SELECTED ISSUES RELATING TO CHOICE OF BUSINESS ENTITY

Scheduled for a Public Hearing
Before the
HOUSE COMMITTEE ON WAYS AND MEANS
on March 7, 2012

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION AND OVERVIEW

The House Committee on Ways and Means has scheduled a public hearing on March 7, 2012, titled "The Treatment of Closely-Held Businesses in the Context of Tax Reform." This document,[1] prepared by the staff of the Joint Committee on Taxation, sets forth data, present Federal tax law, and history, and provides analysis of selected issues relating to taxpayers' choices of business entities.

The first part of this document provides data on passthrough entities and C corporations.[2] The second part of the this document describes present law relating to C corporations along with the types of passthrough entities provided for tax purposes, as well as the current rate structure for individuals and C corporations and the rules relating to social insurance taxes. The second part also provides a chart comparing the features of S corporations[3] and partnerships. The third part of this document provides historical background with respect to business entity classification issues. The fourth part of this document analyzes selected issues relating to choice of business entity.

The vast majority of businesses in the United States are organized for tax purposes as sole proprietorships. In 2009, there were more than 22.6 million nonfarm sole proprietorships out of 33.6 million total business returns. There were approximately 1.7 million C corporations, 1.9 million farms, 3.1 million partnerships, and 4.1 million S corporations. The number of passthrough entities surpassed the number of C corporations in 1987 and has nearly tripled since then, led by growth in small S corporations (those with less than $100,000 in assets) and limited liability companies ("LLCs") taxed as partnerships.

Owners of business enterprises historically have chosen to incorporate a business for various nontax reasons. One reason has been that corporate form generally shields the shareholders from liabilities of the business. Another has been that corporate stock may be issued in public markets for access to capital.

A passthrough entity such as a partnership or S corporation, however, may be preferred for Federal tax reasons. A primary reason is that no Federal income tax normally applies at the entity level in the case of a passthrough entity. Rather, items of income, gain, or loss are taken into account for tax purposes by the partners or S corporation shareholders on their own tax returns. By contrast, a C corporation (which is not a passthrough entity) is taxed separately on its income, and shareholders are taxed separately on distributions by the corporation. Other Federal tax rules may give rise to incentives (or disincentives) to select a particular type of entity through which to conduct a business.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Selected Issues Relating to Choice of Business Entity* (JCX- 20-12), March 5, 2012. This document can be found on our website at www.jct.gov.

[2] A C corporation is so named because its Federal tax treatment is governed by subchapter C of the Internal Revenue Code of 1986, as amended (the "Code").

[3] An S corporation is so named because its Federal tax treatment is governed by subchapter S of the Code.

These incentives have resulted in disputes between the Internal Revenue Service ("IRS" or the "Service") and taxpayers about the proper classification of business entities for Federal tax purposes. Case law and Treasury regulations have addressed whether an entity is properly treated as a C corporation subject to entity-level tax, or as another type of entity such as a partnership.

From the 1950s to 1996, the determination of whether a business entity was a C corporation or a partnership was governed by case law and by 1960 regulations[4] that set forth factors considered indicative of corporate status. These corporate characteristics are (1) continuity of life, (2) centralization of management, (3) limited liability for owners of the entity, and (4) free transferability of interests. An unincorporated entity was classified as a partnership if it lacked any two or more of the four corporate characteristics.[5]

Entity classification issues are not especially relevant to S corporations, passthrough entities which came into being in 1958 Federal tax legislation. S corporation status is open to a domestic corporation, requires an affirmative election, and is subject to specific requirements as to number and nature of shareholders, class of stock, and other characteristics. These features make identification of an entity as an S corporation relatively unambiguous.

In late 1996, the IRS adopted new entity classification regulations known as the check-the-box regulations. These regulations allow tax classification as either a partnership or a corporation to be explicitly elective subject to minimal restrictions for any domestic nonpublicly traded unincorporated entity with two or more members. The check-the-box regulations also provide that a single-member unincorporated entity may be disregarded, that is, treated as not separate from its owner.

The 1996 regulations did not, however, alter the statutory rules enacted in 1987 treating publicly traded partnerships as corporations to address concern about long-term erosion of the corporate tax base. A publicly traded partnership generally is treated as a C corporation for Federal tax purposes, unless 90 percent or more of its gross income is qualifying income.

The existence of two principal categories of business entities with different Federal income tax treatment raises several types of policy questions. What are the effects of individual and corporate income tax rates on taxpayers' choices of business entities? On what basis is it appropriate to distinguish between a C corporation and a passthrough entity for Federal tax purposes? Are there factors that better reflect tax or nontax policy reasons for the distinction between corporations and passthrough entities that are in addition to, or instead of, the present-law statutory and regulatory rules? Would a uniform passthrough regime be simplifying?

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[4] Former Treas. Reg. sec. 301.7701-2. These were known as the Kintner regulations because they were based on the analysis in *U.S. v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

[5] See *Larson v. Commissioner*, 66 T.C. 159 (1976), acq. 1979-2 C.B. 1.

I. DATA ON THE NUMBER AND SIZE OF BUSINESS ENTITIES IN THE UNITED STATES

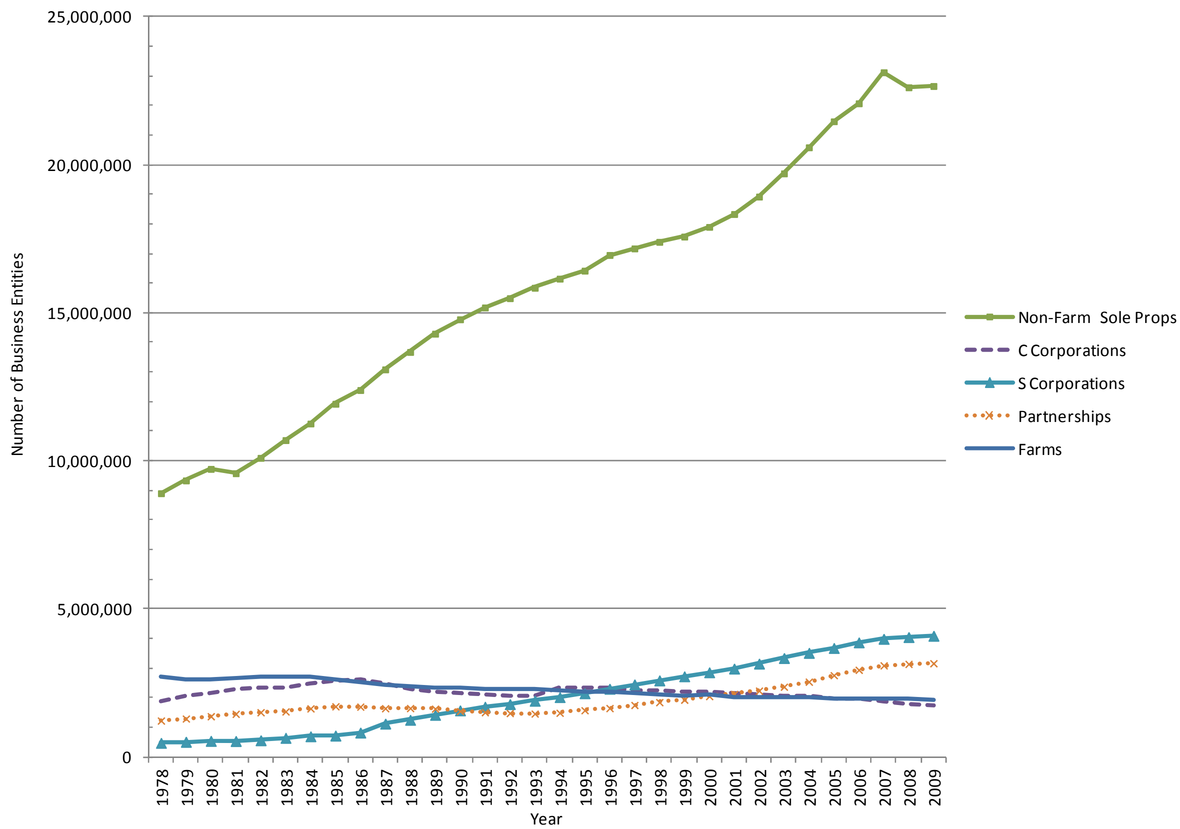
Returns filed by C corporations, S corporations, partnerships, nonfarm sole proprietors, and farming enterprises

For tax purposes, businesses may be organized as various entities including as C corporations, S corporations, partnerships, or sole proprietorships.[6] Throughout the period 1978 to 2009, nonfarm[7] sole proprietorships made up the vast majority of businesses, as shown in Figure 1 and Table 1. The S corporation is the second most prevalent business form. In 2009, S corporations constituted 12.2 percent of all business entities. By contrast, as recently as 1988, S corporations accounted for less than six percent of all business entities. The growth in the number of S corporations was most dramatic immediately following 1986, while the number of C corporations declined each year from 1987 through 1993. After an increase in the number of C corporation returns in the mid-1990s, the number of C corporation returns has again declined each year since 1998. The number of partnership returns filed reached a peak in 1985 and then generally declined until 1993. Since 1993, partnership returns filed and S corporation returns filed have grown at approximately the same rate. As described below, LLCs generally are taxed, at the election of the owners, either as partnerships or as corporations. In the great majority of cases involving U.S. businesses, LLCs are taxed as partnerships. The number of farm returns (that is, individuals operating farms as sole proprietorships and reporting their income on Schedule F of Form 1040) generally declined throughout the period.

[6] The IRS's Statistics of Income division ("SOI") tabulates the number of tax returns filed by different forms of business organizations. These data are based upon returns filed by individuals and entities. The numbers reported for nonfarm sole proprietorships and for farm returns are based upon the number of taxpayers who file a business return as a sole proprietor (Schedule C of Form 1040) and who file a farm income return (Schedule F of Form 1040). One taxpayer may report more than one business organized as a sole proprietorship; in that circumstance, the data reported here count only one sole proprietorship per taxpayer. On the other hand, the data for C corporations, S corporations, and partnerships count the number of tax returns and information returns filed by C corporations, S corporations, and partnerships. One taxpayer may own more than one corporation. When this occurs, unlike the case in sole proprietorships, the data reported here count each corporation as a separate entity. Two (or more) corporations can also form a partnership. Thus, the data are not perfectly comparable across entity classification.

[7] In these data, farms are measured solely by reference to those individuals who report income (or loss) on Schedule F of Form 1040. Other individuals engaged in agricultural enterprises may conduct their farm business through a separate legal entity. When this occurs, the data reported below report that entity among the totals of C corporations, S corporations, or partnerships.

Figure 1.−Number of Different Types of Business Returns, 1978-2009



Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

Table 1.—Number of Different Types of Business Returns, 1978-2009

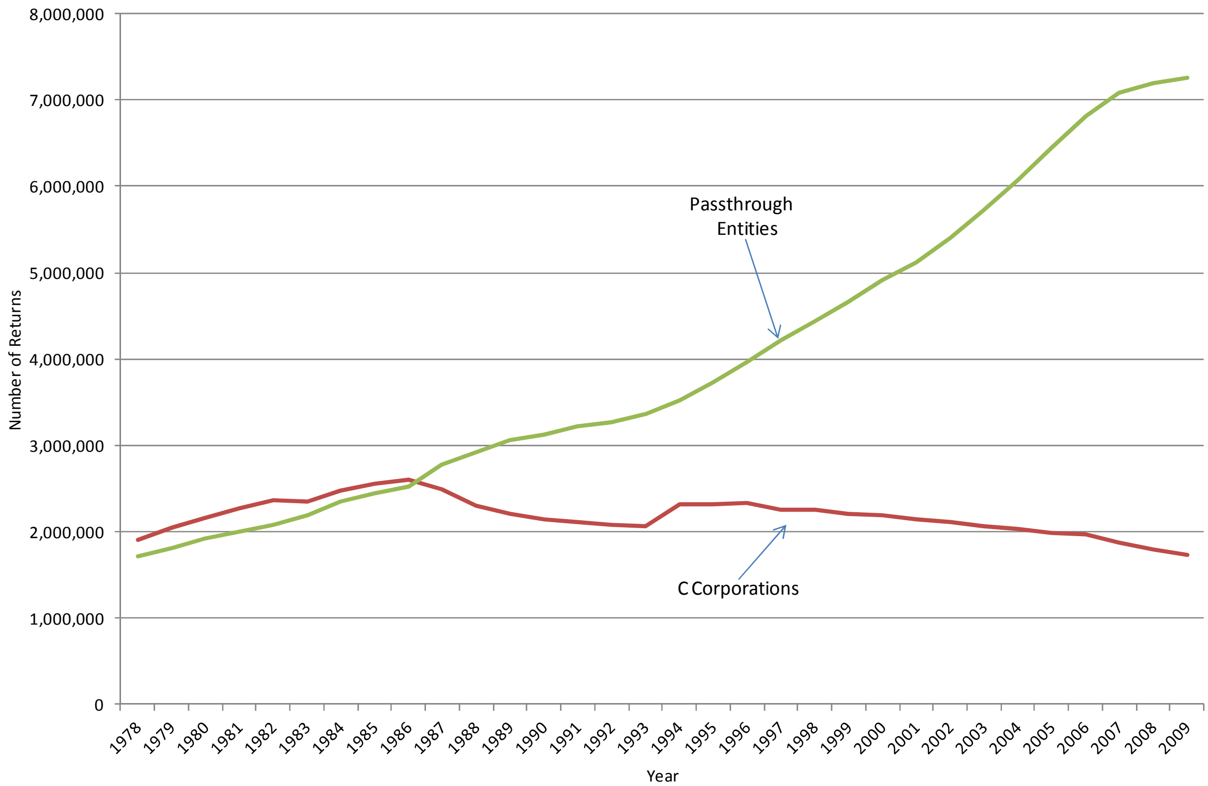
Year	Non-Farm Sole Props	C Corporations	S Corporations	Partnerships	Farms	Total
1978	8,908,289	1,898,100	478,679	1,234,157	2,704,794	15,224,019
1979	9,343,603	2,041,887	514,907	1,299,593	2,605,684	15,805,674
1980	9,730,019	2,165,149	545,389	1,379,654	2,608,430	16,428,641
1981	9,584,790	2,270,931	541,489	1,460,502	2,641,254	16,498,966
1982	10,105,515	2,361,714	564,219	1,514,212	2,689,237	17,234,897
1983	10,703,921	2,350,804	648,267	1,541,539	2,710,044	17,954,575
1984	11,262,390	2,469,404	701,339	1,643,581	2,694,420	18,771,134
1985	11,928,573	2,552,470	724,749	1,713,603	2,620,861	19,540,256
1986	12,393,700	2,602,301	826,214	1,702,952	2,524,331	20,049,498
1987	13,091,132	2,484,228	1,127,905	1,648,035	2,420,186	20,771,486
1988	13,679,302	2,305,598	1,257,191	1,654,245	2,367,527	21,263,863
1989	14,297,558	2,204,896	1,422,967	1,635,164	2,359,718	21,920,303
1990	14,782,738	2,141,558	1,575,092	1,553,529	2,321,153	22,374,070
1991	15,180,722	2,105,200	1,696,927	1,515,345	2,290,908	22,789,102
1992	15,495,419	2,083,652	1,785,371	1,484,752	2,288,218	23,137,412
1993	15,848,119	2,063,124	1,901,505	1,467,567	2,272,407	23,552,722
1994	16,153,871	2,318,614	2,023,754	1,493,963	2,242,324	24,232,526
1995	16,423,872	2,321,048	2,153,119	1,580,900	2,219,244	24,698,183
1996	16,955,023	2,326,954	2,304,416	1,654,256	2,188,025	25,428,674
1997	17,176,486	2,257,829	2,452,254	1,758,627	2,160,954	25,806,150
1998	17,398,440	2,260,757	2,588,081	1,855,348	2,091,845	26,194,471
1999	17,575,643	2,210,129	2,725,775	1,936,919	2,067,883	26,516,349
2000	17,902,791	2,184,795	2,860,478	2,057,500	2,086,789	27,092,353
2001	18,338,190	2,149,105	2,986,486	2,132,117	2,006,871	27,612,769
2002	18,925,517	2,112,230	3,154,377	2,242,169	1,995,072	28,429,365
2003	19,710,079	2,059,631	3,341,606	2,375,375	1,997,116	29,483,807
2004	20,590,691	2,039,631	3,518,334	2,546,877	2,004,898	30,700,431
2005	21,467,566	1,987,171	3,684,086	2,763,625	1,981,249	31,883,697
2006	22,074,953	1,968,032	3,872,766	2,947,116	1,958,273	32,821,140
2007	23,122,698	1,878,956	3,989,893	3,096,334	1,989,690	34,077,571
2008	22,614,483	1,797,278	4,049,943	3,146,006	1,948,054	33,555,764
2009	22,659,976	1,729,984	4,094,562	3,168,728	1,924,214	33,577,464

Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

C corporations, S corporations, and partnerships (including LLCs) are the most common entity choices for business ventures, both new ventures and the re-organization of existing ventures. The major tax difference among them is that business ventures organized as C corporations are subject to tax at the entity level, with the owners subject to tax on subsequent distributions of income from the C corporation, while ventures organized as S corporations and partnerships are not subject to tax at the entity level. The income of S corporations and partnerships passes through to the owner or partner in whose hands it is subject to tax.

Figure 2, below, reports the trend over the past 32 years of the number of C corporation returns filed compared to the sum of S corporation and partnership returns.[8] 1986 was the last year in which the number of C corporation returns exceeded the number of returns from passthrough legal entities. As Figure 2 reports, while the number of C corporations has generally declined in the United States since 1986 by a third, the number of passthrough entities has nearly tripled.

Figure 2.–Number of C Corporation Returns Compared to the Sum of S Corporation and Partnership Returns, 1978-2009

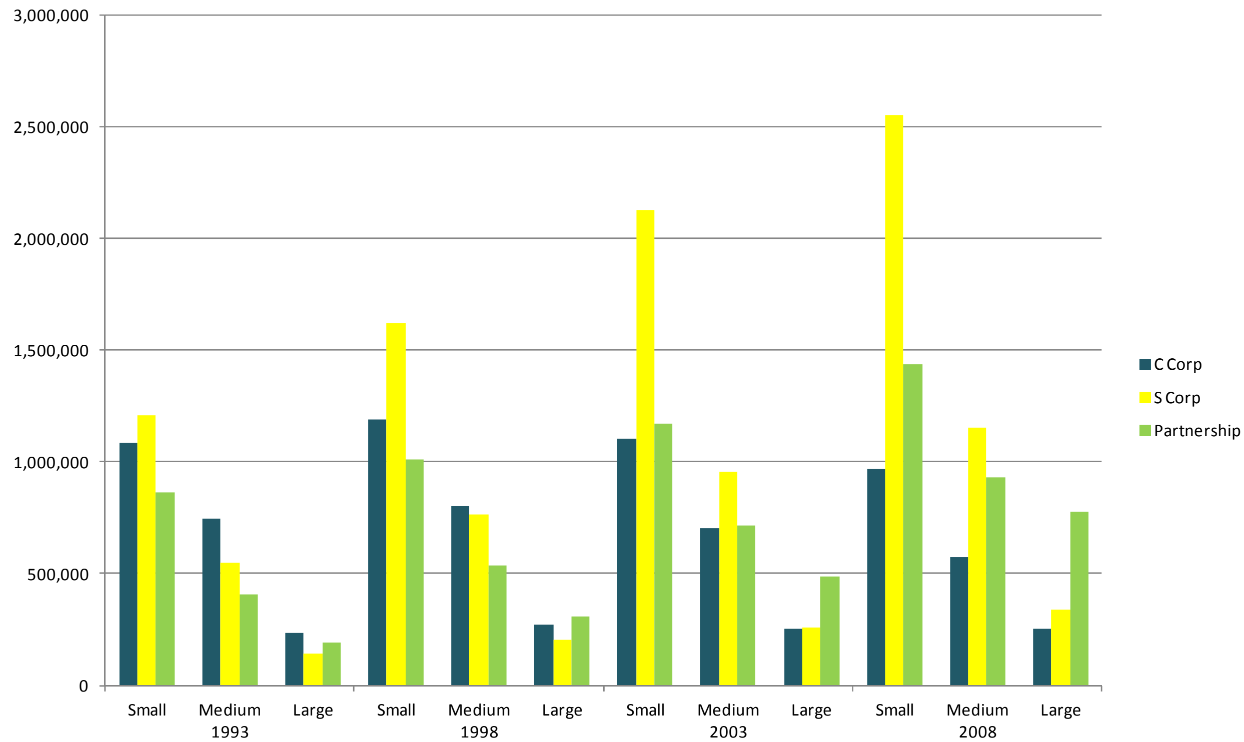


Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

[8] The data reported in this section comparing C corporations and partnerships are derived from entity-level returns filed with the Internal Revenue Service. Some partnerships are partnerships of C corporations, some are partnerships of other partnerships, and some are partnerships of individuals and C corporations or other partnerships. For this reason subsequent comparisons based either on asset size or gross receipt size includes some double counting of assets or gross receipts as such items would be passed through to the returns of a C corporation partner or partnership partner.

