The Effects of Tax Reform on the Structure of U.S. Business

Tom Petska, Internal Revenue Service

The 1980's have been described as a period in which "taxes came to dominate the public agenda [1]." The many changes in each of these reforms to business and individual taxation brought about incentives to alter business legal structure. In this paper, trends in the U.S. business sector in the decade of the 1980's are examined, specifically focusing on whether the tax reforms had an effect on legal business structure. This analysis makes use of a new database, the Statistics of Income (SOI) business analytical database, whose structure and potential usage are also described.

In the first section of this paper, a brief overview of the Federal tax treatment of business income is provided. The second section concisely reviews major provisions of the tax law changes in the 1980-1990 period. Next, time series data on the major types of U.S. business (proprietorships, partnerships and corporations) are examined, focusing on the responsiveness of business legal structure and activity to the major tax law changes. In the final section, some conclusions are presented as well as plans to extend this analysis.

Federal Taxation of Business Income

Federal taxation of business income is a detailed and complicated topic which will only be described at a very basic level [2]. The legal types of business organizations that are examined in this paper are the predominant forms of U.S. business: proprietorships, partnerships, and corporations.

Proprietorships

The income statement of proprietorships, which summarizes the sources of income and expenses of the business, is completed on Schedule C of the owner's individual tax return. The profits of the proprietorship are taxed only at the personal (i.e., owner) level. From this perspective, the proprietorship acts as a conduit through which the income of the business is passed through to the business owner [3].

Partnerships

The partnership entity is not taxed directly; each partnership files an annual information return which includes an income statement, balance sheet, and a schedule of distributions to each partner. Partners report their allocated shares of income and expenses on their own tax returns.

Partnerships may be either general partnerships or limited partnerships. The latter include entities for which the liability of any partner is limited to the amount invested in the business. General partnerships, and general partners as well, face personal liability limited only by their personal resources and the applicable bankruptcy laws [3].

Corporations

Unlike income from proprietorships and partnerships, corporate income is subject to double taxation. Corporate income is taxed directly at the business level (C-Corporations), and shareholders are also taxed at their own applicable rates on dividend income and realized capital gains received. However, certain provisions in the Federal tax code lessen this effect [2].

Subchapter-S corporations are corporations that are not taxed directly, but whose income is taxed at the owner level, much like partnerships. The owners of S-Corporations report their pro-rata shares of income or loss on their own tax returns. S-Corporations also face other restrictions including limits of: 35 shareholders, one class of stock, and no foreign or corporate owners.

Tax Law Changes in the 1980's

Some of the main provisions of the tax reforms of the 1980's that affected the taxation of business income are briefly described in this section. Since all types of business income can be taxed at the individual level, provisions affecting individual taxation, as well as direct business taxation, are also discussed [2,4,5].

The Economic Recovery Tax Act of 1981

Provisions in the Economic Recovery Tax Act (ERTA) substantially lowered the top individual marginal tax rate from 70 to 50 percent and limited the maximum marginal rate on long-term capital gains to 20 percent. Significant changes included indexing the income tax bracket boundaries, the personal exemption, and the standard deduction; however, these changes were not effective until 1985 [1,6].

The most significant change directly affecting business taxation was the initiation of the Accelerated Cost Recovery System (ACRS). This system of accelerated depreciation allowances substantially reduced the time within which a business could write-off its investments in plant, building, and equipment, thereby reducing its current taxable income.

Tax Law Changes, 1982-1985

The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 was focused at generating revenue. Primary provisions included the imposition of a withholding tax on interest and dividends, acceleration of estimated tax payments, expanded information reporting, and increased penalties for non-compliance [1,6].

Several other tax law changes were enacted after TEFRA but prior to the major reform of 1986. Provisions of these acts increased excise taxes on motor fuels, coal, and tobacco products and also raised payroll taxes. Overall, these provisions had some, albeit smaller, impact on the taxation of business income [1].

