S Corporation Elections After the Tax Reform Act of 1986

by Susan M. Wittman and Amy Gill

The Tax Reform Act of 1986 (TRA 86) altered the relative effects of taxation on corporations that are taxed at the corporate level (Subchapter C) versus corporations that elect to have income taxed, not at the corporate level, but at the shareholder level (Subchapter S). A qualified corporation may elect Subchapter S status and generally operate untaxed at the business level. Profits of Subchapter S Corporations are taxed at the applicable rates of their shareholders. In a special study, statistics for 1986 and 1987 confirmed that TRA 86 did indeed have a large effect on how some small corporations were taxed, as certain corporations took advantage of the lower individual tax rates set forth in the Act by converting to S Corporation status for Tax Year 1987.

Subchapter S Corporations are generally small, closely-held corporations that are not taxed directly. The tax liability for an S Corporation falls mainly on shareholders, who are taxed on the profits whether or not distributed to them as dividends. Owners of S Corporations report their *pro rata* shares of income or loss on their own tax returns. The shareholders then pay tax at the appropriate individual income tax rate. Although S Corporations have attractive features, they do face restrictions, including limitations on the number and type of shareholders, as well as on the classes of stock permitted, and prohibition of foreign or corporate ownership [1].

Behavioral Response and Business Organizational Choice

Behavioral response to taxation can take many forms. For individual taxpayers, behavioral response can affect the work/leisure trade-off, by altering either the intensity (i.e., hours worked) or duration (i.e., longevity) of work life. It can also affect the types of compensation, investments, and expenditures, particularly those that are potentially tax-deductible, such as charitable contributions and home mortgage interest expense.

For businesses, behavioral response to taxation can also take similar forms, such as those affecting the types of income or expenditures. In addition, businesses can select, within limitations, a choice of business organizational form or legal structure that maximizes after-tax profits.

The effects of taxation on business organizational choice have never been fully measured. Statistics of Income data have previously been used to examine this issue from differing perspectives. Aggregate time series data on C and S Corporations, partnerships, proprietorships, and nonprofit or tax-exempt organizations have been reviewed to examine changes over time in response to tax law changes [2, 3]. Corporation data have also been reviewed by size of total assets to determine if corporations that did not elect to switch to S Corporation status were able to achieve similar results by distributing tax-deductible salaries paid to qualifying shareholders instead of paying them dividends, which were not tax-deductible [4, 5].

This article examines the behavioral response to TRA 86 by certain types of corporations [6, 7]. Tax returns of both Subchapter C (i.e., taxable corporations) and Subchapter S Corporations were matched for Tax Years 1986 and 1987, the years before and after TRA 86, to assess the impact of these provisions at the business entity level. Specifically, three groups of corporations were examined: (1) C Corporations in 1986 that converted to Subchapter S status for 1987; (2) S Corporations that held this status for both years; and (3) S Corporations that were newly established in 1987. Corporations that converted from C to S Corporation status are then examined more closely.

The results of these comparisons show that TRA 86 had a large effect on corporations eligible to elect Subchapter S status. Corporations that reported profits for 1986 and could anticipate profits for 1987 may have switched to Subchapter S status to take advantage of the lower individual income tax rates and subsequent reduced tax liability. Of the corporations that converted to Subchapter S status after TRA 86, nearly 68.5 percent reported positive net income for 1986. Of these returns, more than two-thirds (68.1 percent) also reported positive net income for 1987. The remaining 31.5 percent of the converted corporations reported a loss for 1986. Of these returns, 61.8 percent also reported a loss for 1987. Corporations reporting losses do benefit from Subchapter S status, as the losses are reported on the individual income tax returns of the shareholders for the tax year in which the losses were reported. This immediate deduction may have attracted some corporations to Subchapter S status. As TRA 86 did reduce or eliminate many provisions of the Internal Revenue Code that were considered tax shelters, active business losses were one of the few remaining ways that individual taxpayers could offset positive income.

