Taxes and Business Organizational Choice: *Deja Vu* All Over Again?

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Do taxes affect the choice of business organizational form or legal structure? This question has been asked by many but has never been fully answered. This paper, an extension of earlier works examining trends in business organizational structure based on statistics compiled from tax and information returns, attempts to contribute to this discussion [1,2,3,4]. The paper examines business aggregate time series data in light of substantial changes to the Internal Revenue Code, which have affected incentives of shifting from one organizational form to another. Data from the major Statistics of Income (SOI) business programs are compiled and examined from 1985 through 1994, the most recent year for which complete data are available.

The paper has three sections. The first section briefly summarizes background information on taxation of business income and business organizational choice. The second section examines aggregate time series data on businesses based on tax and information return filings with the IRS. The third section summarizes some conclusions.

■ Taxation and Organizational Choice

Statistics compiled from business tax returns revealed some dramatic changes since the mid-1980's, particularly between businesses electing to be taxed at individual versus corporate rates. In the period following the landmark 1986 Tax Reform Act (TRA86), a substantial shift occurred toward business organizational structures electing to be subject to the lower individual income tax rates. However, tax reforms for 1991 and 1993 raised individual marginal income tax rates that, when coupled with stable corporate tax rates, resulted in the highest individual marginal tax rates surpassing the highest corporate marginal tax rate [5]. As in the pre-TRA86 years, it might once again be advantageous to elect corporation status rather than any of the organizational types that are effectively taxed at individual rates.

This section summarizes some of the most significant aspects of the taxation of various organizational forms and highlights some of the major tax law changes in the 1985-1994 period [6].

Business Organizational Forms

The data in this paper were compiled from SOI annual cross-sectional studies of corporations, partnerships, and nonfarm sole proprietorships for Tax Years 1985-1994. Data from these annual statistical studies are publicly available and are published in a variety of SOI reports [7-11]. The tax treatment of these organizational forms is briefly summarized below.

- **Corporations.--** Corporation income is generally taxed directly at the business level, then again at the shareholder level at the rates applicable for dividend income. However, certain provisions in the Internal Revenue Code lessen this effect. First, the corporate income potentially taxable at the shareholder level excludes taxes paid by the corporation, so income distributed to shareholders is only taxable on the after-tax profits earned by the corporation. Second, the after-tax corporate income is not taxable at the shareholder level until it is paid out as dividends or until the shareholder realizes capital gains by selling shares that have appreciated in value.

  Subchapter S Corporations are generally small, closely-held corporations that are not taxed directly. Their income is generally subject to tax only at the owner level, much like partnerships (which are discussed below). Owners of S Corporations report their *pro rata* shares of income or loss on their own tax returns. Although S Corporations have attractive features, they do face restrictions, including limitations on the number and type of shareholders and on the classes of stock permitted, as well as prohibition of foreign or corporate ownership.

- **Partnerships.--** The partnership entity is not taxed directly; each partnership files an annual information return, which includes an income statement, a balance sheet (in most cases), and a schedule of allocations or distributions made to each partner. Partners report their allocated shares of income and expenses on their own tax returns. Partners are predominately (though not exclusively) individuals.

  Partnerships may be either general partnerships or limited partnerships. Limited partnerships include all partnerships 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. Limited partners are more like corporate shareholders, with liability limited to the amount invested and generally little active participation in management of the business.

- **Sole proprietorships.**--The profits of sole proprietorships are taxed only at the personal (i.e., owner) level. The income statement of nonfarm sole proprietorships, which summarizes the income and expenses of the business, is completed on Schedule C (or C-EZ) of the owner's individual income tax return. The net income or loss from the proprietorship is added to personal income from all other sources and taxed at the applicable individual income tax rates.