Figure 3, below, reports the number of entities filing returns in 1993, 1998, 2003, and 2008, classified by asset size. The various business entities are grouped into those with less than \$100,000 in assets (labeled "small" entities in Figure 3), those with between \$100,000 and \$1 million in assets (labeled "medium" entities in Figure 3), and those with more than \$1 million in assets (labeled "large" entities in Figure 3). As Figure 3 reports, there were fewer C corporations classified as "small" or "medium" in 2008 than in 1993, and there were slightly more classified as "large." At the same time, the number of S corporations in all size classes grew substantially in each year. Likewise, the number of entities filing returns as partnerships (including LLCs) grew substantially each year. The greatest growth in numbers of entities was among "small" S corporations, those with less than \$100,000 in assets. The number of small S corporations more than doubled between 1993 and 2008, increasing by more than 1.3 million entities. The number of "small" C corporations, those with assets less than \$100,000, fell by approximately 110,000 over the same period.

Figure 3.–The Number of Small, Medium, and Large Business Entities by Type of Legal Entity, 1993, 1998, 2003, and 2008



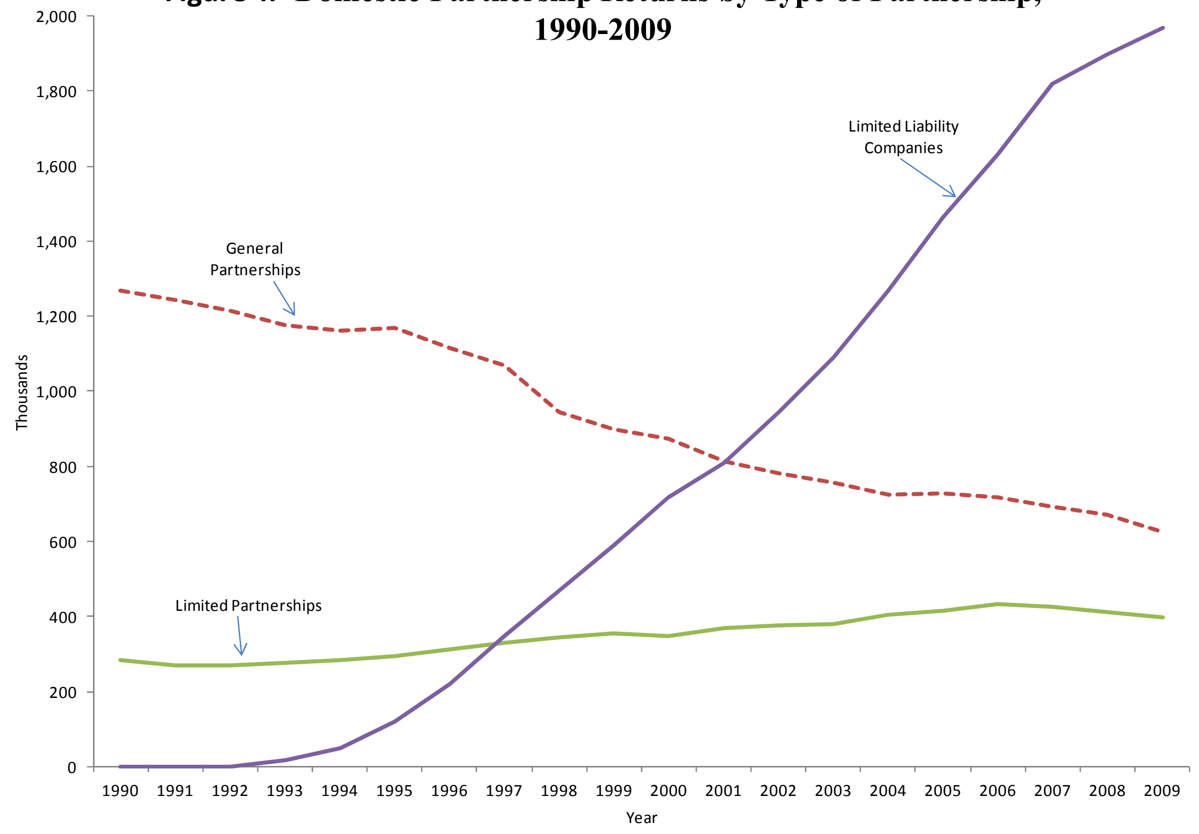
For this purpose, small businesses are those with less than \$100,000 in assets; medium businesses have between \$100,000 and \$1 million in assets; and, large businesses have more than \$1 million in assets.

Source: Joint Committee on Taxation calculations on SOI data.

The growth of limited liability companies

The use of the LLC as an entity is primarily a development of the past 20 years. Most LLCs elect to be taxed as partnerships for Federal reporting purposes and their numbers are counted among the partnership data reported in Table 1 and Figures 1, 2, and 3 above. Figure 4, below, decomposes the number of partnerships for the period 1990 through 2009 into general partnerships, limited partnerships, and LLCs.[9] Figure 4 documents the rapid growth of LLCs relative to other forms of business organization that are taxed as partnerships over the past several years.[10] Since 1996, LLCs have grown at a rate of approximately 18 percent per year. In addition to reporting numbers of general partnerships, limited partnerships, and LLCs, Table 2 provides information on the number of limited liability partnerships and foreign partnerships filing partnership returns.

Figure 4.—Domestic Partnership Returns by Type of Partnership, 1990-2009



Source: Bill Pratt, "Partnership Returns, 2000," *SOI Bulletin*, 22, Fall 2002, and Nina Shumofsky and Lauren Lee, "Partnership Returns, 2009," *SOI Bulletin*, 31, Fall 2011.

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[9] The data in Table 2 may not sum to the total number of partnerships reported in Table 1 because of rounding. Also, this decomposition excludes those businesses that checked the "other" box on Form 1065, Schedule B, line 1. See, Alan Zempel, "Partnership Returns, 1998," *SOI Bulletin*, 20, Fall 2000, and Nina Shumofsky and Lauren Lee, "Partnership Returns, 2009," *SOI Bulletin*, 31, Fall 2011.

[10] For ease of exposition, Figure 4 does not include domestic limited liability partnerships and foreign partnerships.

Table 2.–Number of Partnership Returns by Type, 1990-2009

Year	Type of Partnership					
	Domestic General Partnerships (thousands)	Domestic Limited Partnerships (thousands)	Domestic Limited Liability Companies (thousands)	Domestic Limited Liability Partnerships (thousands)	Foreign Partnerships (thousands)	Other Partnerships (thousands)
1990	1,267	285	n.a.	n.a.	n.a.	n.a.
1991	1,245	271	n.a.	n.a.	n.a.	n.a.
1992	1,214	271	n.a.	n.a.	n.a.	n.a.
1993	1,176	275	17	n.a.	n.a.	n.a.
1994	1,163	283	48	n.a.	n.a.	n.a.
1995	1,167	295	119	n.a.	n.a.	n.a.
1996	1,116	311	221	n.a.	n.a.	5
1997	1,069	329	349	n.a.	n.a.	13
1998	945	343	470	26	n.a.	71
1999	898	354	589	42	n.a.	52
2000	872	349	719	53	3	61
2001	815	369	809	69	5	65
2002	780	377	946	78	3	58
2003	757	379	1,092	88	3	55
2004	725	403	1,270	89	4	56
2005	729	414	1,465	100	5	50
2006	718	433	1,630	109	7	50
2007	694	426	1,819	110	8	40
2008	670	412	1,898	122	11	33
2009	624	397	1,969	118	12	48

n.a. - not available

Source: Bill Pratt, "Partnership Returns, 2000," *SOI Bulletin*, 22, Fall 2002, and Nina Shumofsky and Lauren Lee, "Partnership Returns, 2009," *SOI Bulletin*, 31, Fall 2011.

Size distribution of C corporations, S corporations, partnerships, and nonfarm sole proprietorships

Present law does not impose a limit on the size of a business that is conducted in the form of a sole proprietorship, a partnership, or an S corporation, there is no legal requirement of any correspondence between the size of the business and the form of business organization. While many small businesses are organized as a sole proprietorship, a partnership, or an S corporation, not all businesses organized in those forms are small, and not all businesses organized as C corporations are large. One can use SOI data on assets and total receipts to measure the size of businesses to sort out how small businesses are arrayed across the different forms of organization.

Tables 3 through 6 display 2009 SOI data on C corporations, S corporations, entities taxed as partnerships (which category includes most LLCs), and nonfarm sole proprietorships. For the first three forms of organization, the tables classify all taxpayers using that form of organization both by the size of assets and total receipts.[11] For sole proprietorships (Table 6), there is no tax data on assets, so the table uses only total receipts as a classifier. When businesses are classified by asset size, one can see that there are a significant number of C corporations of small size. More than 750,000 C corporations have assets under $50,000, approximately 45 percent of the total number of C corporations. For S corporations, approximately one-half have assets under $50,000.

The concentration of assets differs among the three entity forms. C corporations have the largest disparity in asset holding. Firms with over $100 million in assets, which represent slightly more than one percent of all C corporations, hold more than 97 percent of all assets owned by C corporations. By comparison, partnerships with $100 million or more in assets constitute 0.6 percent of all entities classified for tax purposes as partnerships; these businesses own only 72 percent of all assets owned by partnerships. S corporations with $100 million or more in assets constitute only 0.08 percent of all S corporations and account for 36 percent of all assets owned by S corporations.

When businesses are classified by total receipts, a picture emerges that is similar to that seen in the asset data. There are a substantial number of relatively small C corporations: more than 430,000 corporations report total receipts of $25,000 or less, approximately 25 percent of the total number of C corporations. However, across the other forms of organization there are higher percentages of businesses with small amounts of total receipts. For nonfarm sole proprietorships, 71 percent have total receipts of $25,000 or less. For S corporations, 26 percent report total receipts of $25,000 or less.

As with assets, the dispersion of total receipts across the classifications is more skewed for C corporations and entities taxed as partnerships than for S corporations. C corporations with over $50 million in total receipts, which represent approximately 1 percent of all C corporations, collect 88 percent of total receipts of all C corporations. For partnerships, the approximately 0.2 percent of partnerships with total receipts in excess of $50 million report 67 percent of all partnership total receipts. For S corporations, 0.3 percent of S corporations with total receipts in excess of $50 million report 35 percent of S corporation total receipts. For nonfarm sole proprietorships, less than 0.002 percent of such businesses report total receipts in excess of $50 million, and these businesses report about 6 percent of all nonfarm sole proprietorship total receipts.

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[11] Total receipts are used in lieu of business receipts to classify statistics for finance and insurance and management of companies (holding companies) sectors. Total receipts may be negative due to the addition of negative items (*e.g.*, net capital losses) to business receipts. Total assets may also be negative if, for example, balance sheet assets reflect depreciation of assets held in a lower tier partnership. This could occur if the balance sheet were prepared using tax accounting rather than generally accepted accounting principles. For example, a partnership may hold an interest in lower tier partnership that in turn holds leveraged assets that have been depreciated for Federal tax purposes. The depreciated basis of the assets may be less than debt encumbering the assets. In some cases this could be reflected as a negative asset value for the underlying partnership interest.

Table 3.–Distribution of C Corporations, 2009

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent: Returns	Cumulative Percent: Total Assets
$0 or less	273,508	0	15.81%	0.00%
$1 to $25,000	358,996	2,539	36.56%	0.00%
$25,001 to $50,000	133,066	4,441	44.25%	0.01%
$50,001 to $100,000	171,749	11,387	54.18%	0.04%
$100,001 to $250,000	249,277	39,079	68.59%	0.09%
$250,001 to $500,000	172,074	61,066	78.54%	0.17%
$500,001 to $1,000,000	132,701	93,489	86.21%	0.30%
$1,000,001 to $10,000,000	182,946	519,705	96.78%	1.01%
$10,000,001 to $50,000,000	28,247	624,593	98.42%	1.87%
$50,000,001 to $100,000,000	6,933	495,061	98.82%	2.55%
More than $100,000,000	20,486	70,873,560	100.00%	100.00%
All Assets	1,729,984	72,724,918		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent: Returns	Cumulative Percent: Total Receipts
$0 or less	212,661	-6,168	12.29%	-0.03%
$1 to $2,500	52,513	54	15.33%	-0.03%
$2,501 to $5,000	24,980	91	16.77%	-0.03%
$5,001 to $10,000	39,714	297	19.07%	-0.03%
$10,001 to $25,000	104,929	1,763	25.13%	-0.02%
$25,001 to $50,000	109,726	4,016	31.48%	0.00%
$50,001 to $100,000	156,939	11,667	40.55%	0.06%
$100,001 to $250,000	253,996	42,299	55.23%	0.29%
$250,001 to $500,000	210,442	75,508	67.39%	0.70%
$500,001 to $1,000,000	191,447	137,633	78.46%	1.45%
$1,000,001 to $10,000,000	309,111	911,390	96.33%	6.43%
$10,000,001 to $50,000,000	46,291	961,365	99.00%	11.68%
More than $50,000,000	17,235	16,156,703	100.00%	100.00%
All Receipts	1,729,984	18,296,619		

* Details do not add to totals due to rounding.

Source: JCT calculations on SOI data.

Table 4.–Distribution of S Corporations, 2009

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent: Returns	Cumulative Percent: Total Assets
$0 or less	721,280	0	17.62%	0.00%
$1 to $25,000	1,070,730	8,087	43.77%	0.25%
$25,001 to $50,000	402,560	13,368	53.60%	0.66%
$50,001 to $100,000	453,838	30,977	64.68%	1.62%
$100,001 to $250,000	538,828	84,182	77.84%	4.22%
$250,001 to $500,000	338,801	120,234	86.12%	7.93%
$500,001 to $1,000,000	238,242	167,096	91.93%	13.09%
$1,000,001 to $10,000,000	293,809	819,687	99.11%	38.39%
$10,000,001 to $50,000,000	29,731	583,507	99.84%	56.40%
$50,000,001 to $100,000,000	3,452	239,129	99.92%	63.78%
More than $100,000,000	3,291	1,173,835	100.00%	100.00%
All Assets	4,094,562	3,240,101		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent: Returns	Cumulative Percent: Total Receipts
$0 or less	584,057	-4,115	14.26%	-0.08%
$1 to $2,500	114,489	126	17.06%	-0.08%
$2,501 to $5,000	63,932	242	18.62%	-0.08%
$5,001 to $10,000	86,784	638	20.74%	-0.07%
$10,001 to $25,000	217,025	3,724	26.04%	0.00%
$25,001 to $50,000	289,109	10,682	33.10%	0.20%
$50,001 to $100,000	419,156	30,532	43.34%	0.77%
$100,001 to $250,000	725,174	118,776	61.05%	3.00%
$250,001 to $500,000	523,936	186,097	73.85%	6.50%
$500,001 to $1,000,000	449,734	315,748	84.83%	12.44%
$1,000,001 to $10,000,000	543,884	1,489,185	98.11%	40.45%
$10,000,001 to $50,000,000	65,093	1,308,125	99.70%	65.05%
More than $50,000,000	12,190	1,857,146	100.00%	100.00%
All Receipts	4,094,562	5,316,907		

* Details do not add to totals due to rounding.

Source: JCT calculations on SOI data.

Table 5.–Distribution of Partnerships, 2009

Firms classified by assets	Number of Returns	Total Assets (millions)	Cumulative Percent: Returns	Cumulative Percent: Total Assets
$0 or less	854,745	-90,869	26.97%	-0.48%
$1 to $25,000	319,891	2,454	37.07%	-0.47%
$25,001 to $50,000	109,858	4,162	40.54%	-0.45%
$50,001 to $100,000	183,970	13,768	46.34%	-0.38%
$100,001 to $250,000	319,220	52,979	56.42%	-0.10%
$250,001 to $500,000	307,309	110,621	66.11%	0.49%
$500,001 to $1,000,000	300,295	215,111	75.59%	1.63%
$1,000,001 to $10,000,000	645,051	1,957,948	95.95%	12.05%
$10,000,001 to $50,000,000	95,770	1,961,332	98.97%	22.48%
$50,000,001 to $100,000,000	14,079	984,921	99.41%	27.72%
More than $100,000,000	18,542	13,585,680	100.00%	100.00%
All Assets	3,168,728	18,798,108		

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent: Returns	Cumulative Percent: Total Receipts
$0 or less	1,973,890	0	62.29%	0.00%
$1 to $2,500	62,591	57	64.27%	0.00%
$2,501 to $5,000	20,996	75	64.93%	0.00%
$5,001 to $10,000	63,494	484	66.93%	0.01%
$10,001 to $25,000	130,282	2,272	71.05%	0.07%
$25,001 to $50,000	116,689	4,245	74.73%	0.19%
$50,001 to $100,000	137,478	10,017	79.07%	0.47%
$100,001 to $250,000	206,261	34,941	85.58%	1.44%
$250,001 to $500,000	132,726	46,624	89.77%	2.73%
$500,001 to $1,000,000	117,055	84,098	93.46%	5.05%
$1,000,001 to $10,000,000	176,841	511,822	99.04%	19.19%
$10,000,001 to $50,000,000	23,394	485,349	99.78%	32.60%
More than $50,000,000	7,029	2,439,579	100.00%	100.00%
All Receipts	3,168,728	3,619,564		

* Details do not add to totals due to rounding.

Source: JCT calculations on SOI data.

Table 6.–Distribution of Nonfarm Sole Proprietorships, 2009

Firms classified by receipts	Number of Returns	Total Receipts (millions)	Cumulative Percent: Returns	Cumulative Percent: Total Receipts
$0 or less	1,160,757	0	5.12%	0.00%
$1 to $2,500	4,566,536	5,318	25.27%	0.45%
$2,501 to $5,000	2,478,730	9,045	36.21%	1.21%
$5,001 to $10,000	3,169,563	23,276	50.20%	3.17%
$10,001 to $25,000	4,665,300	74,641	70.79%	9.47%
$25,001 to $50,000	2,688,913	95,642	82.66%	17.53%
$50,001 to $100,000	1,794,080	126,706	90.57%	28.21%
$100,001 to $250,000	1,358,320	207,083	96.57%	45.67%
$250,001 to $500,000	454,209	159,027	98.57%	59.07%
$500,001 to $1,000,000	207,854	140,939	99.49%	70.96%
$1,000,001 to $10,000,000	112,712	227,087	99.99%	90.10%
$10,000,001 to $50,000,000	2,606	45,756	100.00%[1]	93.96%
More than $50,000,000	395	71,685	100.00%	100.00%
All Receipts	22,659,976	1,186,205		

* Details do not add to totals due to rounding.