Newly-established corporations often operate at a loss. This is because of the time it takes to establish a market share and build a capital base, and because, during this time, they must incur organizational development expen-

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ditures. Newly-established corporations had an average loss of $5,921 for Tax Year 1987. Established S Corporations for 1986 and 1987 show mixed results in terms of profit and loss. Average net income for Tax Year 1987 was $20,262.

Whether using assets, receipts, or net income as the measure, "converted" corporations were generally larger than either established or new S Corporations [8]. Average total assets for a converted S Corporation totaled $1.1 million, as compared to $0.4 million and $0.2 million for established and new S Corporations, respectively (Figure A). Of the corporations that switched from C to S Corporation status between 1986 and 1987, the largest percentage was for those classified in the services industrial division. Established corporations and newly-established corporations also had the largest percentage of returns classified in the services industrial division.

The Tax Reform Act of 1986

Two of the primary objectives of TRA 86 were to broaden the tax base and to reduce marginal tax rates on both individuals and corporations. It was expected that lower tax rates would stimulate economic growth by increasing the after-tax rate of return on labor and investments. Congress also believed that lower tax rates would promote tax compliance by reducing the potential gain from transactions designed to avoid or evade income tax liability.

TRA 86 lowered the maximum corporate tax rate from 46 percent to 34 percent and reduced the number of tax brackets from five to three. Congress preserved a graduated corporate rate structure to promote growth in small businesses. The lowest corporate tax rate for taxable income of $50,000 or less was 15 percent; for taxable income above $50,000 but not over $75,000, it was 25 percent; and for taxable income over $75,000, it was 34 percent.

Individual tax rates were also lowered. For 1986, there were 14 or 15 taxable income brackets depending on filing status, and the maximum tax rate was 50 percent. TRA 86 created a two-bracket system, with the maximum individual tax rate set at 28 percent. Thus, while the top marginal tax rates for both individuals and corporations declined dramatically for 1987, the top individual rate replaced the top corporate rate as the lower of the two. The shifting of tax rates designed to promote the growth of small businesses resulted in a wave of unincorporated business entities electing S Corporation status [9,10].

Figure A

Selected Averages for S Corporations, Tax Year 1987

[Money amounts are in whole dollars]

Selected averages	Converted S Corporations	Established S Corporations	New S Corporations
	(1)	(2)	(3)
Average total assets	1,100,817	361,307	166,850
Average total receipts	2,514,249	747,997	243,492
Average net income (less deficit)	71,986	20,262	5,921

Statistics of Income Data

Three data sets were created to study the differences among C Corporations that converted to S status for 1987: "converted" S Corporations, previously-established S Corporations, and newly-established S Corporations. These three data sets were drawn from the samples of tax returns used for Statistics of Income--Corporation Income Tax Returns for Tax Years 1986 and 1987. To identify the data set of "converted" S Corporations, S Corporation returns for 1987 were matched with C Corporation returns for 1986. To identify previously-established S Corporations, S Corporation returns for 1987 were matched with S Corporation returns for 1986. To identify newly-established S Corporations, S Corporation returns for 1987 were matched and found to have had no corporation income tax return for 1986 of any type and to have elected Subchapter S status since birth.

Data Comparisons

Figure A compares converted, established, and newly-established S Corporations. For 1987, converted S Corporations were much larger than either new or established S Corporations. One possible reason for the differences in size may be due to the repeal of the General Utilities doctrine. Prior to TRA 86, C Corporations were able, in certain circumstances, to distribute gains of appreciated property in a corporate liquidation tax free. With the repeal of the General Utilities doctrine, the double taxation of corporate earnings was exacerbated. This may have provided an additional incentive, beyond the personal income tax rate reduction, for C Corporations to convert to Subchapter S status. Corporations for whom the General Utilities doctrine had the most impact were those with substantial appreciated gains. This may be the reason that converted corporations are much larger in terms of average total assets than established or newly-established corporations.