Tax Law Changes

Many provisions of tax legislation in the 1985-1994 period may have affected the choice of business organizational form. Clearly, the Tax Reform Act of 1986 (TRA86), the most comprehensive revision of the Internal Revenue Code since 1954, had a major impact. Key provisions of TRA86 broadened the tax base of both individuals and corporations by curtailing or rescinding many provisions that had previously eroded the base, while lowering overall tax rates [12]. Provisions of TRA86 that may have affected organizational structure included repealing the "general utilities doctrine," tightening the corporation "alternative minimum tax," limiting losses from passive activities, and repealing the long-term capital gains exclusion. However, the law changes that appear to have had the most significant effect and are the focus of this paper are the changes in individual and corporate marginal tax rates.

The highest marginal tax rates for individuals and corporations for 1985-1994 are presented in Figure A. In the pre-TRA86 period (1985-1986), the highest individual rate (50 percent) exceeded the highest corporation rate (46 percent) by 4 percentage points. TRA86 reversed this relation, however, beginning with 1987 and continuing with the full implementation of the lowered rates for 1988. These new rates remained in effect through Tax Year 1990. Beginning with Tax Year 1991, the top individual rate began to climb. For 1991 and 1992, the 6-percentage point difference between the highest corporation and individual rates was cut in half. In 1993, the top individual tax rate once again increased, this time to 39.6 percent, and the highest individual tax rate surpassed the highest corporation rate.

Since business income is taxable either at the cor-

Figure A.--Maximum Individual and Corporation Marginal Tax Rates, 1985-1994

Tax system	1985-1986	1987	1988-1990	1991-1992	1993-1994
	(1)	(2)	(3)	(4)	(5)
Individual	50.0	38.5	28.0	31.0	39.6
Corporation	46.0	40.0	34.0	34.0	35.0
Difference between individual and corporation rates	4.0	-1.5	-6.0	-3.0	4.6

Source: The Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, Volume 1, Budget Process and Tax Systems,* Tables 7 and 8, 1995.

porate or individual level (or both), changes in the individual income tax rates have an effect on the taxation of business income. In addition, changes in the tax rates for individuals or corporations may create incentives to switch between a corporate and a noncorporate (or Subchapter S structure) to minimize tax liabilities. Thus, not only is the applicable tax rate schedule (whether corporate or individual) significant for the entity, but also significant are the tax rates for other potential organizational forms. In the period immediately after the passage of TRA86 (1987-1990), the individual marginal rate was clearly lower, and the substantial growth in the sector taxed as individuals (and S Corporations, in particular) has been well documented [13]. In that period, not only did the population of entities "taxed as individuals" grow substantially, but the population of taxable corporations also declined. One study documented the fact that some of this growth in S Corporations was the direct result of taxable corporations reorganizing as S Corporations [14].

With a 50-percent reduction of the tax rate differential beginning in Tax Year 1991, the incentive to switch declined and reversed, beginning with the 39.6-percent individual rate, new for Tax Year 1993. So, with this reversal in incentives, was there a renewed interest in taxable corporation status? Clearly, considerations other than just the tax rate would enter into this decision-making, since each of these legal or organizational types has limitations and restrictions. However, the effective tax rate changes are a powerful influence, particularly for new businesses, as well as those that might satisfy the requirements for more than one type of organizational form. Whether or not such changes did occur is a primary focus of the analysis in the next section.

Analysis of Business Data

In this section, data for the 10-year period (1985-1994) is divided into five subperiods, and changes between the subperiods are examined. These years are: (1) the pre-TRA86 period (1985 and 1986); (2) the initial year of TRA86 (1987); (3) the full phase-in of TRA86 (1988 through 1990); (4) the years of rising individual tax rates and the economic recession (1991 and 1992); and (5) the years of reversal of magnitude of the tax rates and economic expansion (1993 and 1994). On the basis of the tax rates alone, the balance of incentives is tilted toward taxable corporations in periods (1) and (5), and unincorporated business or S Corporation status in periods (2) through (4).