[1] The actual figure is 99.9983 percent which rounds to 100.00 percent.

Source: JCT calculations on SOI data.

Distribution of C corporations, S corporations, and partnerships by primary business activity

Taxpayers filing returns as C corporations, S corporations, and partnerships are asked to self-report the primary industry in which the business operates. Table 7, below, reports the distribution of entities by number of returns and by assets across various industry classifications. Distributing by number of returns, for C corporations, the three most prevalent industries are services, retail trade, and construction. These three industries account for approximately 33 percent of all C corporations. For S corporations, the three most prevalent industries are services, construction, and real estate. These three industries account for approximately 41 percent of all S corporations. For entities taxed as partnerships, the three most prevalent industries are real estate, finance and insurance, and services. These three industries account for approximately 64 percent of all partnerships.

Distributing by assets, for C corporations, the three largest industries are finance and insurance, holding companies, and manufacturing. These three industries account for more than 83 percent of all assets reported by all C corporations. For S corporations, the three largest industries are holding companies, construction, and manufacturing. These three industries account for 37 percent of all assets reported by all S corporations. For partnerships, the two largest industries by far are finance and insurance and real estate, followed by manufacturing at a distant third. These three industries account for more than 81 percent of all assets reported on all partnership returns.

Table 7.–Distribution of Certain Business Entities and Assets by Industry, 2009

Industry	C Corporations		S Corporations		Partnerships	
	Percent of Returns	Percent of Total Assets	Percent of Returns	Percent of Total Assets	Percent of Returns	Percent of Total Assets
Agriculture	3.06	0.09	2.10	2.20	4.10	0.90
Mining	0.77	1.16	0.61	1.62	1.01	1.68
Utilities	0.22	2.13	0.05	0.18	0.19	1.33
Construction	10.25	0.42	13.80	11.45	5.72	1.34
Manufacturing	5.69	13.94	3.94	11.20	1.41	3.82
Wholesale Trade	8.27	2.30	5.69	9.92	1.72	1.02
Retail Trade	10.80	2.07	10.01	9.70	5.58	0.70
Wholesale and Retail Trade Not Allocable	0.04	0.00	0.00	0.00	0.00	0.00
Transportation and Warehousing	3.89	0.84	3.13	2.52	1.60	1.24
Information	2.52	3.24	1.78	1.88	1.35	3.35
Finance and Insurance	4.90	45.80	3.79	10.66	9.88	54.36
Real Estate and Rental and Leasing	10.25	1.49	11.47	10.83	48.10	23.71
Professional, Scientific, and Technical Services	12.31	0.97	15.92	3.99	5.97	0.98
Holding Companies	1.35	24.08	0.59	14.39	0.54	2.74
Administrative and Support and Waste Management and Remediation Services	4.10	0.33	4.96	1.76	2.35	0.30
Educational Services	0.80	0.06	1.01	0.28	0.35	0.02
Health Care and Social Services	7.15	0.35	7.46	1.93	2.20	0.66
Arts, Entertainment, and Recreation	1.87	0.10	2.19	1.07	1.84	0.46
Accommodation and Food Services	4.40	0.51	5.42	3.16	3.57	1.28
Other Services	7.33	0.10	6.07	1.26	2.33	0.11
Not Allocable	0.02	0.00	0.00	0.00	0.18	0.00
Total[1]	1,729,984	72,724,918	4,094,562	3,240,101	3,168,728	18,798,108

[1] The totals show the actual numbers of returns in the 'Percent of Returns' columns and the total assets in millions of dollars for the Percent of Total Assets' columns.

* Details do not add to 100 percent due to rounding.

Source: JCT calculations on SOI data.

Distribution of income by entity type and entity size

On average, in any given year, relatively smaller businesses are more likely to operate at a loss. Tables 8 and 9 below classify businesses by size of their reported total receipts. The tables report the aggregate income, or loss, reported within a class by entity type. Tables 8a and 8b report results for S corporations, partnerships, and sole proprietorships while Tables 9a and 9b report results for C corporations. Tables 8 and 9 are not directly comparable because the net income of C corporations may include investment income (*e.g.*, interest income) while S corporations and partnership returns generally provide that investment income be reported separately on the owner's or partner's individual income tax return. Similarly, investment income of the owner of a sole proprietorship is not reported as part of schedule C of Form 1040.

Table 8a reports that in 2009, on average, S corporations and partnerships reporting $50,000 or fewer in total receipts operated at a loss. Consistent with these data, Table 8b reports that among S corporations and partnerships reporting $25,000 or fewer in total receipts more than 50 percent of such entities operated at a loss in 2009. Nonfarm sole proprietorships more consistently reported profits at all size classes but the very smallest, those with $5,000 or fewer in total receipts.

Tables 9a and 9b report similar results for C corporations. Overall, half of all C corporations reported net operating losses in 2009. For C corporations reporting $100,000 or fewer in total receipts, 50 percent or more reported net operating losses in 2009. In contrast to comparably sized S corporations and partnerships, 36 to 47 percent of C corporations reporting total receipts between $100,000 and $10 million reported net operating losses, and the losses were of sufficient magnitude that aggregate C corporate income in those size categories was a loss. Less than a third of the largest C corporations reported losses.

Table 8a.–Distribution of Net Income by Gross Receipts and Entity Type, 2009

	Net Income (millions of dollars)		
Firms classified by receipts	S Corporations	Partnerships	Nonfarm Sole Proprietorships
$0 or less	-7,377	-50,546	-11,616
$1 to $2,500	-1,099	-1,491	-6,374
$2,501 to $5,000	-688	-353	-237
$5,001 to $10,000	-799	-1,165	6,926
$10,001 to $25,000	-1,738	-1,960	32,379
$25,001 to $50,000	-24	-2,128	34,619
$50,001 to $100,000	2,597	-1,717	42,722
$100,001 to $250,000	10,357	-333	59,453
$250,001 to $500,000	12,790	-1,476	36,827
$500,001 to $1,000,000	18,213	-584	24,574
$1,000,001 to $10,000,000	70,924	12,389	22,589
$10,000,001 to $50,000,000	51,109	17,673	2,204
More than $50,000,000	66,623	169,504	757
All Receipts	220,889	137,813	244,822

Table 8b.–Percent of Firms with a Net Operating Loss by Gross Receipts and Entity Type, 2009

Firms classified by receipts	S Corporations	Partnerships	Nonfarm Sole Proprietorships
$0 or less	57	36	82
$1 to $2,500	78	81	39
$2,501 to $5,000	66	66	29
$5,001 to $10,000	63	67	22
$10,001 to $25,000	53	59	14
$25,001 to $50,000	38	52	12
$50,001 to $100,000	30	42	10
$100,001 to $250,000	30	37	12
$250,001 to $500,000	29	40	12
$500,001 to $1,000,000	29	36	13
$1,000,001 to $10,000,000	27	33	16
$10,000,001 to $50,000,000	23	32	29
More than $50,000,000	20	27	66
All Receipts	37	33	25

* Details do not add to totals due to rounding.

Source: JCT calculations on SOI data.

Table 9a.–Distribution of Net Income by Gross Receipts of C Corporations, 2009

Firms classified by receipts	Net Income (millions of dollars)
$0 or less	-8,609
$1 to $2,500	-1,687
$2,501 to $5,000	-756
$5,001 to $10,000	-1,137
$10,001 to $25,000	-1,555
$25,001 to $50,000	-2,157
$50,001 to $100,000	-2,346
$100,001 to $250,000	-4,067
$250,001 to $500,000	-3,744
$500,001 to $1,000,000	-5,987
$1,000,001 to $10,000,000	-14,990
$10,000,001 to $50,000,000	15,416
More than $50,000,000	729,684
All Receipts	698,064

Table 9b.–Percent of C Corporations with a Net Operating Loss by Gross Receipts, 2009

Firms classified by receipts	C Corporations
$0 or less	75
$1 to $2,500	71
$2,501 to $5,000	64
$5,001 to $10,000	55
$10,001 to $25,000	57
$25,001 to $50,000	56
$50,001 to $100,000	51
$100,001 to $250,000	47
$250,001 to $500,000	46
$500,001 to $1,000,000	43
$1,000,001 to $10,000,000	36
$10,000,001 to $50,000,000	31
More than $50,000,000	32
All Receipts	50

* Details do not add to totals due to rounding.

Source: JCT calculations on SOI data.

II. PRESENT LAW

A. Choice of Business Entity

1. C corporations

In general

A C corporation is subject to Federal income tax as an entity separate from its shareholders. A C corporation's income generally is taxed when earned at the corporate level and is taxed again at the individual level when distributed as dividends[12] to its shareholders. Corporate deductions and credits reduce only corporate income (and corporate income taxes) and are not passed directly through to shareholders.

Corporate income that is not distributed to shareholders generally is subject to current tax at the corporate level only. To the extent that income retained at the corporate level is reflected in an increased share value, the shareholder may be taxed at capital gains rates upon sale or exchange (including certain redemptions) of the stock or upon liquidation of the corporation.[13] Foreign investors generally are exempt from U.S. income tax on capital gains, but are subject to withholding tax on dividends. Tax-exempt investors generally are not subject to tax on corporate distributions or on sales or exchanges of corporate stock.

The gain on appreciated corporate assets generally is subject to corporate level tax if the assets are distributed to the shareholders, yielding the same tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders.

Deductible and nondeductible payments

In general, amounts paid as reasonable compensation to shareholders who are also employees are deductible by the corporation,[14] and are taxed as ordinary income at the individual level (unless a specific exclusion applies). On the other hand, amounts paid as dividends to shareholders generally are not deductible by the corporation and are taxed as income to the shareholders (generally at the same preferential rates as apply to capital gains, for dividends

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[12] Distributions with respect to stock that exceed corporate earnings and profits are not taxed as dividend income to shareholders but are treated as a tax-free return of capital that reduces the shareholder's basis in the stock. Distributions in excess of corporate earnings and profits that exceed a shareholder's basis in the stock are treated as amounts received in exchange for the stock which, in general, are taxed to the shareholder at capital gains rates. Sec. 301(c).

[13] If stock is held until the death of the shareholder, the heirs are given a fair market value basis in the stock at death, resulting in no shareholder level income tax on appreciation prior to death if the heirs sell the stock to a third party, or receive corporate distributions in the form of a redemption (*i.e.*, a sale of their stock to the corporation).

[14] Annual compensation in excess of $1 million that is payable to the chief executive officer or the four other most highly compensated employees of a public corporation is not deductible unless the compensation qualifies as performance-based compensation or another exception applies. Sec. 162(m).

received prior to 2013).[15] However, amounts paid to corporate shareholders as dividends generally are eligible for a dividends-received deduction for the recipient corporation that results in the recipient corporation being taxed on at most 30 percent and possibly on none of the dividend received by the shareholder.[16]

Treatment of equity and debt holders

Investors in a C corporation receive different treatment depending upon whether an instrument is characterized as equity or debt for tax purposes.[17] Also, at the entity level, in general, interest paid by a C corporation is deductible but dividends paid are not.[18] The latter rule (especially when coupled with the ability of many tax-exempt or foreign investors to exclude interest income) creates a tax incentive that generally favors debt over equity in a corporation's capital structure. However, in some special situations equity may be preferred to debt. For example, an issuing corporation with losses may prefer to issue preferred stock with characteristics similar to debt, effectively passing through some of the benefit of its losses to shareholders.[19] Foreign shareholders may prefer either dividend or interest income, depending on the tax treatment in their country of residence and the applicable U.S. corporate income tax and withholding tax rates.

Shareholders receive different treatment depending on whether a corporate equity distribution is characterized as a dividend or as a payment in exchange for stock that is entitled to both capital gain treatment and basis recovery. While the individual tax rates for dividends and capital gains on stock generally are the same under present law (discussed in section II.B.2 of

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[15] Sec. 1(h)(11).

[16] Sec. 243. The recipient corporation can generally claim a 100 percent dividends-received deduction if the recipient corporation owns 80 percent or more of the distributing corporation. If the recipient corporation owns less than 80 percent but at least 20 percent of the distributing corporation, the dividends-received deduction is 80 percent. If the recipient corporation owns less than 20 percent of the distributing corporation, the dividends-received deduction is 70 percent.

[17] Debt and equity investments also provide different consequences to certain investors in the passthrough regimes of partnerships and S corporations. For example, tax-exempt and foreign investors are generally not taxed on interest income from a partnership if they are debt investors, but generally would be taxed in their share of partnership income from business activity of the partnership if they are equity investors. The subchapter S rules do not permit certain tax-exempt investors or foreign investors to own stock of an S corporation. Those tax-exempt investors that may own S corporation stock, with the exception of employee share ownership plans, are subject to an unrelated business income tax on their share of S corporation income. These factors can lead to a preference for structuring partnership or S corporation investment by such investors as debt.

[18] If certain requirements are satisfied, dividends paid on stock held by an employee stock ownership plan are deductible by the corporation. Sec. 404(k).

[19] Distributions to shareholders by a loss corporation are taxed as dividends, with accompanying dividend treatment to shareholders, if the loss corporation had prior year earnings and profits that have not yet been distributed. If all earnings and profits have been distributed, distributions to shareholders would be nontaxable return of capital distributions, reducing the shareholders' basis in the stock.

this document), capital gain treatment permits basis recovery.[20] A number of Code provisions have attempted to provide guidance in this area. For example, section 302 provides rules to determine whether a shareholder whose stock has been partially redeemed has experienced a sufficient contraction in his or her interest to be treated as having sold the stock rather than as having received a dividend. Section 304 provides additional rules intended to deal with sales of stock to commonly controlled corporations.

Consolidated returns of affiliated groups of corporations

An affiliated group of corporations may elect to file a consolidated return in lieu of separate returns.[21] A condition of electing to file a consolidated return is that all corporations that are members of the affiliated group must consent to all the consolidated return regulations prescribed prior to the last day prescribed by law for filing the consolidated return. The Treasury department has issued extensive consolidated return regulations under its authority to provide such rules. The regulations generally are directed toward preventing double taxation of income earned within the group, while preserving tax attributes if assets or corporations that were members leave the group and preventing avoidance of tax due to shifting of attributes in the course of intragroup transactions.[22]

A C corporation often is the entity of choice if a corporation anticipates a public offering, because publicly traded partnerships are generally taxed as corporations,[23] and S corporations (discussed below) are not permitted to have more than 100 shareholders.[24]

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[20] Foreign shareholders, in addition, may not be subject to tax on capital gains, though they are taxed (often at a reduced rate under tax treaties) on dividends. On the other hand, some corporate shareholders may prefer dividend treatment if they are eligible for the dividends-received deduction.

[21] Sec. 1504. An affiliated group for this purpose includes a parent corporation that directly owns 80 percent of the vote and value of the stock (excluding certain nonvoting preferred stock) of at least one subsidiary (causing that subsidiary to be a qualified member of the group) and other corporations of which qualified upper tier members in turn hold such stock ownership. Foreign corporations and certain other entities are not eligible to be members of such a group.

[22] Sec. 1502.

[23] Sec. 7704. As discussed below, an exception from the general rule whereby publicly traded partnerships are taxed as corporations is provided under section 7704(c). This exception allows publicly traded partnerships with at least 90 percent of their income qualifying as passive (*e.g.,* interest, dividends, real property rents) to be taxed as a passthrough entity.

[24] In some circumstances, it is possible that nonpublicly traded entities also might choose to operate as C corporations, for example to obtain the benefit of a separate corporate rate bracket or the benefit of special corporate treatment (*e.g.*, the dividends-received deduction) for earnings that are to be retained in the corporation. Appreciation in corporate assets generally is subject to corporate level tax when the assets are distributed to shareholders, and there is no lower rate for corporate capital gains. These factors generally would be a deterrent to placing assets into a C corporation. Nevertheless, there may be situations where lower effective corporate rates could provide benefits. For a more detailed discussion of debt and equity, see Joint Committee on Taxation, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11), December 2, 2011, and

Personal holding companies

In addition to the regular corporate income tax, the Code provides for taxes designed to prevent retention of corporate earnings so as to avoid individual income tax. The personal holding company tax is imposed on certain undistributed personal holding company income, generally where the corporation meets certain closely held stock requirements and more than 60 percent of the adjusted ordinary gross income (as defined) consists of certain passive-type income such as dividends, interest, and similar items.[25] Additional special rules affecting the corporate tax rates are described in section II.B.3 of this document.

2. Partnerships

Federal income tax treatment of partnerships

Partnerships generally are treated for Federal income tax purposes as passthrough entities, not subject to tax at the entity level.[26] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into account in computing the tax of the partners (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners).[27] A partner's deduction for partnership losses is limited to the amount of the partner's adjusted basis in his or her partnership interest.[28] To the extent a loss is not allowed due to a limitation, it generally is carried forward to the next year. A partner's basis in the partnership interest generally equals the sum of (1) such partner's capital contribution to the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) such partner's distributive share of losses allowed as a deduction and nondeductible expenditures not properly chargeable to capital account, and (2) any partnership distributions.[29]

Partnerships provide partners with a significant amount of flexibility to vary their respective shares of partnership income. Unlike corporations, partnerships may allocate items of

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see Joint Committee on Taxation, *Present Law and Background Relating to Tax Treatment of Business Debt* (JCX-41-11), July 11, 2011.

[25] Secs. 541-547. In addition, the accumulated earnings tax can be imposed on certain earnings in excess of $250,000 ($150,000 for certain service corporations in certain fields) accumulated beyond the reasonable needs of the business. However, the rate is 15 percent. Secs. 531-537.

[26] Sec. 701.

[27] Sec. 702(a). The recognition of income under this rule does not necessarily correspond with distributions from the partnership to cover the tax liabilities of individual partners.

[28] Sec. 704(d). In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by partnership deductions (sections 469 and 465). These limitations do not apply to corporate partners (except certain closely held corporations) and may not be important to individual partners who have partner level passive income from other investments.

[29] Sec. 705.

income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect. In general, an allocation is permitted to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation, and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.

Limited liability companies

In the last 35 years,[30] States have enacted laws providing for another form of entity, the LLC. LLCs generally elect to be treated as partnerships for Federal income tax purposes. They are neither partnerships nor corporations under applicable State law, but they generally provide limited liability to their owners for obligations of the business. Under regulations promulgated in 1996, any domestic unincorporated entity with two or more members that is not publicly traded generally may elect to be treated as either a partnership or a corporation for Federal income tax purposes, while under default rules, any single-member unincorporated entity is disregarded (*i.e.*, treated as not separate from its owner)[31] for Federal income tax purposes.[32] These regulations, known as the check-the-box regulations, were a response, in part, to the growth of LLCs.[33]

Publicly traded partnerships

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes.[34] For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).[35]

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income.[36] However, this exception does not apply to any partnership that would be described in section 851(a) if it were a

[30] The first LLC statute was enacted in Wyoming in 1977. All States (and the District of Columbia) now have an LLC statute, though the tax treatment of LLCs for State tax purposes may differ.

[31] Thus, where the single member is an individual, such a disregarded LLC will be treated as a sole proprietorship. Where the single member is a corporation, the LLC will be treated as a branch.

[32] Treas. Reg. sec. 301.7701-3.

[33] The check-the-box rules are discussed in more detail in section III.A of this document.

[34] Sec. 7704(a).

[35] Sec. 7704(b).