The Tax Reform Act of 1986

The 1986 Tax Reform Act (TRA) was the single most comprehensive revision of the Internal Revenue Code ever enacted [6,7,8]. Some of its major provisions are summarized below.

Corporate taxation:

- The top corporate tax rate was reduced from 46 to 34 percent.
- The corporate minimum tax provisions were tightened.
- The investment tax credit was repealed and capital cost recovery periods, which had been shortened in ERTA, were lengthened.

Individual taxation:

- The top marginal tax rate was lowered from 50 percent to 28 percent.
- The standard deduction and personal exemptions were substantially increased.
- The long-term capital gains exclusion, the sales tax deduction, the two-earner deduction, income averaging and the exclusion of unemployment benefits were repealed.
- IRA eligibility, deductions for "passive" losses, consumer interest, medical expenses, business meals and entertainment and miscellaneous expenses were limited and, in some cases, phased-out entirely.

Overall, these changes were primarily focused at broadening the tax base for both individuals and corporations, by curtailing or rescinding many provisions in the tax code that had eroded the base, to offset the effect of lower overall tax rates [1,7,8].

Tax Law Changes, 1987-1990

The post-TRA period was relatively "quiet" in terms of significant tax legislation. Most of these provisions were appended to acts to sustain Federal Government operations, to clarify provisions of TRA, and to make changes to excise taxes and accounting procedures [1].

Summary of Changes

These many changes tend to mask the central focus of this paper, which is investigating how the major tax law revisions affected the choice of business legal structure. Although many provisions of the 1980's tax legislation affected this balance, three key tax law changes appear to have had the most significant effects: the relative changes in the marginal tax rates between corporate and individual taxation; the accelerated depreciation deductions (ACRS); and the limitation of losses on passive activities.

Marginal tax rates.-- Changes in the marginal tax rates on taxable income for both individuals and corporations create incentives to change between corporate and non-corporate structure to minimize tax liabilities. Thus, not only is the applicable tax rate schedule for the taxable entity significant (i.e., whether corporate or individual), but the tax rate for the other type is also important.

Accelerated depreciation deductions.-- The system of accelerated depreciation deductions benefited all types of businesses with depreciable assets by allowing much quicker deductions of investment property. This provision essentially allowed businesses to (at least) defer taxation. Accelerated depreciation deductions affect all types of businesses and thus were not a clear incentive to change business structure.

Passive loss limitations.-- Limitations on deductibility of losses from passive activities had a substantial effect on individuals who received such losses. The passive loss limitations disallowed, under certain conditions, deductions from taxable income of business losses defined as originating in passive activities, such as from some limited partnership investments.

Figure A is a summary of the top marginal corporate and individual marginal tax rates during the 1980-1990 period, and the size of the differences between them [6].

Figure A.--Top Marginal Tax Rates (Percentages) for Corporations and Individuals, 1980-1990

Item	1980	1981	1982-86	1987-91
Corporations	46	46	46	34
Individuals	70	69	50	28
Difference	-24	-23	-4	+6

These rates are only for the highest levels of taxable income and do not account for rates applicable for lower taxable incomes, as well as potentially higher marginal tax rates due to the 33 percent "bubble" caused by the phase-out of deductions and/or exemptions. Two key inferences that may be drawn from Figure A are that:

- The top marginal tax rates for both individuals and corporations declined dramatically in the decade, particularly beginning in 1987, the first year affected by the passage of TRA.

- In relative terms, the individual marginal rate went from the higher to the lower rate, thereby providing an incentive, in combination with the double taxation of some corporate income, to shift to an unincorporated business structure.

The changes effective beginning in 1987 for ACRS and passive loss limitations both raised the effective tax rate on business income. ACRS reduced taxes for all types of businesses with depreciable assets in the early-to-mid part of the decade. The passive loss limitations were aimed at individual recipients of passive losses (directly) and the business generators of such losses (indirectly). Only businesses that generated passive income and losses (i.e., primarily partnerships and S-Corporations) were affected by this provision [7,9].