Figure B

Selected Averages for Converted S Corporations, by Selected Industrial Grouping, Tax Years 1986 and 1987

[All figures are based on samples--money amounts are in whole dollars.]

Selected averages, industrial grouping	Tax Year 1986	Tax Year 1987
Services:		
Average total assets	345,898	365,004
Average total receipts[1]	655,743	672,397
Average net income (less deficit)[1]	29,200	15,465
Average net income[1]	54,810	59,162
Average deficit[1]	15,727	40,675
Retail trade:		
Average total assets	999,354	1,078,228
Average total receipts[1]	3,775,350	3,679,122
Average net income (less deficit)[1]	62,020	49,978
Average net income[1]	104,261	122,205
Average deficit[1]	25,429	54,609
Wholesale trade:		
Average total assets	1,684,350	1,737,911
Average total receipts[1]	5,491,864	5,276,553
Average net income (less deficit)[1]	126,832	136,015
Average net income[1]	184,947	225,387
Average deficit[1]	50,778	71,910
Finance, insurance, and real estate:		
Average total assets	1,102,782	934,390
Average total receipts[1]	411,100	507,816
Average net income (less deficit)[1]	55,517	13,633
Average net income[1]	106,676	99,288
Average deficit[1]	24,028	65,165
Manufacturing:		
Average total assets	2,364,226	2,490,266
Average total receipts[1]	4,850,856	4,899,396
Average net income (less deficit)[1]	253,444	237,740
Average net income[1]	309,093	320,147
Average deficit[1]	65,293	106,586
Mining:		
Average total assets	1,210,613	1,296,810
Average total receipts[1]	1,079,763	1,171,283
Average net income (less deficit)[1]	90,449	198,747
Average net income[1]	96,588	600,563
Average deficit[1]	79,312	35,849
Construction:		
Average total assets	1,074,853	1,182,837
Average total receipts[1]	2,348,963	2,369,858
Average net income (less deficit)[1]	93,225	100,527
Average net income[1]	126,139	187,048
Average deficit[1]	30,813	42,962

[1] Total receipts and net income or deficit for 1987 are not altogether comparable to 1986. For 1986, both include income from investments. For 1987, they do not.

In terms of total receipts, converted S Corporations were over three times larger than established S Corporations, and more than ten times larger than newly-established S Corporations. Average receipts for converted companies were $2.5 million for Tax Year 1987, compared to $0.7 million for established S Corporations, and $0.2 million for a new S Corporations (Figure A). However, total receipts for converted S Corporations varied greatly by industrial group. The largest percentage of converted S Corporations was classified in the services and retail trade groups. Those classified in services had smaller than average receipts ($0.7 million), while average receipts for retailers were significantly larger than average ($3.7 million) (Figure B).