[36] Sec. 7704(c)(2).

domestic corporation, which includes a corporation registered under the Investment Company Act of 1940[37] as a management company or unit investment trust.[38]

Section 7704(d) defines qualifying income to include interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gain from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) where a principal activity of the partnership is the buying and selling of such commodities, futures, options, or forward contracts.

3. S corporations

In general

An S corporation provides the Federal income tax advantage of passthrough treatment while retaining the nontax advantages of corporate status under Federal securities laws and State law. An S corporation and its shareholders generally are treated, for Federal income tax purposes, more like a partnership and its partners than like a C corporation and its shareholders. To make an election to be treated as an S corporation, a corporation must meet certain requirements primarily regarding its capital structure and the identity and number of its shareholders.

Limitations on number and type of shareholders and class of stock

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock.[39] Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock.[40] Although there are limitations on the types of shareholders and stock structure an S corporation may have, there is no limit on the asset size of such a corporation (as there is no limit on the size of a C corporation or partnership). Certain corporations may not

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[37] Pub. L. No. 76-768 (1940).

[38] Sec. 7704(c)(3).

[39] Sec. 1361. For this purpose, a husband and wife and all members of a family are treated as one shareholder. Sec. 1361(c)(1).

[40] Sec. 1362.

elect S corporation status including financial institutions using the reserve method of accounting for bad debts and insurance companies subject to tax under subchapter L.[41]

Passthrough of income and losses to S corporation shareholders

For Federal income tax purposes, an S corporation generally is not subject to tax at the corporate level.[42] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the S corporation are taken into account in computing the tax of the shareholders (under the S corporation's method of accounting and regardless of whether the income is distributed to the shareholders). A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in the S corporation stock and the indebtedness of the S corporation to such shareholder. To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year. The shareholder's basis in the S corporation stock (and debt) is reduced by the shareholder's share of losses and (in the case of stock) by distributions and is increased by the shareholder's share of the S corporation's income and contributions to capital.[43]

S corporations that were previously C corporations

There are two principal exceptions to the general passthrough treatment of S corporations. Both are applicable only if the S corporation was previously a C corporation and generally are intended to prevent avoidance of otherwise applicable C corporation tax consequences. First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if the corporation has subchapter C earnings and profits and has gross receipts more than 25 percent of which are passive investment income for the year.[44] Second, for the first 10 years after a corporation that was previously a C corporation elects to be an S corporation, certain net built-in capital gains of the corporation attributable to the period in which it was a C corporation are subject to tax at the corporate level.[45]

In general, an S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder's basis in the stock of the corporation or the S corporation was formerly a C corporation and has undistributed earnings and profits.[46] To the

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[41] Sec. 1361(b)(2).

[42] Secs. 1363 and 1366.

[43] Sec. 1367.

[44] Sec. 1375. Subchapter C earnings and profits generally refers to the earnings of the corporation prior to its subchapter S election which would have been taxable as dividends if distributed to shareholders by the corporation prior to its subchapter S election. If the S corporation continues to have C corporation earnings and profits and has gross receipts more than 25 percent of which are passive investment income in each year for three consecutive years, the S corporation election is automatically terminated. Sec. 1362(d)(3).

[45] Sec. 1374. The period was seven years for taxable years beginning in 2009 and 2010, and five years for taxable years beginning in 2011.

[46] Sec. 1368.

extent of such earnings and profits, corporate distributions are treated as dividends of C corporations and generally are subject to tax as such in the hands of the shareholders.

4. Comparison of features of partnerships and S corporations

Notwithstanding that they both provide for passthrough treatment, there are several significant Federal tax differences between S corporations and partnerships. First, corporate liabilities (other than those owed to its shareholders) are not included in a shareholder's basis of an interest in an S corporation. Thus, unlike a partner who can take deductions supported by certain partnership indebtedness, S corporation shareholders who wish to obtain similar types of deductions are required to borrow individually and contribute or re-lend such amounts to the S corporation to provide basis against which losses of the S corporation may be taken by the shareholder. Further, S corporations may have only one class of stock and, thus, do not offer the same flexibility as partnerships to allocate income and losses to different investors. In addition, if a tax-exempt entity (including any individual retirement account or qualified retirement plan) is an equity investor in a partnership, its share of business income of the partnership is subject to unrelated business income tax. An S corporation likewise generally is not permitted to have a tax-exempt shareholder that is not subject to unrelated business income tax on S income, except that an employee share ownership plan ("ESOP") is permitted to be a shareholder in an S corporation without unrelated business income tax. Table 10 lists the principal differences in the taxation of the two types of entities and their owners.

Table 10.–Principal Differences in Taxation of Partnerships and S Corporations

Item	**Partnerships**	**S Corporations**
Maximum number of equity interests	No maximum number. Partnerships with over 100 partners may elect a special passthrough regime.[47]	Maximum number of shareholders is 100. Family members treated as one shareholder for this purpose.
Classes of equity interests	No limitation.	One class of stock. Voting rights are disregarded in making this determination.
Ineligible entities	Generally, partnerships with equity interests that are publicly traded.	Foreign corporations; financial institutions using reserve method of accounting; insurance companies; DISCs and former DISCs.
Eligible shareholders	All persons eligible.	Eligible shareholders include individuals, estates and certain trusts, charities, and qualified retirement plans.
Foreign taxpayers	Eligible to be a partner; effectively connected income subject to withholding tax.	Ineligible to be a shareholder.
Tax-exempt taxpayers	Eligible to be a partner; income subject to generally applicable unrelated business income tax	Tax-exempt taxpayers (other than charities and qualified retirement plans) ineligible to be a shareholder. All items of income and loss of charities and qualified retirement plans (other than ESOPs) included in unrelated business taxable income; items of income and loss of ESOPs not included in unrelated business taxable income.
Trusts	Eligible to be a partner; usual trust taxation rules apply.	Only qualified subchapter S trusts and electing small business trusts eligible as shareholders; special taxation rules apply.

[47] See secs. 771-777 and 6240-6255 for treatment of electing large partnerships.

Item	Partnerships	S Corporations
Allocation of income and losses	Allocation in accordance with partnership agreement so long as allocation has substantial economic effect.	Pro rata among shares on a daily basis.
Limitation on losses	Losses limited to basis in partnership interest, which includes partner's share of partnership debt.	Losses limited to basis in stock and indebtedness of corporation to shareholder; no inclusion of corporate debt in shareholder basis.
Contributions of property to entity	Tax-free; built-in gain or loss allocated to contributing partner.	Tax-free (if control requirement met); no special allocation rules.
Distributions of property (liquidating or otherwise)	Generally tax-free; carryover or substituted basis to partner; partnership may elect to make basis adjustment in partnership property to reflect adjustments to distributee partner.	Gain taxed to corporation; fair market value basis to shareholder; no basis adjustments to corporate property.
Transfer of equity interests	Gain treated as ordinary income to extent of ordinary income on assets held by partnership; partnership may elect to adjust basis of its assets with respect to transferee partner to reflect purchase price.	No ordinary income look-through provision; no adjustments to basis of corporate property.
Termination of entity	Termination if sale or exchange of 50 percent or more of partnership interests within 12 months.	No provision.

Item	Partnerships	S Corporations
Treatment of C corporation converting to partnership or S corporation.	Corporation must liquidate and gain or loss is recognized to corporation and shareholders.	Generally no taxation upon election; corporate tax is imposed on built-in gain if assets sold during 10 year period after election effective (special rules in 2009, 2010, and 2011 shortened the period); distribution of subchapter C earnings and profits taxable as a dividend; special rules applicable to a corporation with accumulated earnings and excess net passive investment income.
Mergers, etc. with corporations	Not eligible to engage in tax-free reorganization with corporation.	Eligible party to a tax-free corporate reorganization.
Corporate tax rules of subchapter C	Rules inapplicable.	Rules generally applicable.
Wholly owned corporation	Corporation treated as separate entity.	Wholly owned subsidiary corporation may elect to be treated as part of parent S corporation.
Application of employment taxes	Except in the case of a limited partner, each partner's share of net business income is net earnings from self-employment.	Amounts paid as compensation are wages; no amounts are net earnings from self-employment.

5. Other entities

In general

In addition to partnerships and S corporations, present law provides for several other types of entities that generally are not taxed at the entity level.[48] However, those that allow public shareholders to invest in a vehicle that is not subject to entity-level tax generally are subject to restrictions regarding their structure, nature of income, nature of assets, and ownership of other entities. These limits reduce the potential for indirectly deriving nonpermitted types of income through a related or controlled entity. Additionally, some of the restrictions limit the potential for extracting earnings of a taxable corporation as deductible amounts that reduce corporate-level tax when paid to the nontaxed entity.

Trusts

Regulations governing the classification of entities as trusts or corporations provide that trusts generally do not have associates (for example, shareholders) or an objective to carry on business for profit.[49] Thus, a trust cannot generally conduct an active business of any kind, nor can it engage in the purchase and sale of assets for profit.

A grantor trust is a trust whose grantor has retained the right to exercise certain powers over the trust.[50] A grantor trust is not treated as a separate taxable entity. Instead, the grantor is treated as the owner of the trust's property and is subject to tax on trust income.

Regulated investment companies

In general, a regulated investment company ("RIC") is an electing domestic corporation that either meets (or is excepted from) certain registration requirements under the Investment Company Act of 1940,[51] that derives at least 90 percent of its ordinary income from specified sources considered passive investment income,[52] that has a portfolio of investments that meet certain diversification requirements,[53] and meets certain other requirements.[54]

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[48] The mechanisms for eliminating tax at the entity level differ among the types of entities. In general, the entities are referred to herein as nontaxed entities. They do not all pass through the character of the income received, and some are subject to corporate level tax to the extent they do not either distribute their income or designate undistributed income as currently taxable to their beneficial interest holders.

[49] See Treasury Regulations under section 641.

[50] See sec. 671.

[51] Secs. 851(a) and (b)(1).

[52] Sec. 851(b)(2).

[53] Sec. 851(b)(3).

[54] Secs. 851 and 852.

Many RICs are "open-end" companies (mutual funds) which have a continuously changing number of shares that are bought from, and redeemed by, the company and that are not otherwise available for purchase or sale in the secondary market. Shareholders of open-end RICs generally have the right to have the company redeem shares at "net asset value." Other RICs are "closed-end" companies, which have a fixed number of shares that are normally traded on national securities exchanges or in the over-the-counter market and are not redeemable upon the demand of the shareholder.

In the case of a RIC that distributes at least 90 percent of its net ordinary income and net tax-exempt interest to its shareholders, a deduction for dividends paid is allowed to the RIC in computing its tax.[55] Thus, no corporate income tax is imposed on income distributed to its shareholders. Dividends of a RIC generally are includible in the income of the shareholders; a RIC can pass through the character of (1) its long-term capital gain income, by paying "capital gain dividends" and (2) in certain cases, tax-exempt interest, by paying "exempt-interest dividends." A RIC may also pass through certain foreign tax credits and credits on tax-credit bonds, as well as the character of certain other income received by the RIC.

If RIC stock is "stapled" to the stock of another entity (such that an interest in one changes hands together with the interest in the other) and if such "stapled" stock represents more than 50 percent in value of the beneficial ownership of each of the entities, then the two entities are treated as one.[56] These rules limit the degree to which the shareholders of the RIC may derive income that would not be qualifying income for the RIC indirectly through a related entity, while retaining RIC status for the amounts of income that do qualify. These rules also provide a limit on the extent to which a RIC that is commonly owned with a taxable corporation might extract business income from the corporation in the form of interest or other deductible payments, or by causing the corporation to bear expenses of the RIC's operations.

Real estate investment trusts

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but that qualifies and elects to be taxed under a special REIT tax regime. To qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[57] the REIT must derive most of its income from passive, generally real-estate-related investments; and REIT assets must be primarily real estate related. In addition, a REIT must have transferable interests and at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by five or fewer

[55] Sec. 852(a) and (b).

[56] Sec. 269B. These stapled stock restrictions also generally apply to real estate investment trusts.

[57] Even if a REIT meets the 90-percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under section 4981.

individual shareholders (as determined using specified attribution rules). Other requirements also apply.[58]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders each year as a dividend is deductible by the REIT. As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level.[59] Although a REIT is not required to distribute more than the 90 percent of its income described above in order to retain REIT status, it is taxed at ordinary corporate rates on amounts not distributed. Section 4981 also imposes an additional four-percent excise tax to the extent a REIT does not distribute at least 85 percent of REIT ordinary income and 95 percent of REIT capital gain net income within a calendar year period.

A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real estate related income. Such income including, for example, rents from real property, income from the sale or exchange of real property (including interests in real property)[60] that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.[61] Amounts attributable to most types of services provided to tenants (other than certain "customary services"), or to more than specified amounts of personal property, are not qualifying rents.[62] In addition, rents received from any entity in which the REIT owns more than 10 percent of the vote or value also generally are not qualifying income. An exception applies for certain rents received from taxable REIT subsidiaries (described further below).

In addition, 95 percent of the gross income of a REIT for each taxable year must be from the 75-percent income sources and a second permitted category of other, generally passive investments such as dividends, capital gains, and interest income.[63]

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items, and Government securities. Real estate assets generally include real property

[58] Secs. 856 and 857.

[59] A REIT that has net capital gain can either distribute that gain as a "capital gain" dividend or retain that gain without distributing it but cause the shareholders to be treated as if they had received and reinvested a capital gain dividend. In either case, the gain in effect is taxed only as net capital gain of the shareholders. Sec. 857(b)(3).

[60] The term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon, but does not include mineral, oil, or gas royalty interests. Sec. 856(c)(5)(C).

[61] Secs. 856(c)(3) and 1221(a)(1).

[62] Sec. 856(d). Amounts attributable to the provision of certain services by an independent contractor or by a taxable REIT subsidiary can be qualified rents. Sec. 856(d)(7).

[63] Sec. 856(c)(3).

(including interests in real property and mortgages on real property) and shares in other REITs.[64] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[65]

Except with respect to a taxable REIT subsidiary (described further below), not more than five percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[66] The asset tests must be met as of the close of each quarter of a REIT's taxable year.

A REIT generally cannot own more than 10 percent of the vote or value of a single entity; however, there is an exception for ownership of a taxable REIT subsidiary ("TRS") that is taxed as a corporation, provided that securities of one or more TRSs do not represent more than 25 percent of the value of REIT assets.

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility. However, a TRS is permitted to rent qualified hotel, motel, or other transient lodging facilities, or qualified health care facilities, from its parent REIT and is permitted to hire an independent contractor to operate such facilities.[67] Transactions between a TRS and a REIT are subject to a number of specified rules.

Real estate mortgage investment conduits

A real estate mortgage investment conduit ("REMIC") is an entity used for securitizing mortgages on real estate.[68] A REMIC is not subject to tax at the entity level (except for a 100-percent excise tax on prohibited transactions, which include the receipt of compensation for services or other nonpermitted income).[69] Income or loss of the REMIC is taken into account by the holders of interests in the REMIC. REMICs are subject to restrictions on organizational structure, income, assets, and permitted transactions.

[64] Sec. 856(c)(4)(A). Temporary investments in certain stock or debt instruments also can qualify if they are temporary investments of new capital, but only for the one-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

[65] Sec. 856(c)(4)(B)(i).

[66] Sec. 856(c)(4)(B)(iii).

[67] Sec. 856(d)(8)(B).

[68] Sec. 860A.

[69] Sec. 860F.

Cooperatives

There are several types of cooperatives, including tax-exempt farmers' cooperatives and other corporations operating on a cooperative basis.[70] In determining its taxable income, a cooperative does not take into account the amount of patronage dividends paid to patrons of the cooperative. The cooperative deducts other distributions, including dividends paid on capital stock, and amounts distributed on a patronage basis to patrons during the taxable year. Patrons of the cooperative include in their income the amount of patronage dividends and other distributions made on a patronage basis. Thus, these amounts are subject to tax in the hands of the patrons, but not in the hands of the cooperative. To this extent, a cooperative is treated as a passthrough entity.

A cooperative can be a publicly traded entity; however, only patrons are entitled to the benefits of the passthrough treatment through the dividends paid deduction. To the extent the earnings of the cooperative are allocated or distributed to public shareholders that are not dealing with the cooperative patrons, the cooperative is subject to corporate level tax.

[70] See, *e.g.,* sec. 521.

B. Federal Income Tax Rate Structure

1. Individual tax rates

In general

U.S. individuals (citizens and residents) are taxed at graduated statutory rates ranging from 10 percent (for taxable income of up to $8,700 for single filers and up to $17,400 for married taxpayers filing joint returns or surviving spouses) to 35 percent (for taxable income over $388,350) for taxable year 2012; the intermediate rates are 15 percent, 25 percent, 28 percent, and 33 percent.[71] The maximum tax rate on net long-term capital gains generally is 15 percent.[72] Dividends received by an individual from domestic corporations and qualified foreign corporations are taxed at the same rates that apply to capital gains.[73]

Certain domestic production activities are effectively taxed at lower rates by virtue of a deduction equal to a percentage of the income from such activities.[74] The deduction is equal to nine percent of the income from manufacturing, construction, and certain other activities specified in the statute, for taxable years beginning in 2010.[75] Thus, generally the maximum tax rate for an individual on its domestic production activities income is effectively 31.85 percent.[76]

Tax on net investment income

For taxable years beginning after December 31, 2012, a tax is imposed on net investment income in the case of an individual, estate, or trust.[77] In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income

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[71] Secs. 1(a), (c) and (i).

[72] Sec. 1(h). Net gain from the sale of collectibles is taxed at a maximum 28 percent rate, while certain gain from the sale or exchange of depreciable real estate ("unrecaptured section 1250 property") is taxed at a maximum 25 percent rate. Under present law, for taxable years beginning after 2012, the maximum tax rate applicable to net long-term capital gains (other than collectibles or unrecaptured section 1250 property) increases from 15 percent to 20 percent.

[73] Sec. 1(h)(11). Under present law, for taxable years beginning after 2012, dividends received by an individual are taxed at ordinary income rates.

[74] Sec. 199.

[75] However, for taxpayers that have qualified income related to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (collectively, "oil related production activities income"), the deduction is limited to six percent of its oil related production activities income. Sec. 199(d)(9).

[76] Because of the nine-percent deduction, the taxpayer is taxed at a rate of 35 percent on only 91 percent of income, resulting in an effective Federal income tax rate of 31.85 percent.

[77] Sec. 1411.

over the threshold amount.[78] The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.[79]

2. C corporation tax rates

In general

C corporations are taxed at statutory rates ranging from 15 percent (for taxable income up to $50,000) to 35 percent (for taxable income over $10,000,000); the intermediate rates are 25 percent (for taxable income above $50,000 but not exceeding $75,000) and 34 percent (for taxable income above $75,000 but not exceeding $10,000,000).[80] The benefit of graduated rates below 34 percent is phased out for C corporations with taxable income between $100,000 and $335,000, and the benefit of the 34 percent rate is phased out for C corporations with taxable income in excess of $15,000,000. C corporation long-term capital gains are taxed at the same rates as C corporation ordinary income. Thus, the maximum tax rate for C corporation net long-term capital gains is 35 percent.

Certain domestic production activities are effectively taxed at lower rates by virtue of a deduction equal to a percentage of the income from such activities.[81] The deduction is equal to nine percent of the income from manufacturing, construction, and certain other activities specified in the statute, for taxable years beginning in 2010.[82] Thus, generally the maximum tax rate for a C corporation on its domestic production activities income is effectively 31.85 percent.

Special rules

Accumulated earnings and personal holding company taxes

Taxes at a rate of 15 percent (the top rate generally applicable to dividend income of individuals) may be imposed upon the accumulated earnings or personal holding company

[78] For purposes of the tax on net investment income, modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income). The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes).

[79] For a more detailed description of the tax on net investment income, see Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2012* (JCX-18-12), February 24, 2012.

