http://www.co-oplaw.org/special-topics/worker-cooperatives-performance-and-success-factors/> (last visited Nov. 29, 2017).

²⁴⁴ See Baker, *supra* note 213 (noting that application of the hedge fund manager's tax break means that "[f]or a successful manager earning \$10 million, the savings come to \$1,960,00" and for a manager "earn[ing] 100 million, the savings would be equal to \$19,600,000").

changed, the 99 percent deserve the same treatment as the 1 percent.

IV. ALTERNATE SOLUTION: EMPLOYEES V. INDEPENDENT CONTRACTORS V. NEW TAX STATUS

The time is right for significant change. In its determination that worker-owners of worker cooperatives cannot avoid payroll taxes, the IRS utilized the notion that worker-owners are either employees or they are self-employed independent contractors.²⁴⁵ The IRS has based this opinion around an outdated conception of workers in an archaic workforce. The IRS and Tax Court should reject their previous notions of such a worker and recognize a new classification of worker operating under Subchapter T.

The recent boom of the sharing economy with the creation of companies like Uber,²⁴⁶ Lyft,²⁴⁷ and Juno²⁴⁸ has created challenging tax questions about workers in the United States.²⁴⁹

²⁴⁵ See *Patronage & Tax*, *supra* note 130 (citing IRS conclusion that “in cases where members of a worker cooperative are employees, employees generally do not receive both employment income and self-employment income from the same entity” and thus “patronage refunds from a worker cooperative are not subject to self-employment tax.”).

²⁴⁶ Uber is a phone application that consumers use to book a ride with a driver acting as an independent contractor of Uber. *Finding the Way: Creating Possibilities for Riders, Drivers, and Cities*, UBER, <https://www.uber.com/our-story/> (last visited Nov 29, 2017).

²⁴⁷ Like Uber, Lyft is a ride-sharing phone application whose mission is to “reconnect people and communities through better transportation.” *Accelerating the Lyft Movement*, LYFT BLOG (March 11, 2015), <https://blog.lyft.com/posts/2015/3/11/accelerating-the-lyft-movement>.

²⁴⁸ Juno is at the forefront of change in the ridesharing market, as they believe in protecting drivers and profit-sharing. See Sarah Ashley O’Brien, *Uber Competitor Says Its Drivers Will Own the Company*, CNN TECH (Feb. 20, 2016), <http://money.cnn.com/2016/02/19/technology/meet-uber-competitor-juno/index.html>. Should the worker cooperative business model be accepted by the ridesharing economy, companies like Juno that want to share profits with their workers will likely be at the front of the movement. *Id.* The Subchapter T tax loophole will serve to drive this change and will further incentivize companies like Juno to protect their workers.

²⁴⁹ See Evan Hamilton, *7 Important Lessons for Startups in the Sharing Economy from Lyft, Storefront, Yerdle, and Boatbound*, CMX, <http://cmxhub.com/7-lessons-on-building-community-in-the-sharing-economy->

Lyft drivers are considered independent contractors for tax purposes, and they must pay self-employment taxes on the money that they earn.²⁵⁰ Drivers in the ride-sharing economy are generally not protected as employees, as they are financially responsible for their own injuries and their salaries are dependent on the amount that they drive and on the availability of business.²⁵¹ Based on those factors, it seems as though drivers in the sharing economy incur many risks of ownership.²⁵² However, the tax code treats them as independent contractors for tax purposes,²⁵³ and they must pay the same self-employment taxes as ordinary employees who receive benefits and protections of their employer.²⁵⁴

from-lyft-storefront-yerdlle-and-boatbound/ (last visited Nov. 29, 2017) (discussing the boom of the sharing economy); see also Jessica L. Kerner, 2016 *Emerging Issues* 7416, *The challenge of Taxing the Sharing Economy*, 1 (Apr. 12, 2016), LEXISNEXIS, <https://advance.lexis.com/api/permalink/5165d90f-93d7-4a8d-aa73-f98d728623d9/?context=1000516> (noting that the “sharing economy has led to a host of tax headaches”).

²⁵⁰ Jordan Vesey, *Who Protects the Workers Powering the New Sharing Economy?*, PBS NEWSHOUR (Oct. 10, 2014), <https://www.pbs.org/newshour/economy/sharing-economy-great-consumers-cost-workers> (noting that “Lyft drivers . . . are independent contractor” and that they must pay “self-employment taxes” among other costs).

²⁵¹ See Julie Bawden-Davis, *5 Reasons Uber Can Be A Risky Choice (For Drivers And Passengers)*, SUPERMONEY (last updated Oct. 1, 2017), <https://www.supermoney.com/2016/05/5-reasons-uber-can-risky-choice-drivers-passengers/>; see also Diana Kruzman, *Some Uber Drivers Work Dangerously Long Shifts*, USA TODAY (July 10, 2017) <https://www.usatoday.com/story/money/cars/2017/07/10/some-uber-drivers-work-dangerously-long-shifts/103090682/> (citing concern that drives are working “up to 16 hours a day because of low pay or tempting incentives” and that Uber sends drivers notifications “if they aren’t picking up enough passengers” stating that “they need to take on more rides if they want to keep driving for Uber”).