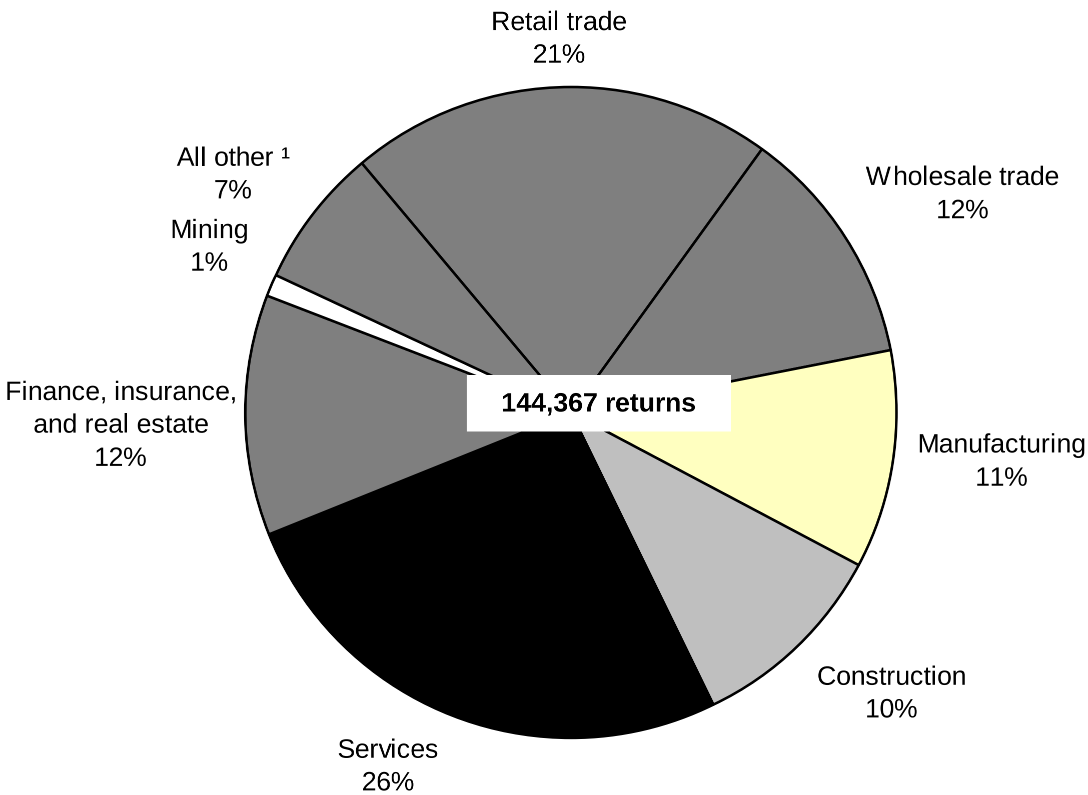
When ranked according to number of returns, the majority of C Corporations for 1986 that converted to S status for 1987 were classified in two industrial groups, services and retail trade. Figure C shows the percentage distribution of corporations that converted, by selected industrial groupings.

Of the corporations that switched from C to S Corporation status between 1986 and 1987, nearly 38 thousand (26 percent) were classified in services. These corporations averaged about $0.4 million in assets, compared to an overall average of $1.1 million for all converted S Corporations.

Average net income (less deficit) from a trade or business for corporations classified in services was

Figure C

Percentage of Converted S Corporations, by Industrial Grouping, Tax Year 1987



[1] All other includes agriculture, forestry, and fishing; transportation and public utilities; and nature of business not allocable.

$15,465 for Tax Year 1987 (Figure B) (See [8]). Of those that converted from C Corporation status for 1986 to S Corporation status for 1987, about 44 percent reported a net loss for 1987. The average loss per return for 1987 was about $41,000. Because these corporations were unprofitable for 1986, the corporate income tax rate did not apply for that year.

The second largest number of converted S Corporations, nearly 31 thousand, comprised companies classified in retail trade. In contrast to services, these companies were much larger, with an average of $1.1 million in assets. These corporations were also more profitable, with an average net income of nearly $50,000 for 1987 (Figure B). About 39 percent reported a deficit, with an average loss of $54,600.

Converted corporations classified in finance, insurance, and real estate comprised 12 percent of all converted companies. They averaged $934,400 in total assets and had average net income (less deficit) of $13,600 for 1987 (Figure B). It is difficult to use SOI data to compare 1986 and 1987 statistics for net income (less deficit), as rent, royalty, interest, dividends, and certain other types of investment income were included in net income statistics for 1986 but not for 1987. This difference in net income (less deficit) is most noticeable when comparing statistics for finance, insurance, and real estate for these 2 years. This is because investment income plays a much more prominent role in statistics for this industrial division.