[80] Sec. 11.

[81] Sec. 199.

[82] However, for taxpayers that have qualified income related to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (collectively, "oil related production activities income"), the deduction is limited to six percent of its oil related production activities income. Sec. 199(d)(9).

income of a corporation. The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs. The personal holding company tax may be imposed upon the excessive passive income of a closely held corporation. The accumulated earnings tax and the personal holding company tax, when they apply, in effect impose the shareholder level tax in addition to the corporate level tax on accumulated earnings or undistributed personal holding company income.

Other rules

A number of other provisions address situations in which individuals have an incentive to direct income to corporations, or where there is an incentive to direct or divide business activity or income among a number of separate corporations, to take advantage of lower corporate graduated rates. Certain related corporations are treated as one for purposes of the graduated corporate rates.[83] Also, certain personal service corporations are not entitled to use the graduated corporate rates below the 35-percent rate.[84] Such a corporation is one in which substantially all the activities involve the performance of services in certain fields,[85] and substantially all the stock of which is held directly or indirectly by employees performing services for such corporation, retirees, or certain estates or heirs of such persons. A separate provision allows the Secretary of the Treasury to reallocate income, deductions, and other items between a differently defined personal service corporation and its owners, to prevent the avoidance of Federal income tax.[86]

3. Alternative minimum tax

In general

Present law imposes a minimum tax on individuals and corporations to the extent their tentative minimum tax exceeds their regular tax liability.[87]

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[83] Sec. 1561.

[84] Sec. 11(b)(2) and sec. 448(d)(2). However, such corporations also are entitled to use the cash method of accounting.

[85] Sec. 448(d)(2). Such fields are health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

[86] Sec. 269A. A personal service corporation for this purpose is a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners (persons who own, or by attribution are deemed to own, more than 10 percent of the stock of the corporation). If substantially all the services of a personal service corporation are performed for or on behalf of one other entity, and the principal purpose of forming or availing of such personal service corporation is the avoidance or evasion of Federal income tax, the Secretary may reallocate items of income or deduction. The provision is in addition to the general provision of section 482 that permits reallocation of income, deductions, or other items among related parties. See also sec. 1551.

[87] Sec. 55.

Individuals

An alternative minimum tax is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. The tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $175,000 ($87,500 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the taxpayer's taxable income increased by the taxpayer's tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

The exemption amounts are: (1) $45,000 ($74,450 in taxable years beginning in 2011) in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 ($48,450 in taxable years beginning in 2011) in the case of other unmarried individuals; (3) $22,500 ($37,225 in taxable years beginning in 2011) in the case of married individuals filing separate returns; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

Personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions, are not allowed to reduce AMTI. Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and a portion of the amount of gain excluded with respect to the sale or disposition of certain small business stock.

C corporations

A corporation is subject to an alternative minimum tax that is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of a $40,000 exemption amount.[88] Certain credits that are allowed to offset a corporation's regular tax liability generally are not allowed to offset its minimum tax liability. If a corporation pays the alternative minimum tax, the amount of the tax paid is allowed as a credit against the regular tax in future years to the extent the regular tax exceeds the tentative minimum tax. Small corporations meeting a gross receipts test are exempt from the corporate alternative minimum

[88] The exemption amount is phased out for corporations with income above certain thresholds, and is completely phased out for corporations with alternative minimum taxable income of $310,000 or more.

tax. Generally, a corporation meets the gross receipts test if its average annual gross receipts for the prior three taxable years does not exceed $7.5 million.

Alternative minimum taxable income is the corporation's taxable income increased by the corporation's tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. Among the preferences and adjustments applicable to the corporate alternative minimum tax are accelerated depreciation on certain property, certain expenses and allowances related to oil and gas and mining exploration and development, certain amortization expenses related to pollution control facilities, and certain tax-exempt interest income. In addition, corporate alternative minimum taxable income is increased by 75 percent of the amount by which the corporation's "adjusted current earnings" exceed its alternative minimum taxable income (determined without regard to this adjustment). Adjusted current earnings generally are determined with reference to the rules that apply in determining a corporation's earnings and profits.

C. Social Insurance Taxes

1. In general

As part of the financing for Social Security and Medicare benefits, a tax is imposed on the wages of an individual received with respect to his or her employment under the Federal Insurance Contributions Act ("FICA").[89] A similar tax is imposed on the net earnings from self-employment of an individual under the Self-Employment Contributions Act ("SECA").[90]

2. FICA tax

In general

The FICA tax has two components. Under the old-age, survivors, and disability insurance component ("OASDI"), the rate of tax is 12.4 percent, half of which is imposed on the employer, and the other half of which is imposed on the employee.[91] The OASDI rate is 10.4 percent for 2012.[92] The amount of wages subject to this component is capped at $110,100 for 2012.

Under the hospital insurance ("HI") component, the rate is 2.9 percent, also split equally between the employer and the employee.[93] The amount of wages subject to the HI component of the tax is not capped. For remuneration received in taxable years beginning after December 31, 2012, the employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages and self-employment income[94] received in excess of a specific threshold amount. However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case (unmarred individual or head of household).

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[89] See chapter 21 of the Code.

[90] Secs. 1401-1403.

[91] Secs. 3101(a) and 3111(a).

[92] A temporary reduction, expiring December 31, 2012, provides a reduced OASDI tax rate of 4.2 percent for employees for wages received through December 31, 2012 for a total OASDI tax rate of 10.4 percent. The temporary reduction was enacted in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312) through December 31, 2011, was extended through February 29, 2012, by the Temporary Payroll Tax Cut Continuation Act of 2011 (Pub. L. No. 112-78) and was extended through December 31, 2012, by the Middle Class Tax Relief and Job Creation Act of 2012 (Pub. L. No. 112-96).

[93] Secs. 3101(b) and 3111(b).

[94] Sec. 3121(a).

The wages of individuals, including owners, employed by a business in any form (for example, a C corporation) generally are subject to the FICA tax. The employee portion of the FICA tax generally must be withheld from wages by the employer and remitted to the Federal government with the employer's portion.

S corporation shareholders

A shareholder of an S corporation who performs services as an employee of the S corporation is subject to FICA tax on his or her wages, but generally is not subject to FICA tax on amounts that are not wages (such as distributions to shareholders).[95] Nevertheless, an S corporation employee is subject to FICA tax on the amount of his or her reasonable compensation, even though the amount may have been characterized as other than wages.[96] A significant body of case law has addressed the issue of whether amounts paid to shareholder-employees of S corporations constitute reasonable compensation and therefore are wages subject to the FICA tax, or rather, are properly characterized as another type of income that is not subject to FICA tax.[97]

In cases addressing whether payments to an S corporation shareholder-employee were wages for services or were corporate distributions, courts have recharacterized a portion of corporate distributions as wages if the shareholder performing services did not include a sufficient amount as wages.[98] In cases involving whether reasonable compensation was paid (not exclusively in the S corporation context), courts have applied a multi-factor test to determine reasonable compensation, including such factors as whether the individual's compensation was comparable to compensation paid at comparable firms.[99] The Seventh Circuit, however, has adopted an "independent investor" analysis differing from the multi-factor test in that it asks whether an inactive, independent investor would be willing to compensate the employee as he

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[95] Although not applicable for FICA tax purposes, present law provides that an S corporation is treated as a partnership and a two-percent shareholder is treated as a partner, for purposes of applying income tax rules relating to employee fringe benefits. Sec. 1372.

[96] The IRS has taken this position in Rev. Rul. 74-44, 1974-1 C.B. 287.

[97] See, *e.g.*, *Renewed Focus on S Corp. Officer Compensation*, AICPA Tax Division's S Corporation Taxation Technical Resource Panel, Tax Advisor, May 2004, at 280.

[98] *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990); see also, *Joseph M. Grey Public Accountant, P.C., v. Commissioner*, 119 T.C. 121 (2002), aff'd, 93 Fed. Appx. 473 (3d Cir. 2004), and *Nu-Look Design, Inc. v. Commisioner*, 356 F.3d 290 (3d Cir. 2004), in which an officer and sole shareholder of an S corporation argued unsuccessfully that he had no wages and that he received payments in his capacity as shareholder or as loans, rather than as wages subject to employment tax. Similarly, see *David E. Watson v. U.S.*, 757 F.2d 877 (2010), aff'd, --- F.3d ---, 2012 WL 539784 (8th Cir. 2012).

[99] See, *e.g.*, *Haffner's Service Stations, Inc. v. Commissioner*, 326 F.3d 1 (1st Cir. 2003).

was compensated.[100] The independent investor test has been examined and partially adopted in some other Circuits, changing the analysis under the multi-factor test.[101]

3. Self-employment tax

In general

The SECA tax rate is the combined employer and employee rate for FICA taxes. Under the OASDI component, the rate of tax is 12.4 percent (10.4 percent for 2012) and the amount of earnings subject to this component is capped at $110,100 for 2012, reduced by wages subject to OASDI.[102] Under the HI component, the rate is 2.9 percent, and the amount of self-employment income subject to the HI component is not capped. For tax years after December 31, 2012, the HI component of SECA tax is increased by 0.9 percent, similar to the increase in the OASDI tax on employees.

In the case of an individual with self-employment income, the income subject to self-employment tax is the net earnings from self-employment.[103] This equals the gross income derived by an individual from any trade or business carried on by the individual, less the deductions attributable to the trade or business that are allowed under the self-employment tax rules. Specified types of income or loss are excluded, such as rentals from real estate in certain circumstances, dividends and interest, and gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers.

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[100] *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).

[101] In *Metro Leasing and Dev. Corp. v. Commissioner*, 376 F.3d 1015 at 10-11 (9th Cir. 2004), the Ninth Circuit court noted that it is helpful to consider the perspective of an independent investor, and pointed to other Circuits that apply the multi-factor test through the lens of the independent investor test, citing *RAPCO Inc. v. Commissioner*, 85 F.3d 950 (2d Cir. 1996).

[102] Secs. 1401(a) and 1402(b). A temporary reduction, expiring December 31, 2012, provides a reduced OASDI tax rate of 10.4 percent for self-employed individuals through 2012. The temporary reduction was enacted in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. No. 111-312) through December 31, 2011, and was extended through December 31, 2012 by the Temporary Payroll Tax Cut Continuation Act of 2011 (Pub. L. No. 112-78) with a limit of $18,350, which was removed by the Middle Class Tax Relief and Job Creation Act of 2012 (Pub. L. No. 112-96).

[103] For purposes of determining net earnings from self-employment, taxpayers are permitted a deduction from net earnings from self-employment equal to the product of the taxpayer's net earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), *i.e.*, 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically the equivalent of an employee's wages plus the employer share of FICA taxes. The deduction is intended to provide parity between FICA and SECA taxes. In addition, self-employed individuals may deduct one-half of self-employment taxes for income tax purposes under section 164(f).

Partners

For an individual who is a partner in a partnership, the net earnings from self-employment generally include the partner's distributive share (whether or not distributed) of income or loss from any trade or business carried on by the partnership.[104] This rule applies to individuals who are general partners. Specified types of income or loss are excluded from net earnings from self-employment of a partner, such as rentals from real estate in certain circumstances, dividends and interest, gains or loss from the sale or exchange of a capital asset or from timber, certain minerals, or other property that is neither inventory nor held primarily for sale to customers, and retirement payments from the partnership if the partner rendered no services for the partnership and certain other requirements are met.

A special rule applies for limited partners of a partnership.[105] In determining a limited partner's net earnings from self-employment, an exclusion is provided for his or her distributive share of partnership income or loss. The exclusion does not apply with respect to guaranteed payments to the limited partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services. This special rule reflects State law at the time it was enacted in 1977, under which limited partners ordinarily were not permitted to participate in management of the partnership's activities without losing their limited liability protection.[106] In recent years, State law has been changing, with the result that individuals who are limited partners under applicable State law may participate in the management and operations of the partnership without jeopardizing their limited liability.[107] This change in the State law rules for limited partners parallels the expansion of limited liability companies.

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[104] There is uncertainty under present law regarding the self-employment treatment of LLC members. Some LLC owners may take the position that they owe little, if any self-employment tax by analogy to the statutory language governing limited partners, or by structuring their business to interpose an S corporation, distributions from which they argue do not constitute labor income. See Joint Committee on Taxation, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity* (JCX-48-08), June 4, 2008, pp. 60-72 for a more detailed description of the issues related to labor income and capital income under the social insurance tax.

[105] Sec. 1402(a)(13). For this purpose, limited partner status is determined under State law.

[106] Social Security Amendments of 1977, Pub. L. No. 95-216. The exclusion of limited partners from the self-employment tax (except with respect to guaranteed payments for services) reflects the perception at that time that the value of accruing benefits under the Social Security system outweighed the tax cost, and that limited partnerships were used for investment rather than for service businesses. See Patricia E. Dilley, "Breaking the Glass Slipper - Reflections on the Self-Employment Tax," *Tax Lawyer*, vol. 54, Fall 2000, p.85 at note 91.

[107] See, *e.g.*, Revised Uniform Limited Partnership Act (2001), sec. 303, providing, "[a]n obligation of a limited partnership, whether arising in contract, tort, or otherwise, is not the obligation of a limited partner. A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership."

III. HISTORY AND BACKGROUND OF ENTITY CLASSIFICATION ISSUES

A. Classification as a Corporation or Partnership

Kintner regulations

Prior to the check-the-box regulations, the Treasury regulations governing the classification of entities as partnerships or, alternatively, associations taxable as corporations for Federal income tax purposes were adopted in 1960. These regulations were known as the "Kintner" regulations because they were a response to the decision in *U.S. v. Kintner*.[108] The classification issue arose in that case because of favorable pension plan rules applicable, at that time, to corporate employees but not to partners. The Kintner regulations generally made it more likely than did the previous entity classification rules that a business entity would be classified as a partnership rather than a corporation.

Corporate resemblance test

The Kintner regulations provided that whether a business entity was taxable as a corporation depended on which form of enterprise the entity more nearly resembled.[109] The regulations listed six corporate characteristics, two of which are common to corporations and partnerships: the presence of associates and an objective to carry on business and divide the gains therefrom. Whether an unincorporated organization was classified as a partnership or a corporation depended on whether the entity had more than two of the remaining four corporate characteristics.

Corporate characteristics or factors

The remaining four corporate characteristics identified in the Kintner regulations were (1) continuity of life, (2) centralization of management, (3) liability for entity debts limited to entity property, and (4) free transferability of interests.[110] The effect of the regulations generally was to classify an unincorporated entity as a partnership if it lacked any two or more of the four corporate characteristics, without further inquiry as to how strong or weak a particular characteristic was or how the evaluation of the factors might affect overall resemblance to a partnership or a corporation.[111]

In 1976, the Tax Court suggested that the regulations might not effectively identify those entities that had an overall corporate resemblance; however, the court concluded it was required to follow the regulations and held that the particular entity at issue was classified as a

[108] 216 F.2d 418 (9th Cir. 1954).

[109] Former Treas. Reg. sec. 301.7701-2(a).

[110] Former Treas. Reg. sec. 301.7701-2.

[111] Former Treas. Reg. secs. 301.7701-2 and -3; *Larson v. Commissioner*, 66 T.C. 159 (1976).

partnership.[112] A proposed revision of the regulations was issued in January 1977,[113] but was withdrawn almost immediately.[114] The revised and withdrawn regulations would have made it less likely that an entity would be classified as a partnership than under the Kintner regulations.

An organization was treated as having continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member did not cause a dissolution of the organization. In the case of a limited partnership, if the death, insanity, bankruptcy, retirement, resignation, expulsion, or other event of withdrawal of a general partner caused a dissolution unless the remaining general partners (or at least a majority in interest of all the remaining partners) agreed to continue the partnership, continuity of life did not exist. The regulations provided that a general or limited partnership subject to a statute corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act lacked continuity of life. Under these rules, continuity of life generally did not exist even if the remaining partners had agreed to continue the partnership.

An organization generally had centralized management under the regulations if any person (or any group of persons that did not include all the members) had continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. A general partnership subject to a statute corresponding to the Uniform Partnership Act could not achieve centralization of management because of the mutual agency relationship between the partners. A limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act generally did not have centralized management unless substantially all the interests in the partnership were owned by the limited partners. However, if all or a specified group of the limited partners could remove a general partner (even with a substantially restricted right of removal), the test for whether there was centralized management was to be based on all the facts and circumstances.

An organization was treated under the regulations as having limited liability if, under local law, there was no member who was personally liable for the debts of, or claims against, the organization. In the case of an organization subject to a statute corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act, personal liability generally existed with respect to each general partner. In the case of a limited partnership, however, personal liability did not exist with respect to a general partner when he had no substantial assets (other than his interest in the partnership) that could be reached by a creditor of the organization and when he was merely a "dummy" acting as the agent of the limited partners.

The Service's ruling position was that a corporate general partner in a limited partnership did not have substantial assets unless its net worth (excluding the partnership interest) was greater than or equal to 10 percent of the total contributions to the partnership.[115] For

[112] *Larson v. Commissioner*, 66 T.C. 159 (1976).

[113] 42 Fed. Reg. 1038, January 5, 1977.

[114] 42 Fed. Reg. 1489, January 7, 1977.

[115] Rev. Proc. 92-88, 1992-2 C.B. 496.

partnerships with more than one general partner, this test could be met on a collective basis. If this test was met, the corporate partner was considered to have substantial assets, and the entity was considered not to have limited liability, for advance ruling purposes. Some taxpayers successfully contended that a limited partnership lacked limited liability under the regulations if the corporate general partner was not a "dummy" acting as the agent of the limited partners.[116]

An organization was treated as having free transferability of interests under the regulations if members owning substantially all the interests had the power, without the consent of other members, to substitute another person as a member and to confer upon the substitute all the attributes of the transferred interest. Although the regulations indicated, in examples, that free transferability did not exist where unanimous consent of the general partners was required for the assignee of a limited partner's interest to become a substitute limited partner, the court in *Larson* found free transferability where the consent of the general partner to substitute limited partners could not be unreasonably withheld.

If a noncorporate entity had no more than two of these four corporate characteristics (in addition to the two factors that corporations and partnerships have in common), then, under the regulations, it was classified as a partnership rather than a corporation for Federal income tax purposes. All foreign entities, whether or not considered corporations under local law, were treated as noncorporate entities for this purpose, with the result that they were classified as corporations only if they possessed more than two of the four corporate characteristics.[117]

<u>Classification as corporation or trust</u>

The prior regulations also provided that, in general, the term "trust" refers to an arrangement created either by a will or by an *inter vivos* declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.[118] The regulations further provided that, in general, an arrangement was treated as a trust for tax purposes if it could be shown that the purpose of the arrangement was to vest in trustees responsibility for the protection and conservation of property for beneficiaries who could not share in the discharge of this responsibility and, therefore, were not associates in a joint enterprise for the conduct of business for profit. The income of a trust generally is subject to one level of tax. The income generally is subject to tax either at the beneficiary level (simple trusts), or at the trust level with a corresponding deduction for distributions to beneficiaries (complex trusts).

Because the four characteristics discussed above that distinguished partnerships from corporations under the regulations generally are common to trusts and corporations, the regulations used the other factors–namely the presence of associates and an objective to carry on

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116 *Larson v. Commissioner*, 66 T.C. 159 (1976).

117 Rev. Rul. 88-8, 1988-1 C.B. 403.

118 Former Treas. Reg. sec. 301.7701-4(a).

business and divide the gains therefrom–in distinguishing a corporation from a trust.[119] Thus, an entity was not treated as a trust for tax purposes if it was used for carrying on a profit-making business that ordinarily would be carried on through a business organization such as a corporation or partnership. This type of organization is known as a business or commercial trust (*e.g.*, a Massachusetts business trust).[120]

The prior regulations also provided rules for the classification of investment trusts (sometimes also called "management trusts"). An investment trust with a single class of ownership interests was treated as a trust, rather than an association taxable as a corporation, where there was no power under the trust agreement to vary the investment of the certificate holders (as in the case of so-called "fixed investment trusts" or "unit investment trusts").