Two re-aggregations were made to the data to focus on the effects of the systems of individual and corporate taxation. Although partnership income is subject to tax at the applicable rates of the partners (that can be individuals, corporations, tax-exempt organizations, or virtually any other legal type), most partners are individuals. In this paper, it is assumed that partnership income is predominately taxed at individual rates. Corporation data, which include all filers of the Form 1120 series, *U.S. Corporation Income Tax Return,* are divided into those taxed at corporate rates and those electing to be taxed through their shareholders at individual tax rates as Subchapter S Corporations (or, simply, S Corporations). Data for S Corporations have been combined with partnership and proprietorship data to create an aggregate of entities "Taxed as individuals." The corporate data that remain are the non-S or taxable corporations, which are referred to in the figures as "Taxed as corporations."

Average annual and percentage changes (which appear in parentheses) between these five periods were compiled and are presented in Figure B for the number of business entities, business receipts, and net income (less deficit) or profits. Since the tax rates are applied to the amount of gains or profits, the effect of rate changes on businesses with or without gains can be substantial. What incentive is there to shift to a lower-taxed organizational type if there are no profits to be taxed? For this reason, businesses taxed as individuals and corporations have been split into those with gains versus those with losses [15].

Number of Entities

In the first part of Figure B, average and percentage changes in the number of businesses are shown for the five periods. Most striking are the large annual increases in the number of businesses taxed as individuals for the entire period. These businesses increased annually by over 400,000, peaking with more than 944,000 new businesses for 1987 alone (6.1 percent). After 1987, indi-

Figure B.--Average Annual and Percentage Changes for the Number of Businesses, Business Receipts, and Net Income (Less Deficit) by System of Taxation, 1985-1994

[Numbers of entities are in thousands, money amounts are in billions of dollars, and percentage changes appear in parentheses]

Tax system	Percentage change from--				
	1985 to 1986	1986 to 1987	1987 to 1990	1990 to 1992	1992 to 1994
	(1)	(2)	(3)	(4)	(5)
	Number of entities				
All businesses:					
Taxed as individuals	555.9	944.2	681.4	427.1	453.0
	(3.8)	(6.1)	(4.0)	(2.3)	(2.4)
Taxed as corporations	49.8	-118.1	-114.2	-29.0	117.5
	(1.9)	(-4.6)	(-4.9)	(-1.4)	(5.3)
Businesses with gains:					
Taxed as individuals	636.2	827.7	509.0	333.8	385.3
	(6.3)	(7.6)	(4.2)	(2.5)	(2.8)
Taxed as corporations	33.6	-89.5	-95.2	-7.0	29.1
	(2.2)	(-6.1)	(-7.5)	(-0.6)	(2.5)
Businesses with losses:					
Taxed as individuals	-80.2	116.5	172.4	93.3	67.7
	(-1.8)	(2.6)	(3.6)	(1.8)	(1.3)
Taxed as corporations	16.3	-28.6	-19.1	-21.9	88.4
	(1.5)	(-2.7)	(-1.8)	(-2.2)	(8.4)
All businesses, adjusted counts:					
Taxed as individuals	555.9	840.2	716.1	427.1	453.0
	(3.8)	(5.5)	(4.3)	(2.3)	(2.4)
Taxed as corporations	49.8	-118.1	-62.1	-26.7	37.0
	(1.9)	(-4.6)	(-2.6)	(-1.2)	(1.6)
	Business receipts				
All businesses:					
Taxed as individuals	101.2	583.7	277.0	113.2	299.5
	(7.4)	(34.6)	(11.6)	(3.9)	(9.0)
Taxed as corporations	180.0	420.7	363.7	77.7	601.5
	(2.3)	(5.2)	(4.1)	(0.8)	(6.0)
Businesses with gains:					
Taxed as individuals	73.8	486.0	186.7	137.8	318.9
	(7.1)	(37.2)	(10.2)	(6.1)	(11.8)
Taxed as corporations	186.7	190.8	287.9	49.2	750.6
	(3.1)	(3.1)	(4.3)	(0.7)	(9.5)
Businesses with losses:					
Taxed as individuals	27.4	97.7	90.3	-24.6	-19.4
	(8.6)	(25.9)	(16.3)	(-3.6)	(-3.1)
Taxed as corporations	-6.7	229.9	75.8	28.5	-149.1
	(-0.4)	(12.1)	(3.6)	(1.3)	(-7.0)
	Net income (less deficit)				
All businesses:					
Taxed as individuals	3.9	42.8	22.0	26.4	39.9
	(5.0)	(52.7)	(17.7)	(13.9)	(16.4)
Taxed as corporations	28.7	42.8	11.4	8.7	73.8
	(12.4)	(16.4)	(3.8)	(2.6)	(20.7)
Businesses with gains:					
Taxed as individuals	17.7	41.8	29.8	14.5	35.4
	(9.0)	(19.5)	(11.6)	(4.2)	(9.4)
Taxed as corporations	42.2	35.3	21.5	3.1	70.9
	(12.3)	(9.2)	(5.1)	(0.6)	(14.4)
Businesses with losses:					
Taxed as individuals	-13.8	1.1	-7.8	11.9	4.5
	(-11.6)	(0.8)	(-5.9)	(7.6)	(3.4)
Taxed as corporations	-13.5	7.5	-10.0	5.6	2.9
	(-12.2)	(6.1)	(-8.6)	(3.8)	(2.1)