As a result of the relative change in magnitude between the top corporate and individual marginal tax rates that became effective in 1987, a C-Corporation could consider, if possible, to reorganize as an S-Corporation, partnership, or proprietorship. Whether or not such a change actually did occur will be a primary focus of the analysis of the database in the next section.

Analysis of Time Series Data

Data on trends in the business sector are examined in this section. The primary focus in this preliminary analysis is on changes in composition of business by legal type as an apparent response to tax law changes that occurred in 1982 (with the passage of ERTA) and in 1987 (with the passage of TRA).

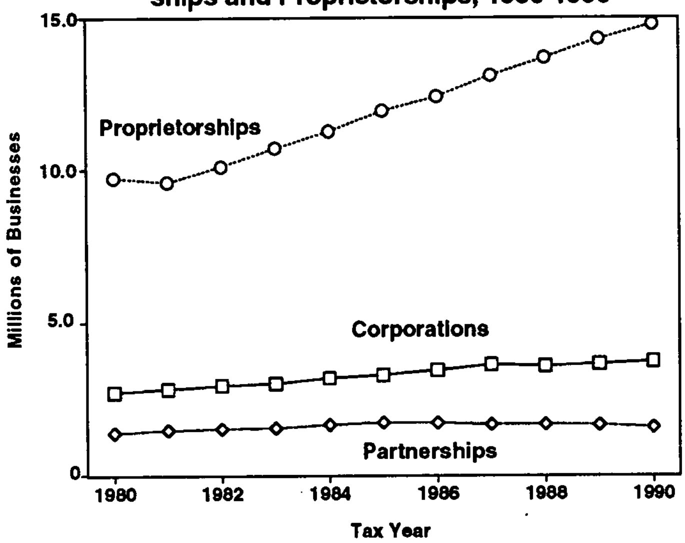
Overview of the Database

This multi-year analysis is a first use of the SOI business analytical database to examine trends in the business sector. The database is comprised of data for corporations (C- and S-Corporations), partnerships, and proprietorships for 1980-1990. These data are publicly available and published in a variety of Statistics of Income (SOI) reports [10-14]. They represent weighted estimates of U.S. totals by year for each legal type and industry.

Trends in the Number of Businesses

Figures B and C summarize some trends in the number of businesses for the 1980-1990 period. In Figure B, the number of businesses is plotted over time by type of business. Proprietorships dominate the number of businesses throughout the decade, and the trend is for even greater domination with continued higher growth in more recent years. After declining between 1980 and 1981, apparently as a result of the 1981-1982 recession, proprietorships exhibited stable growth for the remainder of the decade.

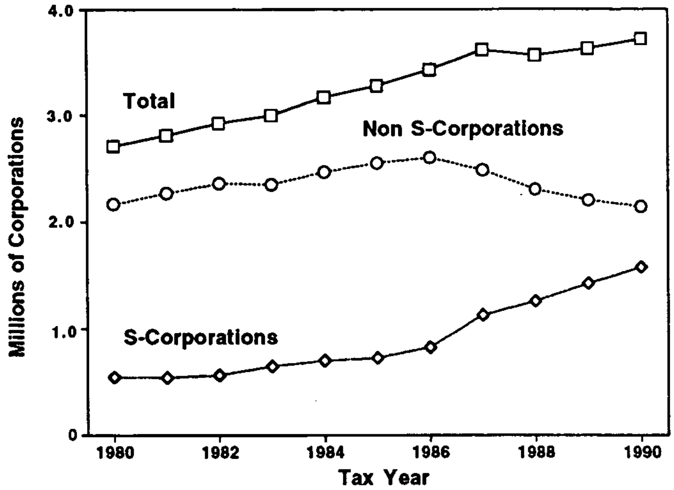
Figure B.--Number of Corporations, Partnerships and Proprietorships, 1980-1990



Corporation and partnership numbers of businesses both showed relatively modest growth for this period. However, unlike corporations, which continued to grow in number in virtually every year, partnerships declined in number after the passage of TRA, which is consistent with an expected response to the passive loss limitations in TRA.