Treasury regulations issued in March 1985, (the so-called "Sears" regulations)[121] provided rules for the classification of trusts with more than one class of ownership interest as trusts, or alternatively, as associations taxable as corporations.[122] Under the regulations, a trust having more than one class of ownership interest generally was classified as a corporation or partnership rather than a trust. Thus, if a trust held a portfolio of mortgages, and one class of interest in the trust was to receive all principal collected by the trust and a specified rate of interest thereon, until the trust had collected a specified amount of principal on the mortgages, and another class of beneficiaries was to receive all remaining amounts collected by the trust, then such trust was treated as a corporation or partnership under the regulations. The regulations provided a limited exception for certain trusts with multiple classes of ownership interests, where the existence of multiple classes of interests was incidental to the purpose of facilitating direct investment in the assets of the trust.

Tax treatment of limited liability companies

The State-law entity known as an LLC generally provides the limited liability of a corporation for State law purposes while allowing for the possibility of partnership treatment for Federal tax purposes. In 1988, the Service ruled that an LLC organized under the Wyoming LLC statute[123] could be treated as a partnership for Federal tax purposes, applying the four-factor test of the prior entity classification regulations then in effect.[124] All 50 States have enacted LLC statutes. Over the years following the 1988 revenue ruling, the Service issued a series of revenue rulings on a State-by-State basis, eventually addressing the issue for many of the States,

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[119] Former Treas. Reg. sec. 301.7701-2(a)(2).

[120] Treas. Reg. sec. 301.7701-4(b)).

[121] The impetus for these regulations was the issuance of the multi-class mortgage backed security certificates by the Sears Mortgage Securities Corporation in 1984.

[122] Treas. Reg. sec. 301.7701-4(c).

[123] Wyo. Stat., secs. 17-15-101 through 17-15-136 (1977).

[124] Rev. Rul. 88-76, 1988-1 C.B. 260.

concluding that LLCs organized under each such State's laws could be classified as a partnership for Federal tax purposes. No further such rulings have been issued since December 17, 1996, when the final check-the-box regulations were issued, because as described below, those regulations generally make classification of an entity as a partnership for Federal tax purposes elective.

Check-the-box regulations

On April 3, 1995, the Service announced in Notice 95-14[125] that it was considering repealing the Kintner regulations and replacing them with new regulations that would allow taxpayers to treat domestic unincorporated business entities as partnerships or, alternatively, associations taxable as corporations on an elective basis. The Service also stated that it was considering the possible extension of such treatment to foreign business organizations. Proposed regulations implementing these changes were issued by the Treasury Department on May 13, 1996,[126] and were adopted without fundamental changes as final regulations on December 17, 1996.[127] The final regulations generally are effective January 1, 1997.

The major change made by the check-the-box regulations is to allow tax classification as either a partnership or a corporation to be explicitly elective, subject to minimal restrictions (compared to the prior entity classification regulations),[128] for any domestic nonpublicly traded unincorporated entity with two or more members. In addition, the check-the-box regulations explicitly provide that a single-member unincorporated entity may be treated as a corporation or may be disregarded (treated as not separate from its owners). A disregarded entity is treated in the same manner as a sole proprietorship, in the case of an entity owned by individuals, and in the same manner as a branch or division, in the case of an entity owned by a corporation. The check-the-box regulations also differ from the previous regulations in treating certain entities as *per se* corporations for tax purposes.

The check-the-box regulations retain the rules of the previous regulations for distinguishing "business entities" from trusts. Under the check-the-box regulations, certain business entities will be classified automatically as *per se* corporations.[129] These generally are domestic entities formed under a State corporation statute that describes the entity as a corporation, joint-stock company, or in similar terms. They also include insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State or a

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[125] 1995-1 C.B. 297.

[126] 1996-24 I.R.B. 20.

[127] T.D. 8697.

[128] For domestic LLCs organized in States on whose LLC statutes the Service issued revenue rulings, classification as a partnership was generally attainable if the taxpayer so desired, even prior to the check-the-box regulations.

[129] Under the check-the-box regulations, whether an arrangement is an "entity" for purposes of the check-the-box regime is determined under Federal, not local, law.

foreign government,[130] and organizations that are taxable as corporations under other Code provisions, such as the provisions for publicly traded partnerships.[131]

Similarly, the check-the-box regulations classify as *per se* corporations certain foreign business entities that are listed in the regulations, including, for example, a U.K. Public Limited Company.[132] In broad terms, the foreign entities listed in the regulations are corporations that generally are not closely held and the shares of which can be traded on a securities exchange.

A domestic or foreign entity that is not classified as a *per se* corporation under the above rules is a so-called "eligible" entity that may elect how it will be classified under the regulations' check-the box regime. An eligible entity with two or more members may elect to be classified as a corporation or a partnership. An eligible entity with a single member may elect to be classified as a corporation or to be disregarded (treated as not separate from its owner). If the single owner of a business entity that elects to be disregarded is a bank (as defined in sec. 581), then the special rules applicable to banks continue to apply as if the wholly-owned entity were a separate entity.

For eligible entities that fail to make an election, the check-the-box regulations include certain default rules. Under the default rules, a domestic entity that has multiple members is classified as a partnership. In the case of a domestic single-member entity, the default classification is as a disregarded entity not separate from its owner. In the case of foreign entities with multiple members, the default classification is as a partnership if at least one member does not have limited liability, and as a corporation if all members have limited liability. Default classification for a single-member foreign entity is as a corporation if the single owner has limited liability, and as a disregarded entity if the owner does not have limited liability.

The check-the-box regulations were intended to relieve both taxpayers and the IRS from the need to expend resources determining the proper classification of unincorporated entities, when classification was effectively elective for well-advised taxpayers. The regulations extended elective classification to foreign, as well as domestic, entities on the basis that the complexities and resources devoted to classification of domestic unincorporated business entities were mirrored in the foreign context. Nevertheless, Treasury and the IRS recognized that such increased flexibility in entity classification in the foreign context could provide greater opportunities than under existing regulations for inconsistent, or hybrid, entity classification in the international context.[133]

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[130] T.D. 9012, amending Treas. Reg. sec. 301.7701-2(b)(6) to include any business entity wholly owned by a foreign government.

[131] Sec. 7704.

[132] An entity is treated as domestic if it is created or organized under the law of the United States or of any State; an entity is treated as a foreign entity if it is not domestic under this definition.

[133] Notice 98-11 addresses the use of "hybrid branches" to circumvent the purposes of subpart F. Shortly after the publication of Notice 98-11, the IRS issued temporary and proposed regulations addressing the transactions described in the Notice. Prior to the regulations taking effect, the IRS issued Notice 98-35, which withdrew Notice

B. Incentives for Entity Classification

Incentives under prior law for classification as a C corporation

At the time that the Kintner regulations were issued, several incentives were in place that encouraged the choice of a C corporation rather than a passthrough as a business entity. Under law relating to pensions at that time, partners were at a disadvantage relative to employees in the ability to participate in qualified retirement plans, primarily in terms of contribution and benefit limits.[134] In 1982, the retirement plan qualification requirements were changed, largely eliminating the distinctions in the tax law between plans maintained by partnerships for partners and plans maintained by corporations for employees.[135] Thus, after the 1982 legislation, this incentive to choose a C corporation rather than a passthrough entity as a business entity was removed.

Another Federal tax incentive to choose a C corporation over a passthrough entity, which remains under present law, is the income tax exclusion for employer-provided fringe benefits and cafeteria plans,[136] applied to C corporation owner-employees, but not to partners of partnerships or two-percent shareholders of S corporations.[137] In the past, this rule created an incentive related to the exclusion of work-provided health insurance coverage, of which only 40 percent could be deducted from the income of a partner. However, that incentive no longer exists under present law as partners can deduct 100 percent of the cost of premiums for health insurance.[138] Under present law, differences remain with respect to other fringe benefits.

98-11, and announced its intention to withdraw the temporary and proposed regulations. See Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, pp. 48-49.

[134] See Teresa C. Campbell, "Self-Employed Individuals Tax Reform Act of 1962," *Fordham Law Review*, vol. 32, 1963, p. 279, for a discussion of this pension plan limitation as an incentive to structure business entities in the corporate rather than partnership form prior to 1962. The Self-Employed Individuals Tax Retirement Act of 1962 (Pub. L. No. 87-792) added section 401(c) to the Code which allows self-employed individuals (including partners) to be treated, for purposes of the qualified retirement plan rules, as employees of the business owned by the individual or, in the case of partner, of the partnership. However, a number of special qualification rules applied to plans maintained by partnerships including lower contribution and benefit limits for partners. Corresponding limits applied to qualified plans of S corporations.

[135] The Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248).

[136] Sec. 125. For example, a cafeteria plan may provide employees with a method of paying for health or dependent care expenses with pre-tax dollars.

[137] For purposes of applying provisions related to employee fringe benefits, an S corporation is treated as a partnership and any two-percent shareholder of an S corporation is treated as a partner of such partnership. See Rev. Rul. 91-26, 1991-2 C.B. 184.

[138] Sec. 162(l). However, employer-provided health insurance is also generally exempt from FICA taxes whereas a partner's deduction for health insurance does not apply for self-employment tax purposes.

Another incentive to choose a C corporation or an S corporation rather than a partnership, which remains in the law, is the ability to maintain an ESOP, which is a type of qualified retirement plan designed to be invested primarily in employer securities (generally common stock of the employer or a member of the controlled group).[139] Under present law, the tax advantage of maintaining an ESOP is greater in the case of an S corporation than a C corporation because, to the extent that shares of S corporation stock are held by the ESOP, the income of the S corporation generally passes untaxed through to a tax-exempt entity (an ESOP trust).[140]

Under prior law, the top marginal income tax rates in effect created an incentive toward organizing in the form of a C corporation. Prior to the Tax Reform Act of 1986,[141] the corporate income tax rate tended to be significantly lower than the individual income tax rate. For example, at the time the Kintner regulations were issued in 1960, the top corporate rate was 52 percent, while the top individual rate was 91 percent. In 1980, the top corporate rate was 46 percent, while the top individual rate was 70 percent. Thus, the C corporation form was attractive due to the lower rate on corporate earnings, to the extent the individual was able to defer corporation distributions and hence defer income tax on the distributions.

Incentives under present law for classification as a passthrough entity

Prior to the check-the-box regulations, incentives shifted toward avoidance of the entity level tax associated with C corporations thorough the use of passthrough entities. After the check-the-box regulations, taxpayers were able to elect to conduct business through either a taxable or a nontaxable entity. The change in the relative individual and corporate tax rates contributed to the shift in incentives, given the potential for taxation at both the entity level and the individual level for distributed income of C corporations.[142] Following tax rate changes enacted in 1986, the top corporate tax rate (34 percent) became higher than the top individual tax

[139] Under an ESOP, employee stock is acquired by the plan for the benefit of employees and allocated to their individual accounts. ESOPs are afforded preferential tax treatment under the Code as an incentive for corporations to finance their capital requirements or their transfers of ownership in a way that employees have an opportunity through an ESOP to gain an equity interest in their employer.

[140] Section 1361(c)(6) allows tax-exempt charities and qualified retirement plans to be S corporation shareholders. Section 512(e) subjects the pass-through income with respect to the stock held by these shareholders to the unrelated business income tax but provides an exemption from this tax for ESOPs. There are a series of rules applicable in the case of an ESOP maintained by an S Corporation designed to limit the extent to which the rights with respect to accumulated tax-exempt income can be concentrated in a small group of individuals either through equitable ownership of shares through the ESOP or through other rights to access the tax-exempt income, such as stock options.

[141] Pub. L. No. 99-514.

[142] After enactment of tax legislation in 1986, even large corporate business entities tried to transform themselves into passthrough entities by "disincorporating." Rules generally treating publicly traded partnerships as corporations were enacted in the Revenue Act of 1987 (Pub. L. No. 100-203, sec. 10211(a)) to address concern about the long-term erosion of the corporate tax base following a series of disincorporations.

rate (28 percent), reversing the long-standing pattern of higher individual rates.[143] Individual rates subsequently increased (narrowing the differential), and eclipsed the corporate rate in 1993, then equalized in 2003. The top individual income tax rate has been consistently lower than the summation of the top corporate rate and the dividend rate for individual taxpayers.

More generally, under present law, from the point of view of 2012 tax rates alone, the C corporation form is unattractive relative to a passthrough entity whose income is taxes to individual owners, due to the general equivalence between the top individual and top corporate rate (35 percent) and the potential for a second level of tax of 15 percent on corporate earnings distributed as dividends to an individual in the case of domestic corporations and qualified foreign corporations. Dividends that are not qualified dividends magnify this disincentive, as they may be taxed at rates above 15 percent.

Present law provides an incentive for business owners to prefer a passthrough entity over a C corporation because: (1) owners may not wish business earnings to be subject to two levels of tax (once when earned, and again when distributed); (2) the average or marginal tax rates for the individual shareholders may be lower than that of the corporation; or (3) owners may wish to use losses generated by the business to offset income from other sources. While S corporations and partnerships are both passthrough entities, there are significant Federal tax differences between them that make use of one or the other appropriate for particular taxpayers.

For taxpayers choosing between these two forms, differences between employment (and self-employment) tax rules can result in an incentive to choose an S corporation. An S corporation employee, like employees of other entities, is subject to employment tax (FICA) on his wages, but the shareholder's distributive share of S corporation income is not subject to FICA or self-employment tax (provided that it does not represent reasonable compensation for the shareholder's services). By contrast, a general partner in a partnership is subject to self-employment tax on his distributive share of trade or business income of the partnership (reduced by capital gains, dividends, interest, and other items provided by statute), though an exception to this rule applies to limited partners other than those receiving guaranteed payments for services rendered.[144] The IRS has taken the position that a partner cannot also be an employee of a partnership,[145] unlike an S corporation shareholder who may be both an employee and a

[143] This discussion assumes taxpayers are in the top income tax rate bracket. The incentives may be different for individuals and C corporations whose income does not exceed the lower graduated tax rates. C corporations are taxed at the following statutory rates: 15 percent (for taxable income up to $50,000); 25 percent (for taxable income above $50,000 but not exceeding $75,000); 34 percent (for taxable income above $75,000 but not exceeding $10,000,000). The benefit of graduated rates below 34 percent is phased out for C corporations with taxable income between $100,000 and $335,000, and the benefit of the 34 percent rate is phased out for C corporations with taxable income in excess of $15,000,000.

[144] As discussed above, there is uncertainty under present law regarding the self-employment treatment of LLC members.

[145] Rev. Rul. 69-184, 1969-1, C.B. 256.

shareholder of the S corporation. These differences may have contributed to the relative growth of S corporations.[146]

On the other hand, partnerships may be an attractive business entity choice because it permits for more flexible allocations of items of partnership income, deduction, gain, or loss (provided the allocations have substantial economic effect), while shareholders' distributive shares of items of S corporation income, deduction, gain, or loss are determined on a per-share, per-day basis. Further, partnerships may have a relative advantage of S corporations because of differences in the determination of an owner's basis in his interest, which serves as a limitation on the share of losses that may be passed through to the owner. In general, certain liabilities of a partnership may be included in the partner's basis for his partnership interest, thus serving to increase the amount of partnership loss and deduction that may be passed through to the partner. Liabilities of an S corporation, by contrast, are not included in the basis of the S corporation shareholders' stock, and thus do not serve to enhance the passthrough of losses; though shareholder-level debt may serve this purpose for an S corporation shareholder that is able to borrow to increase his equity contribution, if the arrangement is respected for tax purposes.[147]

[146] See section I of this document for data illustrating the growth of S corporations.

[147] Rules to limit the ability to transfer losses among partners and to preclude the ability to reduce the basis of corporate stock of a partner in certain transactions were enacted in response to perceived abuses and tax shelter transactions relating to partnerships in the American Jobs Creation Act of 2004 (Pub. L. No. 108-357, sec. 833).

IV. ISSUES AND ANALYSIS

A. Effect on Entity Choice of Corporate Tax Rate, Individual Tax Rate, and Tax on Dividends and Gains

Along with other factors, the choice of entity may be influenced by the tax burden on income earned in that form. In general, one may expect capital to flow to the sector (*e.g.*, corporate vs. noncorporate) that is most lightly taxed. Changes in the burden of taxation alter the incentives to organize business activity in a certain form and may result in some businesses changing their form in response to these changing incentives.

The presence of a separate entity level tax creates a disincentive to organize in corporate form, even in situations where nontax considerations indicate that corporate form would otherwise be preferable. To some extent, this depends on the ultimate incidence of the corporate income tax, whether on shareholders in the form of reduced after-tax returns to capital, consumers in the form of higher prices, employees in the form of lower wages, suppliers in the form of lower prices for inputs, or some combination thereof.[148]

A proper analysis of the tax burden includes the effect of taxation of income not only at the entity level, but also at the investor/owner level. Distributions of corporate income in the form of dividends may be subject to additional taxation at the shareholder level. Retained corporate earnings may increase the value of corporate stock resulting in capital gains that may be taxed upon sale of the stock. However, a shareholder may be a tax-exempt entity or a foreigner and not bear any additional U.S. income tax.

An analysis of the effect of taxation on entity choice depends on the marginal corporate income tax rate, the marginal individual income tax rate on noncorporate business income, the marginal individual income tax rate on dividend distributions by a corporation, and the capital gains tax rate. Figure 5 and Table 11 below report the top marginal tax rate for each category of income from 1909 through 2012.[149] The marginal tax rates applicable to a particular corporation or individual may vary based on the source and amount of taxable income.