NOTE: Data represent the average change between years indicated. Percentage changes (which appear in parentheses) also reflect the appropriate number of years.

vidually-taxed businesses continued to increase in number, though at slower rates. Taxable corporations, on the other hand, declined in number by over 100,000 annually for 1987-1990, nearly 5 percent per year. This rate of decline slowed considerably for 1990-1992 and reversed for 1992-1994, when they once again grew in number.

As might be expected, entities with gains were largely responsible for these overall changes. Nearly 88 percent of the net increase in the number of individually-taxed businesses for 1987 were from those with gains, and businesses with gains dominated the growth of all individually-taxed businesses throughout the period. However, individually-taxed businesses with losses had increases in four of the five periods. The only exception is for the initial period, the change from 1985 to 1986, in which the number of individually-taxed businesses with losses declined by over 80,000 (1.8 percent). This was attributable to a decline in the number of loss-generating proprietorships at a time when proprietorships were experiencing record profits.

Similarly, most of the changes for taxable corporations result from the changes in the number of corporations with gains, except after 1990. Corporations with gains declined in number from 1987 through 1992, though at decreasing rates after 1990. Despite the onset of the 1990-1991 recession, which would have reduced the number of profitable corporations, *ceteris paribus*, declines in the number of taxable corporations with gains fell from 7.5 percent for the 1987-1990 period to only 0.6 percent for 1990-1992. This could be both from the restoration of profitability that occurred in late 1991 and the decline in switching to individually-taxed status as a result of the new 31-percent individual tax rate, which halved the previous rate differential.

The picture of the number of business entity changes is somewhat clearer with two adjustments. First, S Corporations were required to align their accounting periods with their shareholders beginning for Tax Year 1987. Since these shareholders are individuals (by law), S Corporations that were fiscal year filers had to make this change, resulting in two return filings for 1987. It is estimated that there were about 100,000 such returns that were essentially "double-counted" for 1987, and an adjustment was made to remove this double count (although no adjustment was needed for the financial data, which had already been "prorated" for the actual months in the calendar year).

Second, Personal Service Corporations (PSC's) were omitted from the population estimates of taxable corporations for 1987 through 1993. To rectify this shortcoming, an adjustment was made to the entity counts. Unlike the S Corporation duplicate filings for 1987, where the financial data were unaffected, the absence of PSC's affected the financial data as well. However, because these are, by definition, small, taxable corporations, they have a far greater impact on the entity counts than on the financial activity, so no adjustment was made to the latter at this time.