In Figure C, the number of corporations is shown in total (again) and is subdivided between S-Corporations and Non-S Corporations. (A different scale was used in this figure.) Although overall growth in the number of corporations is quite stable, the trends of S-Corporations and Non-S Corporations are not. Growth in the number of S-Corporations accelerated beginning with the passage of TRA in 1986, while Non-S Corporations declined in number in every year since the passage of TRA.

Figure C.--Number of Corporations: Total, S and Non-S Entities, 1980-1990



Some trends in the number of corporations in the 1980-1990 period:

- ❑ Corporations grew in number in every period, although their rate of growth declined (to only 1 percent) in the post-TRA period.
- ❑ S-Corporations accounted for much of the corporate growth in general, and appear to have grown substantially at the expense of other types of corporations after passage of TRA.
- ❑ While the large increase (31 percent) in the number of S-Corporations for 1987 is largely attributable to conversions from C-Corporations, switching to calendar year accounting periods for 1987 may have inflated these counts [15].

Analysis of the Receipts Data

Figures D and E show trends in overall business activity as defined by data on business receipts. In Figure D, trends in total receipts show a very different picture than those for the numbers of businesses. Corporations clearly dominate this measure of gross financial activity, and the trend is for even greater

Figure D.--Business Receipts of Corporations, Partnerships and Proprietorships, 1980-1990

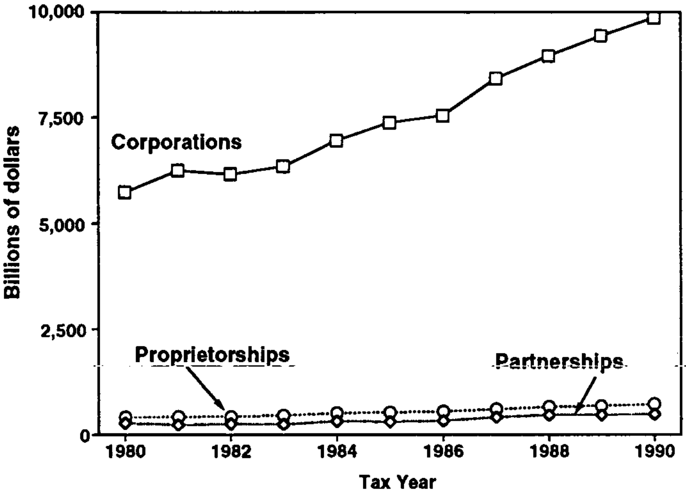
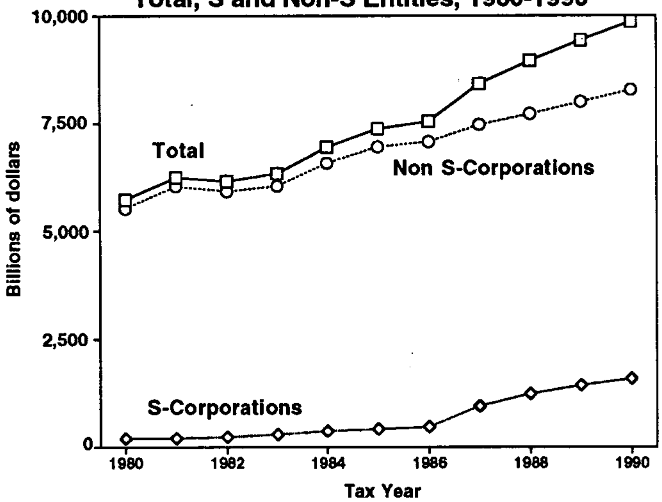


Figure E.--Business Receipts of Corporations: Total, S and Non-S Entities, 1980-1990



domination. Partnerships and proprietorships both show small but stable portions of business receipts.