²⁵² *Id.*

²⁵³ See Vesey, *supra* note 250 (noting that “Lyft drivers . . . are independent contractors” and that they must pay “self-employment taxes” among other costs).

²⁵⁴ See *Independent Contractor (Self-Employed) or Employee?*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee> (last updated Sept. 18, 2017); see also *Self-Employed Individuals Tax Center*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/self-employed-individuals-tax-center> (last updated

This is entirely inequitable. If workers are not afforded the same protections as ordinary employees, why must they be taxed at the same rate as ordinary employees? The tax code provides provisions to support the idea that those who incur the risks of ownership deserve more favorable taxation including the tax treatment of capital gains,²⁵⁵ S corporations,²⁵⁶ and worker cooperatives.²⁵⁷ However, when it comes to working-class citizens who technically do not own their companies, the IRS requires them to pay taxes as either employees or independent contractors, forcing them to pay payroll taxes on their income one way or another.²⁵⁸

The two categories of taxpayers are limiting and are not representative of the true differences between different types of working-class citizens. Akin to drivers in the ride-sharing economy, worker-owners incur the risks of ownership, as they have a stake in the game in their jointly owned cooperatives.²⁵⁹ They are not ordinary employees, nor are they ordinary owners.²⁶⁰ However, the IRS and the Tax Court have required worker-owners to fit into one of two categories of employment,²⁶¹ ignoring the possibility of creating a third category of employment.

There is a solution to this problem, though it may lead to some administrative complexity.²⁶² A new tax status for workers who incur the risks of ownership is necessary in our newly evolved economy. There are many people working in the sharing economy who are more than employees, as they incur risks of ownership,

Sept. 11, 2017) (explaining that self-employed individuals are generally required to pay self-employment taxes as well as income taxes).

²⁵⁵ See Chris Edwards, *Six Reasons to Keep Capital Gains Tax Rates Low*, CATO INSTITUTE (Dec. 27, 2012), <https://www.cato.org/publications/commentary/six-reasons-keep-capital-gains-tax-rates-low>.

²⁵⁶ See *S Corporations*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations> (last updated Sept. 7, 2017).

²⁵⁷ See I.R.C. § 1381 (2012).

²⁵⁸ *Independent Contractor (Self-Employed) or Employee?*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee> (last updated Dec. 28, 2017).

²⁵⁹ *Think Outside the Boss*, *supra* note 2, at 8–10.

²⁶⁰ See *id.* at 1, 3.

²⁶¹ See Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 1–3.

²⁶² See Stone, *supra* note 54.

and less than owners, as they have not established themselves as business entities.²⁶³ A new tax status allowing these in-betweeners to treat their income more like a capital gain and less like a salary would support many policy goals.

First, this new tax status would allow the Subchapter T loophole to thrive, as worker-owners would not need to be classified as employees or independent contractors, allowing them to treat their entire income as patronage dividends. Additionally, this new tax status, reserved for worker-owners and similar workers who incur the risks of ownership and whose paychecks depend on their individual performance,²⁶⁴ would provide stability to those with an entrepreneurial spirit and the courage to take risks. Finally, because worker cooperatives and similar business models provide great social value to their workers and communities,²⁶⁵ a new tax status for worker-owners and members of the sharing economy would be a way for the government to support socially beneficial business models. Offering worker-owners and workers in the sharing economy a break on payroll taxes would convey to the world that the United States government supports business, entrepreneurship, and more importantly, fairness.²⁶⁶

CONCLUSION

The IRS and the United States Tax Court have consistently maintained that worker-owners of worker cooperatives must either pay payroll taxes as employees or self-employment taxes as independent contractors.²⁶⁷ Using the language of Subchapter T and other sections of the code, this Note has demonstrated that worker-owners of worker cooperatives can treat their entire income as patronage dividends, avoiding payroll taxes, on the condition that they are employees of their worker cooperatives.²⁶⁸ While the

²⁶³ Bawden–Davis, *supra* note 251.

²⁶⁴ *Think Outside the Boss*, *supra* note 2, at 2, 8–10; Vesey, *supra* note 250.

²⁶⁵ *Think Outside the Boss*, *supra* note 2, at 1, 3–4.

²⁶⁶ See *IRC Section 521 Exempt Farmers' Cooperatives*, *supra* note 5; see also *CICOPA*, *supra* note 5; *IRS Strategic Plan*, *supra* note 31 (articulating the goals of the IRS in serving taxpayers including and fairness).

²⁶⁷ Wilson, *Taxation of Patronage Dividends*, *supra* note 9, at 1–3.

²⁶⁸ See discussion *supra* Section III.D.

IRS may not accept this argument, considering a new worker status for worker cooperative owners would be prudent, as it would serve many stated policy goals of the tax code including entrepreneurship, equality, and fairness.²⁶⁹

²⁶⁹ See *IRC Section 521 Exempt Farmers' Cooperatives*, *supra* note 5; see also *CICOPA*, *supra* note 5.