The results of these adjustments are shown as the "All businesses, adjusted counts" in Figure B. For the entities taxed as individuals, these adjustments lessen the peak in growth for 1987, reducing the increase from 6.1 percent to 5.5 percent. Adjusting for the omission of PSC's affects taxable corporations in two ways. First, the decline in the taxable corporation population in the 1987-1990 period is substantially reduced. The rate of decline is decreased from 4.9 percent to 2.6 percent. Second, reintroducing the PSC's in 1994 had caused the population to grow substantially for this period; the 1992-1994 growth was at a 5.3-percent annual rate. Adjusting for this phenomenon reduced the growth in this period to only 1.6 percent.

Business Receipts

Similar data for business receipt changes are also shown in Figure B. These data exhibit some similarities to and differences from data on the number of entity changes. Most striking about this figure is that business receipts increased for all types of entities (individual and corporate, with gains or losses) in virtually all periods. The exceptions to this were only for individually-taxed businesses with losses for 1990-1992 and 1992-1994, and for corporations with losses for 1992-1994. Clearly, the recovery from the recession affected these data.

As for the number of businesses, the rate of receipt growth for individually-taxed businesses peaked for

1987 and continued, though at diminished rates. Growth for individually-taxed business receipts accelerated sharply in the post-recession period (1992-1994), unlike the modest growth exhibited for the number of entities. Entities taxed as corporations still registered steady 4- to 6-percent growth in business receipts in the post-TRA period, despite declining numbers, except for the recession period of 1990-1992.

Business receipts of entities taxed as individuals with gains again dominated the individual data, as they did for the numbers of entities. However, unlike the latter, which were relatively flat in comparison, business receipts of individually-taxed entities with gains increased by over 37 percent for 1987 and grew from 6 to 12 percent through 1994. Even the business receipts of individually-taxed entities with losses grew substantially for 1986-1990.

For taxable corporations, more than half of the overall 5.2-percent increase in business receipts for 1986-1987 was from corporations with losses. This is another indication that profitable corporations were more likely to switch status to take advantage of the lower individual tax rates brought in by TRA86. In the post-recession period, corporations with gains showed nearly a 10-percent increase in business receipts, while those with losses declined.

Net Income (Less Deficit)

Since net income (less deficit) or profits is what is directly taxed, and thereby most affected by the tax rate changes, did they exhibit the most pronounced changes in the direction of the tax rate incentives? Data on changes for net income (less deficit) or profits are also displayed in Figure B. These data do in fact show some of the most substantial changes [15].

The profits of entities taxed as individuals increased by $42.8 billion, or nearly 53 percent, for 1987 alone. Almost all of this was as a result of growth in net income (less deficit) by entities showing gains. Growth in these profits continued at 14 to 18 percent through 1994. Taxable corporations registered an identical $42.8-billion increase for 1986-1987, although this was a smaller percentage increase than for individuals (because of the larger base). Unlike individual entities, however, their rate of change dropped substantially after 1987, but rebounded dramatically in the post-recession period.

The data clearly show a strong swing in the direction of individual taxation in the 1987-1992 period, though at decreasing rates after 1987. This is what would be expected--a shift toward lower-taxed status would begin shortly after enactment of the new tax rates, but the rate of change would slow over time. And this decreasing rate of change was further bolstered by the decline in the tax rate differential that began for 1991. Thus, it is not surprising to see the slower growth in profits of individually-taxed businesses. Beginning with 1993, with the conclusion of the recession, as well as the initiation of the 39.6-percent individual tax rate, the profit picture swung strongly to entities taxed as corporations.

■ Conclusions and Final Thoughts

So what do these data tell us about the developments in organizational choice dynamics in the 1985-1994 period? First, businesses taxed as individuals grew substantially in the post-TRA86 period, both in overall number and in financial activity. This rate of growth peaked for 1987, the first post-TRA86 year, but continued irrespective of the 1990-1991 recession.

Despite declining numbers in the 1987-1992 period, the receipts and profits of taxable corporations still increased. This was because many of the businesses that shifted to S Corporation status were relatively small, thereby causing a larger change in the number of businesses than in financial activity. Corporations exhibited substantially-increased growth in the post-recession, 1992-1994 period, particularly for profits. However, entities taxed as individuals also registered strong increases for this period.