Corporations classified as manufacturers had the largest average net income, $237,700 for Tax Year 1987 (Figure B). While total business receipts for manufacturers increased slightly from 1986 to 1987, average net income declined somewhat, from $253,400 to $237,700. As would be expected for these capital-intensive industries, manufacturing showed both the largest average and total amounts for assets. For 1987, average total assets were $2.5 million, compared to an overall average of $1.1 million for all converted corporations.

S Corporations classified in mining had the second largest average net income with $198,700 (Figure B). Although mining accounted for the largest percentage of deficit returns (71.1), the average loss for this group was relatively small ($35,800). A large percentage (83.9) of net income was due to a small number of corporations with net income of $1 million or more. Mining corporations also showed a large increase in average net income, increasing from $90,400 to $198,700.

Wholesalers showed the third largest average net income with $136,000 for Tax Year 1987 (Figure B). Only 30 percent of wholesale trade corporations reported a net loss. This was less than the overall percentage of loss returns for companies that converted (41 percent).

Summary

TRA 86 had a large effect on how certain corporations chose to be taxed. Certain C Corporations took advantage of the lower maximum individual tax rate and converted to S status in 1987. Corporations that elect Subchapter S status are not subject to tax at the corporate level, since the tax liability of S Corporation profits falls on shareholders whether or not profits are distributed to shareholders as dividends. Converted companies were generally larger than either established S Corporations or new S Corporations. Of corporations that switched status between 1986 and 1987, the largest percentage was in the services division. These corporations were smaller overall than other converted corporations.

Data Sources and Limitations

Three data sets were created to study the differences among C Corporations that converted to S status in 1987: “converted” S Corporations, “established” S Corporations, and “newly-established” S Corporations. These three data sets were drawn from the samples used for Statistics of Income--Corporation Income Tax Returns for Tax Years 1986 and 1987. The Statistics of Income sample was a stratified probability sample of approximately 80,000 active corporation income tax returns, selected after administrative processing but before audit examination. The strata were based on the type of tax return filed, which is related to the type of corporation, and, within types of returns, by size of corporation in terms of total assets and a measure of income.

To identify the data set of “converted” S Corporations, all S Corporations in the 1987 sample were matched by Employer Identification Number (EIN) against returns in the 1986 sample. There were 3,942 S Corporations in the 1987 sample that matched C Corporations in the 1986 sample. Because TRA 86 also required S Corporations to file calendar year returns, many corporations were forced to file two returns for 1987 to effect the changeover. After adjusting for these returns, 3,897 returns remained. The weight used for these records was the higher of the weights for these same companies for the 2 years. Based on 3,897 active corporation returns in the sample, the estimated number of active “converted” S Corporations for 1987 was 144,367.

The second data set consisted of “established” S Corporation returns, corporations that held Subchapter S status for both 1986 and 1987. A match was made to identify all 1987 S Corporations that were also S Corporations for 1986. After adjusting for corporations that had to file 2 returns, there were 6,967 returns that matched. Again, using the larger of the 1986 or 1987 weighting factors, the estimated number of "established" S Corporations for 1987 was 637,386.

The third data set consisted of returns for "newly-established" S Corporations. These were corporations that first appeared as newly-incorporated S Corporations that held S status since birth. All "newly-established" S Corporation returns for 1987 were matched against the 1986 sample. Only S Corporation returns that were not in the 1986 file were included in this data set. Based on 636 active corporation returns in the sample, the estimate of active "newly-established" S Corporations for 1987 was 211,998.

The sample is selected using each company's Employer Identification Number (EIN). The actual selection uses a random transformation of each company's EIN. Because companies do not change their EIN's often, and because the EIN transformation does not change, a large overlap occurs in the samples from year to year [11].

Finally, because of the weighting procedure used, that of using the larger weight of any matched 1986 and 1987 records, the sums of the three data sets differ somewhat from the published 1987 S Corporation data [12].