Corporate business receipts grew substantially between 1980 and 1981, which is somewhat surprising with the onset of the 1981-1982 recession. For 1982, however, there was no growth. The rate of increase in the growth of corporate receipts accelerated between 1982 and 1987, culminating with a 10-percent rise for 1987. In the post-TRA period, receipt growth slowed but still maintained nearly a 6-percent pace.

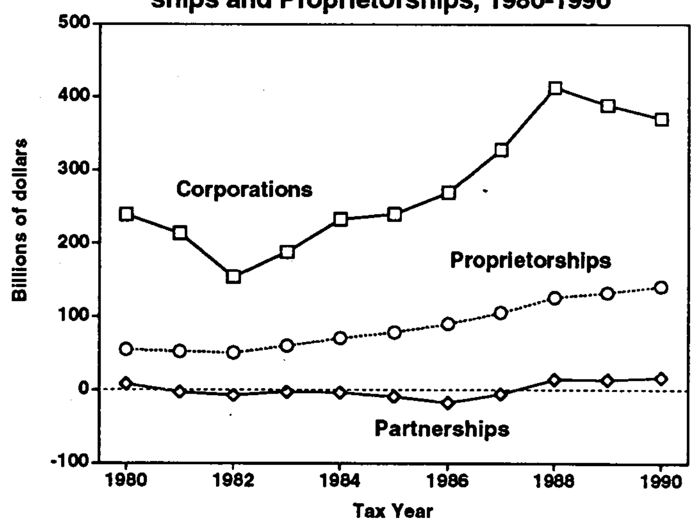
Although changes in business receipts look quite flat for both partnerships and proprietorships, a closer look at the data for Figure D shows volatility, especially for partnerships in the 1980-1983 period. However, beginning in 1983, receipts grew in double digits through 1987, then slowed somewhat in the post-TRA period. Proprietorships, on the other hand, grew in every period, and this rate of growth stayed above 6 percent from 1983 through the end of the decade.

As evidenced in Figure E, receipts for S-Corporations have grown substantially in the post-TRA period. However, for receipts, Non-S Corporations still clearly dominate corporate financial activity. While the rate of growth in business receipts did accelerate for S-Corporations after the passage of TRA, growth in the receipts of Non-S Corporations continued throughout the decade, although it appears that their rate of growth may have been reduced by the growth of S-Corporations after TRA.

Trends in Profits

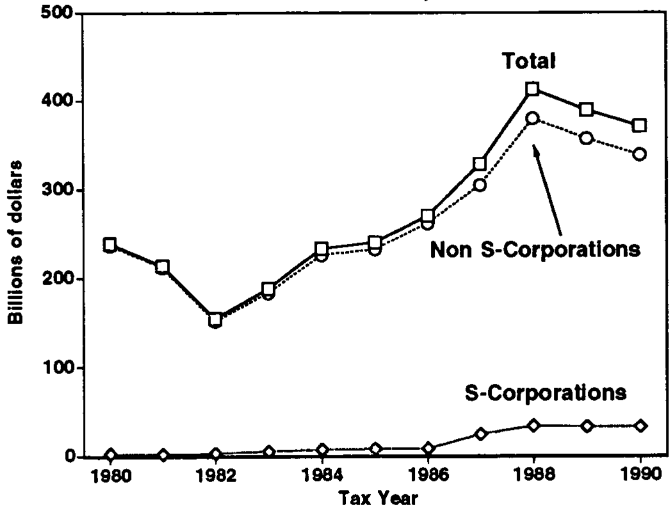
For an additional look at the data, Figures F and G present data on profits or net income (less deficit). In Figure F, corporations again dominate the business sector, but not quite to the same degree as for receipts. In addition, corporate profits are more sensitive to the economic downturns in 1981-82 and 1989-90. Profits of proprietorships show modest but steady growth throughout the decade. Partnerships, on the other hand, show increasing deficits for the entire pre-TRA period, and only return to profitability in 1988, the second post-TRA year.