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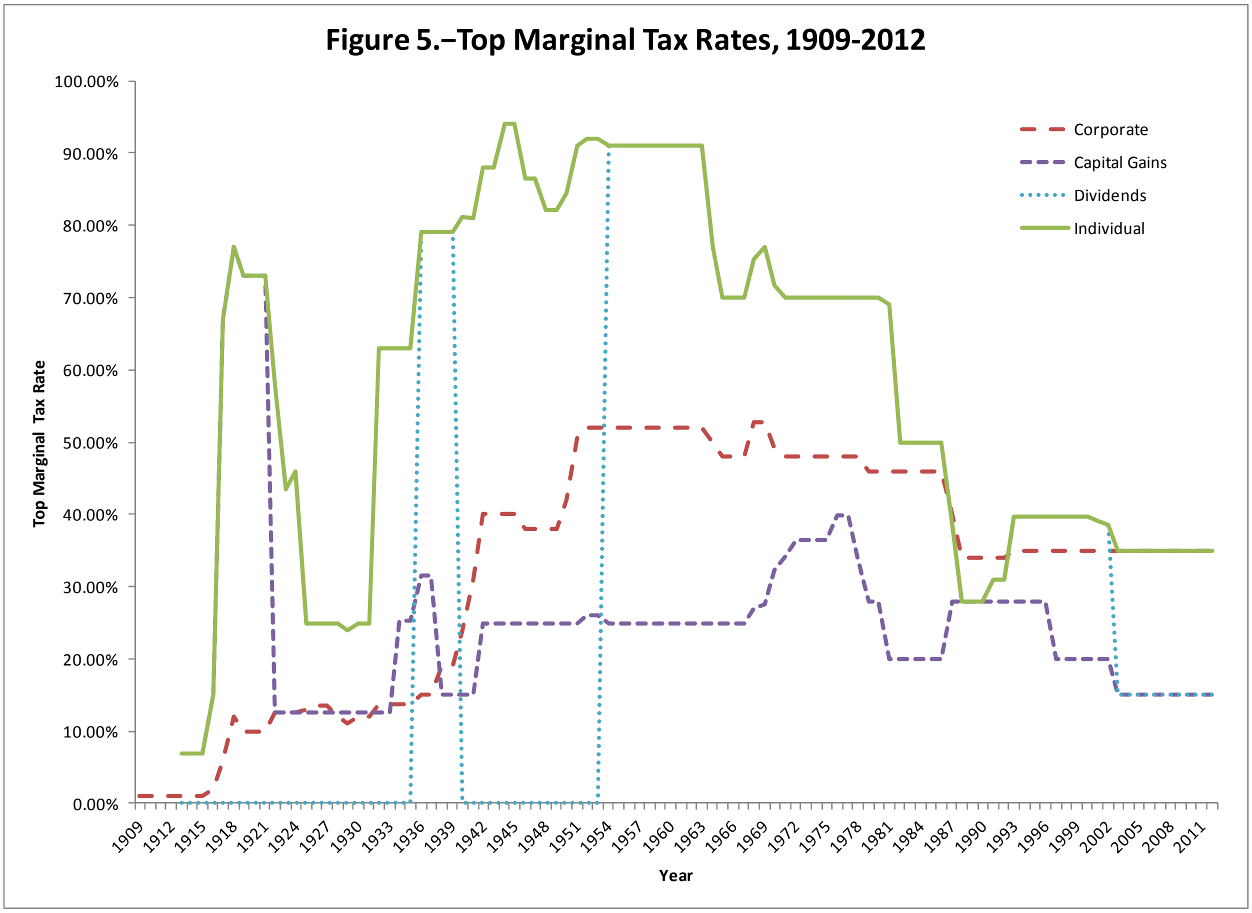
[148] The incidence of the corporate income tax is beyond the scope of this discussion. All that is important for the following analysis is that the burden of taxation is related to the marginal tax rates in the corporate and noncorporate sector.

[149] The table reports the rate that applies as of the end of the year for years in which there was a midyear change in tax rates. Midyear rate changes occurred in 1978, 1981, 1997, and 2003. The table includes the effect of income tax surcharges and exclusions, but not the effect of phase-outs of itemized deductions or the deduction for domestic production activities.

As shown below, for most of the history of Federal income taxation, the top individual income tax rate has exceeded the top marginal corporate income tax rate. This has been the case except for the period from 1987 through 1992 following enactment of the Tax Reform Act of 1986.[150]



Source: Statistics of Income Bulletin, Historical Tables 23 and 24, Treasury Department, and JCT staff calculations.

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[150] Pub. L. No. 99-514. For an empirical analysis of the effect of tax rate changes in the Tax Reform Act of 1986 on corporate decisions to organize as C corporations or S corporations, see Robert Carroll and David Joulfaian, "Taxes and Corporate Choice of Organizational Form," Office of Tax Analysis Working Paper 73, Department of the Treasury, October 1997, available at http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/ota73.pdf.

Table 11.–Top Marginal Tax Rates, 1909-2012

Year	Corporate	Individual	Capital Gains	Dividends	Year	Corporate	Individual	Capital Gains	Dividends
1909	1.00%				1961	52.00%	91.00%	25.00%	91.00%
1910	1.00%				1962	52.00%	91.00%	25.00%	91.00%
1911	1.00%				1963	52.00%	91.00%	25.00%	91.00%
1912	1.00%				1964	50.00%	77.00%	25.00%	77.00%
1913	1.00%	7.00%	7.00%	0.00%	1965	48.00%	70.00%	25.00%	70.00%
1914	1.00%	7.00%	7.00%	0.00%	1966	48.00%	70.00%	25.00%	70.00%
1915	1.00%	7.00%	7.00%	0.00%	1967	48.00%	70.00%	25.00%	70.00%
1916	2.00%	15.00%	15.00%	0.00%	1968	52.80%	75.25%	26.90%	75.25%
1917	6.00%	67.00%	67.00%	0.00%	1969	52.80%	77.00%	27.50%	77.00%
1918	12.00%	77.00%	77.00%	0.00%	1970	49.20%	71.75%	32.21%	71.75%
1919	10.00%	73.00%	73.00%	0.00%	1971	48.00%	70.00%	34.25%	70.00%
1920	10.00%	73.00%	73.00%	0.00%	1972	48.00%	70.00%	36.50%	70.00%
1921	10.00%	73.00%	73.00%	0.00%	1973	48.00%	70.00%	36.50%	70.00%
1922	12.50%	58.00%	12.50%	0.00%	1974	48.00%	70.00%	36.50%	70.00%
1923	12.50%	43.50%	12.50%	0.00%	1975	48.00%	70.00%	36.50%	70.00%
1924	12.50%	46.00%	12.50%	0.00%	1976	48.00%	70.00%	39.88%	70.00%
1925	13.00%	25.00%	12.50%	0.00%	1977	48.00%	70.00%	39.88%	70.00%
1926	13.50%	25.00%	12.50%	0.00%	1978	48.00%	70.00%	33.85%	70.00%
1927	13.50%	25.00%	12.50%	0.00%	1979	46.00%	70.00%	28.00%	70.00%
1928	12.00%	25.00%	12.50%	0.00%	1980	46.00%	70.00%	28.00%	70.00%
1929	11.00%	24.00%	12.50%	0.00%	1981	46.00%	69.13%	20.00%	69.13%
1930	12.00%	25.00%	12.50%	0.00%	1982	46.00%	50.00%	20.00%	50.00%
1931	12.00%	25.00%	12.50%	0.00%	1983	46.00%	50.00%	20.00%	50.00%
1932	13.75%	63.00%	12.50%	0.00%	1984	46.00%	50.00%	20.00%	50.00%
1933	13.75%	63.00%	12.50%	0.00%	1985	46.00%	50.00%	20.00%	50.00%
1934	13.75%	63.00%	25.20%	0.00%	1986	46.00%	50.00%	20.00%	50.00%
1935	13.75%	63.00%	25.20%	0.00%	1987	40.00%	38.50%	28.00%	38.50%
1936	15.00%	79.00%	31.60%	79.00%	1988	34.00%	28.00%	28.00%	28.00%
1937	15.00%	79.00%	31.60%	79.00%	1989	34.00%	28.00%	28.00%	28.00%
1938	19.00%	79.00%	15.00%	79.00%	1990	34.00%	28.00%	28.00%	28.00%
1939	19.00%	79.00%	15.00%	79.00%	1991	34.00%	31.00%	28.00%	31.00%
1940	24.00%	81.10%	15.00%	0.00%	1992	34.00%	31.00%	28.00%	31.00%
1941	31.00%	81.00%	15.00%	0.00%	1993	35.00%	39.60%	28.00%	39.60%
1942	40.00%	88.00%	25.00%	0.00%	1994	35.00%	39.60%	28.00%	39.60%
1943	40.00%	88.00%	25.00%	0.00%	1995	35.00%	39.60%	28.00%	39.60%
1944	40.00%	94.00%	25.00%	0.00%	1996	35.00%	39.60%	28.00%	39.60%
1945	40.00%	94.00%	25.00%	0.00%	1997	35.00%	39.60%	20.00%	39.60%
1946	38.00%	86.45%	25.00%	0.00%	1998	35.00%	39.60%	20.00%	39.60%
1947	38.00%	86.45%	25.00%	0.00%	1999	35.00%	39.60%	20.00%	39.60%
1948	38.00%	82.13%	25.00%	0.00%	2000	35.00%	39.60%	20.00%	39.60%
1949	38.00%	82.13%	25.00%	0.00%	2001	35.00%	39.10%	20.00%	39.10%
1950	42.00%	84.36%	25.00%	0.00%	2002	35.00%	38.60%	20.00%	38.60%
1951	50.75%	91.00%	25.00%	0.00%	2003	35.00%	35.00%	15.00%	15.00%
1952	52.00%	92.00%	26.00%	0.00%	2004	35.00%	35.00%	15.00%	15.00%
1953	52.00%	92.00%	26.00%	0.00%	2005	35.00%	35.00%	15.00%	15.00%
1954	52.00%	91.00%	25.00%	91.00%	2006	35.00%	35.00%	15.00%	15.00%
1955	52.00%	91.00%	25.00%	91.00%	2007	35.00%	35.00%	15.00%	15.00%
1956	52.00%	91.00%	25.00%	91.00%	2008	35.00%	35.00%	15.00%	15.00%
1957	52.00%	91.00%	25.00%	91.00%	2009	35.00%	35.00%	15.00%	15.00%
1958	52.00%	91.00%	25.00%	91.00%	2010	35.00%	35.00%	15.00%	15.00%
1959	52.00%	91.00%	25.00%	91.00%	2011	35.00%	35.00%	15.00%	15.00%
1960	52.00%	91.00%	25.00%	91.00%	2012	35.00%	35.00%	15.00%	15.00%

Source: Statistics of Income Bulletin, Historical Tables 23 and 24, Treasury Department, JCT staff calculations.

Issues when individual rate is higher than corporate rate

The corporate tax may serve as a backstop to the individual income tax in the case of retained corporate earnings. Without either a deemed distribution system analogous to the S corporation model or a substantial corporate tax on retained earnings, income could be accumulated without bearing similar income tax compared to the amount of tax that would be paid if the income were earned directly by individuals. On the margin, when the individual income tax rate is substantially higher than the corporate income tax rate, it may create an incentive to organize business activity in corporate rather than passthrough form.

For example, if there were either no corporate tax or a corporate tax imposed at a much lower rate than the individual tax, individuals would be able to invest assets in corporations where those assets would earn and accumulate income that was not taxed currently (or taxed at low rates currently). Such income earned by corporations, to the extent reflected in increased value, would be taxed on a deferred basis to the individuals, perhaps at capital gains rates or perhaps not at all in the case of an individual who holds appreciated shares of stock at death.[151] Thus, some contend that absent full integration,[152] the imposition of a substantial corporate tax on undistributed corporate earnings may prevent deferral or complete avoidance of taxation of the income earned through corporations. If the corporate rate is significantly below the individual's marginal rate (for example, because of the graduated corporate income tax rate structure), the deferral advantage can more than offset the extra burden of the corporate income tax. Present law imposes limits on the use of corporations for this purpose through the personal holding company rules, as discussed in section II of this document. The separate tax is intended to compensate adequately for deferral that may occur to the extent that an individual's marginal tax rate exceeds a corporation's marginal tax rate.

Issues when corporate rate is higher than the individual rate

Conversely, the incentive to organize in passthrough form to escape the entity-level taxation is made stronger when the corporate rate rises relative to the individual income tax rate, because the burden of the corporate tax rises. When the corporate income tax rate is higher than the individual income tax rate, it may also distort decisions to retain or to distribute corporate earnings. If the effective tax rate on shareholders is significantly lower than the corporate effective tax rate there may be an incentive to distribute earnings rather than retain them at the corporate level. This can create an economic distortion if a corporation is better able to invest capital than its shareholders. If the corporation and its shareholders are both able to make the best possible investments, no inefficiency necessarily results from incentives to retain or distribute earnings.

[151] Sec. 1014.

[152] A discussion of proposals to integrate the corporate and individual income taxes is beyond the scope of this document.

Examples

In general

Consider two corporations that are identical in every respect except that one, ABC, is organized as a C corporation and the other, QRS, is organized as an S corporation. Taxpayer T, owns one-tenth of one percent of the stock in both ABC and QRS and has sufficient other income to be in the highest marginal individual income tax bracket, τ_i. ABC is taxed at the marginal corporate tax rate, τ_c, dividends paid to shareholders are taxed at the dividends tax rate, τ_d, and capital gains are taxed at the capital gains tax rate, τ_g. Each corporation is financed entirely by equity (*i.e.*, there are no tax deductible payments of interest), has taxable income of TI, and retains after-tax corporate profits of RE. Retained earnings increase the value of the corporate stock.[153]

Under these assumptions, the combined corporate and individual income taxes paid on an investment in ABC by T and ABC are equal to

$$ABC\ tax = \tau_c TI + \tau_d\,[TI(1-\tau_c) - RE] + \tau_g RE$$

Since all of the income of QRS is passed through to its shareholders, the total taxes paid on an investment in QRS by T and QRS are equal to

$$QRS\ tax = \tau_i TI$$

Numerical examples

In 1980, the top marginal individual income tax rate was higher than the top marginal corporate income tax rate. The top individual rate (including on distributed corporate dividends) was 70 percent, the top corporate rate was 46 percent, and the top capital gains tax rate was 28 percent. Assume that ABC and QRS each had $100 million of taxable income and ABC had a policy to retain all after-tax earnings ($RE = [TI(1-\tau_c)]$) for future investment opportunities. Assume that Taxpayer T disposed of his share of stock in ABC and was eligible for the 28-percent rate on long-term capital gains. Total taxes on an investment by Taxpayer T in ABC and QRS, respectively, would have been:

$$ABC\ tax_{1980} = .46(100{,}000) + .70\,[0] + .28[100{,}000(1-.46)] = \$61{,}120$$

$$QRS\ tax_{1980} = .70\,(100{,}000) = \$70{,}000.$$

In 1988, the top marginal corporate tax rate dropped to 34 percent, while the top individual income tax rate, the dividends tax rate, and the capital gains tax rate were all 28

[153] While sales of S corporation stock may generate capital gains, the amount of gain in these examples is equal to zero because the shareholder receives an increase in basis equal to the amount of earnings previously taxed at the shareholder level.

percent. Given the same fact pattern above, total taxes on an investment by Taxpayer T in ABC and QRS, respectively, would have been:

$$ABC\ tax_{1988} = .34(100{,}000) + .28\ [0] + .28[100{,}000(1 - .34)] = \$52{,}480$$

$$QRS\ tax_{1988} = .28\ (100{,}000) = \$28{,}000.$$

In 2012, the top marginal corporate and individual income tax rates are both 35 percent, while dividends and long-term capital gains are both taxed at 15 percent. Given the fact pattern above, total taxes on an investment by Taxpayer T in ABC and QRS, respectively, would be:

$$ABC\ tax_{2012} = .35(100{,}000) + .15\ [0] + .15[100{,}000(1 - .35)] = \$44{,}750$$

$$QRS\ tax_{2012} = .35\ (100{,}000) = \$35{,}000.$$

Effect of dividend payout ratio

If the rate on capital gains and dividends differs, the relative tax burden of an investment in a C corporation versus in an S corporation also depends on the corporate policy with respect to dividend payouts. If ABC had a policy to pay out half of its after-tax earnings as dividends ($RE = \left[\frac{TI(1-\tau_c)}{2}\right]$), instead of retaining all its after-tax earnings, the total tax result for ABC in 1980 would have been:

$$ABC\ tax_{1980} = .46(100{,}000) + .70\ \left[\frac{100{,}000(1-.46)}{2}\right] + .28\left[\frac{100{,}000(1-.46)}{2}\right] = \$72{,}460.$$

The additional burden of the corporate tax on earnings distributed as dividends may have made a company prefer to organize as an S corporation, and incur a $70,000 total tax liability as calculated above, rather than as a C corporation, and incur the $72,460 total tax liability calculated here. The tax results would be unaffected for 1988 and 2012 because the tax rate on dividends equals the tax rate on capital gains in those years.

Effect of deferring or eliminating capital gains taxes

The present value of the tax on capital gains may be reduced by delaying the sale of corporate stock. In the extreme case, tax on capital gains may be eliminated if a taxpayer holds appreciated shares of stock until death. The ability to reduce or eliminate the tax on capital gains offsets some of the disincentive effect of the second level of tax on distributed C corporation earnings. Consider the tax result for ABC in 1980 if Taxpayer T died on December 31, 1980 (so taxable capital gain is zero), and ABC paid out half of its after-tax earnings as dividends.

$$ABC\ tax_{1980} = .46(100{,}000) + .70\ \left[\frac{100{,}000(1-.46)}{2}\right] + .28[0] = \$64{,}900$$

In this circumstance, a C corporation is more attractive from a tax standpoint than an S corporation, as in the first numerical example above. Thus, the negative effect of the increased dividend payout ratio is partially offset by the ability to reduce the capital gains tax.[154]

[154] If capital gains taxes are deferred rather than eliminated, the total tax paid on an investment in ABC would still be reduced, though not as much. In this example, if the effective capital gains tax rate were reduced below 18.89 percent ($70,000-$64,900) / $\left[\frac{100{,}000(1-.46)}{2}\right]$), the total tax paid on an investment in ABC would be less than on an investment in QRS. Assuming a discount rate of 10 percent, this could be accomplished by deferring the gain for at least five years.

B. Distinguishing Entities Taxable as C Corporations or Partnerships

In general

Historically, tax rules have relied on a notion of resemblance when determining whether an entity should be classified for tax purposes as a C corporation or as an entity taxable as a partnership. Under this approach, entities resembling already existing corporations in meaningful respects should be taxed as corporations, while entities that do not resemble corporations can be taxed differently (*e.g.*, as partnerships).[155] Specific factors thought to be independent, nontax characteristics of corporations served to distinguish among entities for tax purposes. However, applicability of these factors eroded over time as characteristics once thought to clearly distinguish corporations from partnerships became common features of both, even before the adoption of the 1996 check-the-box regulations.[156] Electivity of business tax treatment has been further enhanced by the increase in the use of S corporations, the restrictions on which, since their inception in 1958, have been liberalized to permit, *inter alia*, up to 100 shareholders (with expanded attribution rules).

While a case can be made that horizontal equity dictates that all business entities should receive the same Federal tax treatment, as a practical matter, differing tax regimes are still provided under present tax law. Arguments for each can be made. For example, the corporate tax functions to simplify the collection of income tax directly from corporate businesses rather than separately and less efficiently in smaller segments from each owner of the business. Similarly, tax issues relating to the items of income, gain, loss, and deduction of a corporate business can be resolved as a group at the business level rather than independently – with reduced efficiency and consistency – with each owner of an interest in the business. On the other hand, for passthroughs (partnerships and S corporations), each owner is taxed on his, her, or its share of income or loss from the business as if the owner owned the business directly, like a sole proprietor, regardless of whether the business makes distributions. The tax result can thereby follow the business arrangement among the owners, permitting the tax result to match more closely the economic result.

Assuming, however, that corporate tax treatment and passthrough tax treatment are to be retained for different types of entities, the question arises whether a reasoned basis can be

[155] Integration of the corporate and shareholder level taxes would be a means of treating business income more neutrally across several forms of business entities. Moreover, it is possible to combine a change to the scope of the corporate income tax with an integration of the corporate and individual income taxes. However, a discussion of integration proposals is beyond the scope of this document. It is presumed for purposes of this discussion that both a corporate tax regime and passthrough tax regimes continue.

[156] For example, as practice and State laws evolved, most of the corporate characteristics under the Kintner regulations (such as limited liability for owners, continuity of entity existence, and transferability of interests) could be achieved along with passthrough treatment for Federal income tax purposes, even before the check-the-box regulations. For example, limited partners could establish a single corporate general partner to effect a large degree of limited liability. See, *e.g.*, Rev. Rul. 92-88, 1992-2 C.B. 496 and *Larson v. Commissioner*, 66 T.C. 159 (1976). In addition, taxpayers could use contractual arrangements among partners to help insure continuation of the partnership (*e.g.*, in the event of a partner's withdrawal) or to facilitate the free transferability of interests (*e.g.*, by requiring that consent to a partnership interest transfer not be unreasonably withheld).

identified for distinguishing between businesses properly subject to an entity-level tax and those properly treated as passthroughs. The distinction could be based on multiple factors or on a principal factor that enables a reasoned distinction. Possible factors include (1) whether interests in the entity are publicly traded, publicly owned, are owned by a minimum (or maximum) number of persons, or are otherwise distinguishable; (2) whether the owners are accorded limited liability for obligations of the business; (3) the relative size of the business, which could be measured by receipts, assets, number of interests or owners, or some other measure; or (4) the nature of the activities conducted by the entity.