Notes and References

[1] To quality as an S Corporation, a business entity must meet all of the following criteria set forth in the Internal Revenue Code, Subchapter S section 1361(a). The criteria for 1987 were that a corporation have no more than 35 shareholders; that the shareholders be individuals, estates, or certain qualified trusts; that none be nonresident alien shareholders; and that the corporation have only one class of stock. Corporations that were ineligible to be treated as S Corporations were insurance companies subject to provisions of Subchapter L of the Internal Revenue Code; corporations eligible to elect the U.S. possessions tax credit; banks or building and loan associations to which the Internal Revenue Code section 585 applied; an Interest-Charge Domestic International Sales Corporation or former Domestic International Sales Corporation; and an affiliated group member eligible for inclusion in a consolidated return.

[2] Petska, Tom, "Do Taxes Affect Business Legal Structure? An Analysis of IRS Data," presented at the Allied Social Science Meetings, San Francisco, California, January 7, 1996.

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

[4] Nutter, Sarah, Young, James, and Wilkie, Patrick, "Tax Legislation and Business Form Choice: C Corporation Behavior Before and After TRA 86," presented at the Allied Social Science Meetings, San Francisco, California, January 7, 1996.

[5] Wilkie, Patrick, Young, James, and Nutter, Sarah, "Corporation Business Activity Behavior Before and After the Tax Reform Act of 1986," *Statistics of Income Bulletin*, Winter 1995-96, Volume 15, Number 3.

[6] Wittman, Susan and Gill, Amy, "S Corporation Elections After the Tax Reform Act of1986," presented at the Allied Social Science Meetings, San Francisco, California, January 7, 1996.

[7] For a more complete explanation of the effects of TRA 86 on S Corporations, see Gill, Amy, "S Corporation Returns, 1992," *Statistics of Income Bulletin*, Spring, 1995, Volume 14, Number 4. Additional sources of information on TRA 86 include U. S. Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* and U.S. Department of the Treasury, Internal Revenue Service, *Explanation of the Tax Reform Act of 1986 for Individuals*, Publication 920.

[8] For 1986 statistics, net income (less deficit) includes net income from a trade or business, gross rents, gross royalties, taxable interest, and nonqualifying dividends. For 1987 statistics, gross rents, gross royalties, taxable interest, and nonqualifying dividends are not included in the statistics for net income (less deficit) due to a change in the form as a result of TRA 86. Thus, net income (less deficit) for 1986 and 1987 is not altogether comparable.

[9] For additional information about the growth of S Corporations after the Tax Reform Act of 1986, see Nelson, Susan, "S Corporations: The Record of Growth After Tax Reform," *Journal of S Corporation Taxation*, Fall 1993, Volume 5, Number 2.

[10] Studies addressing organizational choice in response to changes in tax rates include Carroll, Robert and Joulfain, David, "Taxes and Corporate Choice of Organizational Form," October 1997, OTA Paper 73, U.S. Department of the Treasury, Office of Tax Analysis, and Plesko, George, "Corporate Taxation and the Financial Characteristics of Firms," *Public Finance Quarterly*, July 1994. Other more general sources on TRA 86 include Steuerle, C. Eugene, *The Tax Decade: How Taxes Came to Dominate the Public Agenda*, The Urban Institute, 1991; Pechman, Joseph A., *Federal Tax Policy*, The Brookings Institution, 1987; and Scholes, Myron S. and Wolfson, Mark A., *Taxes and Business Strategy: A Planning Approach*, Prentice-Hall, 1991.

[11] There are undoubtedly some nonmatches between the 2 years. This is a limitation of the data. However, this is not a major problem due to the overlap that occurs in the sample.

[12] For a more complete explanation of Statistics of Income samples, see Hughes, Stephanie and Hinkins, Susan, "Creation of Panel Data from Cross-Sectional Surveys," in the *1995 Proceeding of the American Statistical Association, Section on Survey Methodology*, 1996.

SOURCE: IRS, SOI Bulletin, Publication 1136, Spring 1998.