Figure F.--Profits of Corporations, Partnerships and Proprietorships, 1980-1990



In Figure G, profits for each type of corporation are plotted. Here again, we see a picture somewhat similar to that for business receipts. Although S-Corporation

Figure G.--Corporate Profits: Total, S and Non-S Entities,1980-1990



profits have increased since the passage of the 1986 Tax Reform, Non-S Corporations still very much dominate the corporate sector. Thus, while the numbers of S-Corporations have shown dramatic growth, the financial activity of the corporate sector, and the business sector as a whole, remains the predominant domain of Non-S Corporations.

Conclusions and Future Plans

This preliminary analysis of trends in business structure in the decade of the 1980's due to tax reform shows that taxes do matter, at least to an extent. The most substantial evidence in these data was a shift to S-Corporations in 1987, the first year for which TRA was in effect, although this was more evident in the number of businesses than in the financial activity. This is consistent with a response to the provisions of TRA, particularly the lower individual marginal tax rates. Also, the fact that this change was primarily for smaller corporations is also consistent with the restrictions affecting the size of S-Corporations, particularly the limitations on numbers of shareholders and the limitation to one class of stock. However, conversions from fiscal to calendar year accounting periods by S-Corporations may have inflated these counts [15]. The effects of the business cycle, particularly the recessions, were significant and probably have a predominant impact on these data.

As previously noted, this analysis is a first attempt at examining the business analytical database in multi-year analysis. Current plans are to extend both the content and scope, particularly examinations at the industry level.

Acknowledgments

The author would like to extend special thanks to: Saundra Harris and Michelle Sloan, for developing the database; Beth Kilss, Sarah Nutter, George Plesko, and Bob Wilson, for reviewing the manuscript; Clem Brittain, for graphics assistance; and Dan Trevors, for layout and publication processing. Any errors are the responsibility of the author.

Notes and References

[1] Steuerle, C. Eugene, *The Tax Decade: How Taxes Came to Dominate the Public Agenda*, The Urban Institute Press, 1991.

[2] For more information on these topics, see [1,3,5,6,7].

[3] Scholes, Myron S., and Wolfson, Mark A., *Taxes and Business Strategy: A Planning Approach*, Prentice-Hall, 1992.

[4] Plesko, George A., "Corporate Taxation and the Financial Characteristics of Firms," *Public Finance Quarterly*, forthcoming.

[5] Pechman, Joseph A., *Federal Tax Policy*, fifth edition, The Brookings Institution, 1987.

[6] Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, Volume 1, *Budget Processes and Tax Systems*, Tables 9-10, 1993.

[7] Internal Revenue Service, *Explanation of the Tax Reform Act of 1986 for Individuals*, Publication 920, 1987.

[8] Birnbaum, Jeffrey H. and Murray, Alan S., *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform*, Random House, 1987.

[9] Petska, Tom, "Partnerships, Partners and Tax Shelters after Tax Reform, 1987-1989," *SOI Bulletin*, Volume 12, Number 1, Internal Revenue Service, 1992.

[10] *Statistics of Income -- 1990, Corporation Income Tax Returns*, Publication 16, Internal Revenue Service, 1993.

[11] Wheeler, Timothy D., "Partnership Returns, 1991," *SOI Bulletin*, Volume 13, Number 2, Internal Revenue Service, 1993.

[12] Statistics of Income Division, *Source Book, Corporation Income Tax Returns*, 1990, Publication 1053, Internal Revenue Service, 1993.

[13] Ammon, Craig, "Sole Proprietorships, 1991," *SOI Bulletin*, Volume 13, Number 2, Internal Revenue Service, 1993.

[14] Statistics of Income Division, *Statistics of Income -- 1990, Individual Income Tax Returns*, Publication 1304, Internal Revenue Service, 1993.

[15] Beginning in 1987, S-Corporations were required to have accounting periods identical to those of their owners. Since the owners are individuals with calendar year accounting periods, many S-Corporations with other accounting periods had to convert to calendar year accounting and were subjected to double counting for 1987. ■