Overall, the relatively lower corporation tax rates appear to have contributed to the corporate sector rebound after 1991. However, the recovery from the 1990-1991 recession has brought about increased profitability of individually-taxed entities as well, somewhat masking the extent of the effects of the tax law changes.

The data in this paper can best be characterized as "the tip of the iceberg," since each study for each year is a statistical compilation of data from literally thousands of tax and information returns, and no attempt was made to link entities changing from one organizational form to another [14]. Still, analysis of trends can provide a useful framework for assessing the relative size of changes over time of the various types, as well as the possible effects of taxation on business organizational structure. The data most significantly show a correlation between changes in the marginal tax rates and the choice of organizational structure. While this does not demonstrate causality, it can provide a framework for insight into the underlying dynamics.

■ Notes and References

[1] Petska, Tom, "Taxes and Organizational Choice: An Analysis of Trends, 1985-1992," *Statistics of Income Bulletin*, Spring 1996, Volume 15, Number 4.

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[3] Petska, Tom and Wilson, Robert, "Trends in Business Structure and Activity, 1980-1990," *Statistics of Income Bulletin*, Spring 1994, Volume 13, Number 4.

[4] Petska, Tom, "The Effects of Tax Reform on the Structure of U.S. Business," *1993 Proceedings of the American Statistical Association, Section on Business and Economic Statistics*, 1994.

[5] The Omnibus Budget Reconciliation Act of 1990 initiated a 31-percent rate for income other than capital gains, effective for Tax Year 1991. The Omnibus Budget Reconciliation Act of 1993 initiated 36- and 39.6-percent rates, effective for Tax Year 1993.

[6] For more details on these major changes to the Internal Revenue Code, see Steuerle, C. Eugene, *The Tax Decade: How Taxes Came to Dominate the Public Agenda*, The Urban Institute, 1991; Pechman, Joseph A., *Federal Tax Policy*, The Brookings Institution, 1987; and Scholes, Myron S. and Wolfson, Mark A., *Taxes and Business Strategy: A Planning Approach*, Prentice-Hall, 1991.

[7] Internal Revenue Service, *Source Book of Statistics of Income, Corporation Income Tax Returns*, 1994, and *Statistics of Income--Corporation Income Tax Returns*, 1994.

[8] See Wittman, Susan M., "S Corporation Returns, 1994," *Statistics of Income Bulletin*, Spring 1997, Volume 16, Number 4.

[9] See Wheeler, Timothy D., "Partnership Returns, 1995," *Statistics of Income Bulletin*, Fall 1997, Volume 17, Number 2.

[10] See Cruciano, Therese, "Sole Proprietorships, 1995," *Statistics of Income Bulletin*, Summer 1997, Volume 17, Number 1.

[11] Data from Schedule F, *Farm Income and Expenses*, were excluded from the annual SOI study of sole proprietorships beginning with Tax Year 1981, so the data base is deficient in this respect.

[12] See, for example, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986;* Internal Revenue Service, *Explanation of the Tax Reform Act of 1986 for Individuals*, Publication 920; and Nelson, Susan and Petska, Tom, "Partnerships, Passive Losses, and Tax Reform," *1989 Proceedings of the American Statistical Association, Section on Survey Research Methods*, 1990.

[13] See for example [1-4].

[14] In this paper, "S Corporation Elections after TRA86," presented at the 1996 American Economic Association Meetings, Amy Gill and Susan Wittman linked S Corporation microdata from before and after TRA86 to assess the impact at the individual entity level.

[15] As with business receipts, efforts were made to construct time series data that were consistent over time. However, some inconsistencies remain. For example, from 1985-1991, net income (less deficit) for S Corporations excludes taxable income (less deficit) from investments, including capital gains and losses. For a more detailed discussion of these issues, see footnote 2 to Table 1 in [3].