Public trading

Access to public equity capital markets is often cited as the principal nontax distinction between corporate and passthrough entities.[157] Some might argue that public trading of equity interests should be maintained as a basis for imposing the entity-level tax, and even applied more expansively than under present law. If public trading were uniformly applied (as a sole factor without exceptions) to determine corporate tax status, the result would likely be an expansion of the entities treated as corporations. Many publicly traded partnerships and investment vehicles currently tax as passthroughs (or quasi-passthroughs) could become subject to entity-level tax.

A variety of arguments have been made to support public trading as a basis for entity-level tax. Proponents might argue the corporate tax is justified as payment in return for the greater liquidity possible through the maintenance and regulation of public capital markets.[158] Some argue that tax neutrality with respect to organizational form argues in favor of treating all publicly traded entities the same.[159] For example, some might support the elimination of the exception in section 7704 for publicly traded partnerships with sufficient qualified income because, to the extent these partnerships compete with similar entities subject to the corporate tax, such a change could equalize the treatment of similarly situated taxpayers and reduce distortions in how business entities organize themselves.

Proponents may argue that subjecting all publicly traded partnerships to corporate tax could have significant benefits for the administration of the tax system, for both the IRS and for taxpayers. For example, the IRS would not have to depend upon the accurate filing by potentially thousands of partners whose interests could be constantly changing through public trading. Rather, the audit, adjustment, collection, and refund process could more efficiently

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[157] See sec. 7704.

[158] See, *e.g.*, Alvin C. Warren, "The Corporate Interest Deduction: A Policy Evaluation," *Yale Law Journal*, vol. 83, July 1974, p. 1600 (noting that a "separate tax on corporate income is sometimes considered appropriate because of the privileges and benefits granted corporations by the state, such as perpetual life, limited liability for investors, and marketability of shares" but noting that such benefit rationales are subject to considerable criticism).

[159] See, *e.g.*, the preliminary report prepared by Senate Finance Committee staff, *The Reform and Simplification of the Income Taxation of Corporations*, S. Prt. 98-95, September 22, 1983, p. 106 ("The principal argument against permitting publicly traded limited partnerships to be taxed as pass-through entities is one of neutrality: publicly traded partnerships are simply too similar to business entities that are taxed as corporations.").

focus on a single entity rather than potentially thousands of individual partners. For taxpayers, collection of tax at the entity level could reduce compliance burdens including the need to file separate partnership returns for each State in which the enterprise conducts business, or separately identify items of deduction or credit, or various categories of income with potentially different tax treatments.

Access to debt capital

Those in favor of public trading as a basis for entity-level taxation might argue that the present law conception of public trading is too narrow. For example, the publicly traded partnership rules of section 7704 only look to the trading of equity interests. Passthrough entities whose equity interests are not publicly traded may nonetheless access liquid, public debt markets. If imposition of an entity level tax should turn on access to liquid public capital markets, one might ask why publicly traded equity and debt are treated differently for this purpose.

Access to nontraded capital or other forms of financing

Alternatively, if public trading is thought to represent access to capital,[160] one might argue that the present law conception of "public" capital is too narrow. For example, the issuance of equity interests tradable on an established securities exchange is not the only way of accessing large pools of equity capital. In lieu of a public offering, a closely held company might access equity capital by issuing interests to an investment fund that receives its capital from pension funds, public university endowments, sovereign wealth funds, and high net worth individuals. It is reasonable to argue that such capital ultimately derives from the general public, but through a different mechanism.

Those opposed to treating all publicly traded entities as corporations might argue that such an approach does not, in fact, achieve neutrality because similar businesses could still be subject to different tax regimes. For example, a partnership engaged in the trade or business of natural resource exploration, development, and production with publicly traded interests would be subject to entity-level tax, but a nonpublicly traded partnership identical in every other respect would not.

With regard to eliminating the qualifying income exception to corporate status in section 7704, it can be argued that the exception reflects a policy objective that passive income ought not be subject to a corporate or entity level tax.

It could also be said that arguments to expand the definition of public capital prove too much, either because an individual (or small group of individuals) might be a source of significant equity capital, or because financial intermediaries in general aggregate public capital.

[160] See, *e.g.*, *Morrissey v. Commissioner*, 296 U.S. 344 (1935), p. 359 (noting the possibility of a "large number of participants" as a corporate-type feature); *Outlaw v. U.S.*, 494 F.2d 1376 (Ct. Cl. 1974), p. 1385 (including as an additional "significant" factor in classifying a trust as a corporation that financing was promoted with the use of an offering memorandum "similar to that used by many corporations to obtain initial capital.").

For example, the ultimate source of a depository institution loan may be, in fact, its public depositors.

Further, opponents might argue that subjecting additional entities to the corporate tax increases tax distortions. An entity-level tax on entities not currently subject to one could increase the cost of capital for those traded entities. The transition from noncorporate to corporate taxation for existing entities could be complex and costly. On the other hand, proponents might note that these issues could be addressed, in part, by combining an extension of the corporate tax with an integration of the corporate and individual income taxes.

Number of owners

A factor for distinguishing corporate and passthrough tax treatment might be whether the entity has a sufficiently large number of owners.[161] This factor could relate to what it means to be held by the public, or it could relate to the size of the business. Under present law, number of owners is relevant to the taxation of an entity in several instances. For example, a corporation is not eligible for passthrough treatment under subchapter S if it has more than 100 shareholders (taking into account attribution rules),[162] while a REIT must have 100 or more beneficial owners, along with transferable shares.

If ease of revenue collection or administrative convenience (for the government and for taxpayers) are factors favoring corporate status, then the existence of a large number of owners may arguably support treating an entity as a corporation. The question of what constitutes a large number of owners may not be simple to resolve, however, because some entities may have thousands or hundreds of thousands of owners, and a principled boundary between small and large may be difficult to establish. In addition, it may not be clear how to count owners, particularly if owners are other entities, or if debt (or other financial instruments) are taken into account.[163]

It could be argued, however, that a large number of owners alone should not be determinative of corporate tax status. If neutrality is the principal concern, critics might argue that any number chosen might lead to inequitable results because a small group of wealthy individuals could pool their capital and form a passthrough entity while a comparable entity with slightly less well-off (and therefore more numerous) partners would be subject to tax. If choice

161 See, *e.g.*, Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, vol. 2, November 1984, pp. 146-48 (proposing to tax limited partnerships with more than 35 limited partners as corporations). The proposal was not included in the subsequent Administration proposal, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, May 1985.

162 When originally enacted, the shareholder limit for S corporations was just 10 shareholders.

163 See, *e.g.*, Herwig J. Schlunk, "I Come Not to Praise the Corporate Income Tax, But to Save It," *Tax Law Review*, vol. 56, Spring 2003 (advocating an entity-level tax that looks to number of "participants" in the business enterprise including, equity holders, creditors, lessors, licensors, and employees).

of entity distortions are a concern, opponents can argue that taxpayers might seek ways to structure around such limitations.[164]

Limited liability

Some have argued for investor limited liability as a basis for entity-level taxation. Proponents may argue that an entity-level tax is appropriate given this benefit conferred investors by the government.[165] Limited liability might also be considered evidence of sufficient separateness between the owners of the enterprise and the entity to justify entity level taxation.[166]

Opponents of relying on this characteristic may raise a variety of objections. Some may argue the Federal corporate income tax has very little connection to limited liability, both because limited liability is a benefit conferred under State law and because corporate income is unrelated to the benefit.[167] More practically, opponents may argue that developments in practice and State law have simply outstripped this argument because limited liability is a common feature of nearly all business entities today. Even before the advent of the State law LLC and the check-the-box regulations, both limited liability and passthrough taxation could be achieved through careful planning. For example, limited partnerships could establish a single corporate general partner (effecting a large degree of limited liability).[168] Any expansion of limited liability as a basis for corporate taxation would have to address such planning techniques.

In addition, given the increase in LLCs and S corporations, a proposal to tax all entities offering investors limited liability as corporations would have to address transition for the millions of entities operating in passthrough form. Opponents may argue that the cost and complexity of such a transition would outweigh any benefit.

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[164] See, *e.g.*, David R. Keyser, "Publicly Traded Limited Partnerships: The Treasury Fights the Wrong War," *Tax Notes*, April 29, 1985 (criticizing the Treasury's 1984 35-partner proposal).

[165] See, *e.g.*, Reuven S. Avi-Yonah, "Corporations, Society, and the State: A Defense of the Corporate Tax," *Virginia Law Review*, September 2004, pp. 1220-21 (noting that limited liability as a justification for the corporate tax extends all the way to the 1909 Act).

[166] See, *e.g.*, Joint Committee on Taxation, *Federal Income Tax Treatment of Pass-Through Entities* (JCS-13-86), June 9, 1986, pp. 13-15.

[167] Reuven S. Avi-Yonah, "Corporations, Society, and the State: A Defense of the Corporate Tax," *Virginia Law Review*, September 2004, p. 1206.

[168] A corporate general partner, even though itself a limited liability entity, would not cause a partnership to be treated as a corporation, under the IRS ruling position, if that partner had assets equal to or greater than 10 percent of the total contributions to the partnership. Rev. Rul. 92-88, 1992-2 C.B. 496. Some taxpayers successfully contended that even this capitalization requirement was not necessary so long as the corporate general partner was not a "dummy" acting as the agent of the limited partners. See *Larson v. Commissioner*, 66 T.C. 159 (1976).

Size of the business

Another nontax factor one might consider for determining corporate tax status is the size of the business, for example, subjecting all large business entities to entity-level tax. This approach has been considered in recent Administration proposals. In 2005, the President's Advisory Panel on Tax Reform recommended separate business tax regimes for large, medium-sized, and small businesses.[169] In its 2012 Framework for Business Tax Reform, the current Administration suggests reforming the corporate tax base to, among other things, establish greater parity between large corporations and their noncorporate counterparts.[170]

As a threshold matter, such an approach would have to define what it means to be large, because there is no consistent definition of what constitutes a small or large business under present law. For purposes of the S corporation election, a small business is defined by reference to the number of shareholders. As discussed above, this number has changed over time, increasing from no more than 10 when originally enacted to no more than 100 (using an expansive attribution rule that counts husband and wife and all members of a family[171] as a single shareholder). In different contexts the Code also looks to assets (*e.g.*, the section 1202 exclusion of capital gain on small business stock), gross receipts (*e.g.*, the section 38 eligible small business credits), number of employees (*e.g.*, the section 41 eligible small business contract research), and production or capacity (*e.g.*, the section 40(b)(4) small ethanol producer credit). In 2005, the President's Advisory panel recommended sorting the business world by gross receipts. A small business under the proposal is one with less than $1 million in receipts, a medium business one with $1 million or more but less than $10 million, and a large business one with $10 million or more. Under that proposal, large business entities (including partnerships) are subject to tax at the entity level.[172]

Proponents of business size as a basis for determining corporate tax treatment might argue that parity between businesses of similar size is warranted as a matter of horizontal equity, so that business competitors are subject to comparable tax rules. Alternatively, proponents might argue that business size is a suitable proxy for a business's ability to comply with a more complex set of tax rules. To the extent such a change broadens the corporate tax base, it is

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[169] The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, pp. 126-131.

[170] *The President's Framework for Business Tax Reform*, A Joint Report by the White House and the Department of the Treasury, February 2012, p. 10. See also, President's Economic Recovery Advisory Board, *Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, August 2010, pp. 74-77 (suggesting "company size" as a possible basis for corporate taxation, without further specification).

[171] See sec. 1361(c)(1). Members of a family means a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of any such lineal descendant. For this purpose, an individual is not considered a common ancestor if the individual is more than six generations removed from the youngest generation who would otherwise be members of a family.

[172] The President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, p. 129.

possible that such a change could be used to generate revenue to finance lower tax rates more generally. For reasons similar to those discussed above, proponents might argue that applying an entity level tax to large entities could offer administrability advantages for both the government and for taxpayers.

Those opposed to determining entity-level taxation based on business size may argue that the concept raises significant issues, even without regard to the chosen metric (*e.g.*, number of owners, gross receipts, assets, employees). For example, opponents might argue that such a proposal provides a disincentive for businesses to expand or grow. In addition, rules would need to be developed to address an entity's transition across the threshold, and rules for cases where a taxpayer satisfies the threshold but then fails to satisfy the threshold in a future period. Using business size as the basis for taxation may create incentives for the very taxpayer behavior the proposal is designed to alleviate. That is, taxpayers could have the incentive to structure their business operations in particular ways for the purpose of avoiding the entity level tax. Rules would be needed to prevent business from splitting into multiple entities or spreading income, assets, or employees across multiple entities in order to avoid crossing the threshold. In addition, opponents may argue that using size as a basis for entity-level taxation could decrease market efficiencies, such as the formation of joint venture partnerships involving two or more entities, or the securitization of assets,[173] and economies of scale.

Activities

Under present law, certain activities (like those generating qualifying income of a publicly traded partnership) can allow an entity to avoid entity-level taxation. Other activities (like insurance) can only be conducted in corporate form. In some cases there is overlap between the two, and in many cases there is no correlation between an entity's activities and its taxation.

Some might argue that this lack of coordination under present law presents horizontal equity issues to the extent similarly situated businesses are subject to different tax treatment, including taxation at the entity level. As just one example, banking activities can be conducted in an entity taxable as a C corporation, an S corporation,[174] or as an entity exempt from Federal tax.[175] Similarly, an insurance business may be conducted in an entity taxable as a C corporation[176] or as a tax-exempt organization.[177] Some might argue that this type of electivity is

[173] See, *e.g.*, James M. Peaslee and David Z. Nirenberg, *Federal Income Taxation of Securitization Transactions and Related Topics*, Frank J. Fabozzi Associates, 2011 (Fourth Edition), pp. 16-17 (noting that a common feature of securitization transaction structures is the avoidance of entity level tax because "[i]t would not be economical to issue an asset-backed security if the issuer incurred any material tax costs with respect to payments it collects on assets and pays over to investors.").

[174] As a result of changes to the S corporation rules, a corporation conducting banking activities may elect S corporation status. However, to be eligible, the entity must otherwise meet the requirements of subchapter S and satisfy certain accounting requirements related to bad debts.

[175] Sec. 501(c)(14).

[176] Sec. 7701(a)(3) and subchapter L of the Code.

inappropriate, contributes to unnecessary complexity in the tax system, or results in unintended or undesireable distortions in taxpayer behavior.[178] Putting aside the issue of how to distinguish entities taxable as a C corporation or a partnership, arguably the tax system could be simplified if it provided only one regime for taxable entities and one regime for nontaxable entities.

[177] See secs. 501(c)(8), (15), (26), (27), and (29) for examples.

[178] For example, under present law, a REIT and a partnership are two entities through which investors might invest in real estate without paying an entity-level tax. However, certain corporate tax features of the REIT regime make the REIT a more attractive investment for some investors, such as foreign investors subject to FIRPTA or tax-exempt organizations subject to UBIT. A partnership, however, might be more attractive to investors that prefer the passthrough of business losses.

C. Uniform Passthrough Regime

Reduction in the number of different tax regimes for business entities arguably could achieve greater neutrality and greater simplicity.[179] For example, if it were determined that fundamental nontax distinctions between corporate-type entities, and noncorporate entities (such as public trading of interests) merit retention of the corporate tax regime, neutrality and simplicity might be improved by having only one other tax regime permitting single-level taxation of business entities.

Under a hypothetical unified passthrough regime, any domestic business entity, whether a corporation, partnership, or LLC, could elect to be treated as a passthrough entity. The two-tier system for taxing income of a corporation under subchapter C of the Code would be retained for nonelecting entities. Either the present-law partnership rules, the present-law S corporation rules, or a new set of rules, could be selected as the passthrough paradigm.

Selecting the partnership rules would have the advantage of permitting taxpayers greater flexibility than is available under the S corporation rules. While the partnership regime has been criticized as complex and opaque, a partnership need not be complex. Using the flexible partnership tax rules, taxpayers either can establish a very simple venture along the lines of an S corporation, with per-interest, per-day allocations to owners, or can set up a complex business arrangement with different classes of interests and special allocations of particular items to match the tax results to the business arrangement. In either case, so long as the partnership tax rules are observed, the entity through which the venture is conducted can be treated as a passthrough for tax purposes.

The partnership regime has also been criticized as manipulable and susceptible to tax avoidance, and these administrability concerns would have to be addressed in devising a single passthrough regime. In addition, allowing existing corporations to elect partnership status would raise administrative, revenue, and equity concerns that might outweigh the simplification benefit for taxpayers. For example, because it may not be feasible to allocate entity income among existing stock interests, this approach might require a corporation to formally liquidate and reorganize as an unincorporated business. Under present law, many corporations have not undergone such transactions because of the applicable corporate and shareholder taxes. To

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[179] See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System* (JCS-3-01), April 2001, pp. 269-277, discussing options for reducing the number of passthrough tax regimes in the law, and describing proposals to modify existing regimes, including a unified passthrough entity regime and repeal of the S corporation rules. A number of the types of passthrough entities provided under present law do not overlap. Many of them are special-purpose vehicles designed for particular lines of business or types of transactions. These regimes provide not only some form of passthrough treatment, but also special rules targeted to particular economic activity. In addition, the rules governing cooperatives, although not exclusively limited to a particular line of business, provide certainty for a particular method of doing business, that is, in cooperative form, with distributions or allocations to patrons of the cooperative. The provisions governing cooperatives might be viewed as a further example of a targeted type of passthrough entity. Also, one type of passthrough entity provided under present law, a trust, differs from all the rest, in that a trust generally is not used for the purpose of conducting business activities.

address revenue concerns, a toll charge could be imposed on a corporate-to-partnership conversion based upon a portion of the gain that would be recognized on a fully taxable liquidation. Different toll charges could apply to electing C corporations and S corporations. In addition, it would be necessary to consider whether the election should be limited (*e.g.*, to non-publicly traded domestic corporations or to corporations below a certain size), or by allowing existing corporations to elect only for a limited time.

Further, significant transitional issues would result from adopting a unified passthrough entity regime based on the partnership rules. For example, currently almost 4.1 million S corporations are in existence, many of them the vehicle for small business ventures. Forcing these businesses to adopt a new business form, even after a waiting period of several years, would not constitute simplification for those taxpayers. Alternatively, maintaining the S corporation rules indefinitely for these existing corporations, but not allowing the formation of new S corporations, would not achieve the simplification goal of reducing the number of pass-through regimes in the tax law. Preventing the formation of new S corporations while permitting the continuation of existing ones might be perceived as unfair or arbitrary, as well as maintaining the complexity of current law. The availability of the new form of passthrough entity to existing C corporations would also have to be addressed.

It is also argued that both the S corporation and the partnership tax rules are too complex for small businesses, and that a new, much simpler passthrough regime just for small businesses should be added to the tax law. Partnership and S corporation tax treatment would be reserved for larger or more sophisticated business ventures. Under this view, repeal of the S corporation rules would not achieve simplification for unsophisticated taxpayers.[180] In addition, more taxpayers would be exposed to the partnership rules, which some argue can be complex in certain circumstances. On the other hand, such an approach would necessitate a definition of a small business eligible for the new simplified regime, which could be a difficult exercise in line drawing.

[180] See George K. Yin and David J. Shakow, "Reforming and Simplifying the Income Taxation of Private Business Enterprises," in Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Vol. III, Academic Papers Submitted to the Joint Committee on Taxation* (JCS-3-01), April 2001, p. 220.