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

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The 1990's have been described as a period of immense and protracted profit-taking in the stock market. Mergers and acquisitions have impacted business demographics. Tax law changes have also had a marked effect by continually providing incentives and disincentives for certain business legal forms of ownership, such as those affecting the growth rates of companies moving from corporate to noncorporate status. Law changes, such as the landmark 1986 Tax Reform Act, the Small Business Job Protection Act of 1996, and the Omnibus Reconciliation Act of 1997, have had significant impacts on Subchapter C corporations, including small business (or Subchapter S) corporations; partnerships (general, limited, and limited liability companies LLC's); and sole proprietorships.

This paper is an examination of the changes in business demographics or "business organizational choice" of the various types of business during the 1990's and the changes in the historical trend from the 1980 period. Tax data will be used to focus on changes in the various business types, receipts, profitability, and tax rates over two recessions due to modifications in the tax code on administrative records sampled at Statistics of Income (SOI) Division of IRS.

The paper is divided into three sections. The first defines the various types of businesses. The second explains tax law changes during the 1990's. The third analyzes a time series dataset for the three distinct business types (and their subsets) based on tax filings with the IRS.

▶ Organizational Type

For this paper, corporations are divided into C corporations, those taxed at corporate rates, and S corporations, those taxed at individual income tax rates. Partnerships are divided into general partnerships, limited partnerships, and limited liability companies (LLC's). Since the tax treatment of the business organizational forms varies significantly, a brief synopsis follows.

Corporations. Corporation (or Subchapter C) income is generally taxed directly at the business level, and again at the shareholder level for receipt of dividend income. Income distributed to shareholders is only taxable on the after-tax profits earned by the corporation. However, after-tax corporate income is taxable at the shareholder level once it is distributed as dividends or the shareholder realizes capital gain.

Subchapter S. S corporations are incorporated entities that have many of the same attributes as the traditional C corporation, including limited liability, freely transferable ownership, and unlimited life span. Unlike the C corporations, income and losses are passed through to the shareholder and are subject to tax only at the owner level. S corporation shareholders report their shares of income or loss on their own tax returns. Therefore, any resulting tax liability is the responsibility of the shareholders. S corporations offer the benefits of partnership taxation without the liability. Subchapter S corporations must be compared with the limited liability company (LLC), which they resemble in operation and concept. Despite having several appealing characteristics, S corporations do face inherent limitations, including the number and type of shareholders, permitting only one class of stock, and exclusion of foreign, corporate, partnership, or LLC ownership.

Partnerships. Similar to the S corporation, a partnership does not pay tax on its income but passes through any income or losses to its partners. Partners include this passthrough income on their tax returns.

Partnerships may be general partnerships, limited partnerships, limited liability partnerships, and limited liability companies. Creditors of general partnerships, composed solely of general partners, may collect amounts owed to them from both the general partnership assets and the assets of the general partners. General partners are personally liable, limited to their personal resources, and actively participate in management of the business. Limited partnerships (LP's) have at least one general

partner. A limited partner is similar to a corporate shareholder, whose liability to third-party creditors is limited to the amount invested in the partnership. Limited liability partnerships (LLP's) are formed under State-limited liability partnership law. Limited liability partners, whose owners are general partners, are not personally liable for the debts of the LLP or any other partner, nor is the partner liable for the malpractice committed by other partners.

Limited liability companies (LLC's). The LLC is a State-formed entity with the limited liability of a corporation and the tax liability of a partnership. This hybrid entity has quickly become an alternative to the traditional partnership and corporate business structures. The members of the LLC are treated similarly to limited partners, in that income passes through an LLC to the members. The members include this passthrough income on their tax returns. Unlike general partners, the members of the LLC are not personally liable for the LLC's debts.

Data from LLC's have been collected since their first appearance on the partnership annual information return in 1993. LLC's are required to file on the partnership annual information return (Form 1065), although some file on the S corporation return. The LLC data displayed in this article are representative of the data gathered from the partnership annual information return only.

Sole Proprietorships. An owner of a non-farm sole-proprietorship summarizes the income and expenses of the business on Schedule C (or C-EZ) of the owner's individual income (Form 1040) tax return. The net income or loss from the business is added to the owner's personal income from all other sources and taxed at the applicable individual income tax rates.

▶ Tax Law Changes

The Tax Reform Act of 1986 (TRA86), the most comprehensive revision of the Internal Revenue Code since 1954, had a major impact on business decisions in the period after 1986 by broadening the tax base of both individuals and corporations by tightening the corporation "alternative minimum tax," limiting losses from passive activities, and repealing the long-term capital gain exclusion. The most marked effect has been on the changes in the individual and corporate marginal tax rates. In pre-TRA86, the highest individual rate (50 percent) exceeded the highest corporation rate (46 percent) by 4 percentage points.

TRA86 reversed this trend, starting in 1987 and continuing with the final lowered rates of 1988-1990 of 34 percent for corporations and 28 percent for individuals, a 6-percentage point reversal. For 1991 and 1992, this difference was cut in half when the individual rate was increased to 31 percent (Figure A).

In 1993 to the present, the top individual rate increased to 39.6 percent surpassing the highest corporation rate of 35 percent. Although both rates are lower than pre-TRA86, the difference of 4.6 percentage points between the individual rate and the corporation rate looks almost identical to the pre-TRA86 difference of 4 percentage points. The incentive to switch business types declined and reversed. With the reversal in incentives, was there renewed interest in the corporation type of business? We will investigate, using the SOI data for 1990-2000 for all three types of business entities.

Figure A. Top Marginal Tax Rates (Percentages) Corporations and Individuals, 1990-2000

Item	1990	1991-1992	1993-2000
Corporations	34.0	34.0	35.0
Individuals	28.0	31.0	39.6
Difference	6.0	3.0	-4.6

Note: These rates are for the highest levels of taxable income and do not reflect alternative minimum tax.

The Small Business Job Protection Act of 1996 (SBJPA) made several noteworthy changes that have significantly affected S corporation filings. First, the SBJPA increased the maximum number of shareholders from 35 to 75. Second, it enabled financial institutions, which did not use the reserve method of accounting for bad debts, to make an S election. Third, small business

trusts electing to be S corporations, were permitted to be shareholders in an S corporation. Finally, restrictions on the percentage of another corporation's stock that an S corporation might hold were eliminated. S corporations may now make an election to treat the assets, liabilities, income, deductions, and credits of wholly-owned subsidiaries as those of the parent S corporation.

Even though the SBJPA eased Federal tax restrictions on S corporations, the number of S corporation entities has not grown as fast as the partnership limited liability corporation. The IRS ruled in late 1988 (Revenue Ruling 88-76, 1988-2 C.B.360) that any Wyoming LLC would be treated as a partnership. Thus, the door was opened for other States to consider LLC legislation, and the growth of LLC's has not diminished since the IRS's 1988 ruling. By 1993, some 36 States had ruled to allow LLC's as a legal entity. In 1994, that number grew to 46 States, plus the District of Columbia. By 1997, all 50 States and the District of Columbia had enacted LLC legislation. The "check-the-box" regulations, implemented by the IRS in January 1997, relaxed the requirements for LLC's to obtain the favorable partnership tax classification, leading to a wider acceptance of LLC's.

▶ Analysis of Business Data

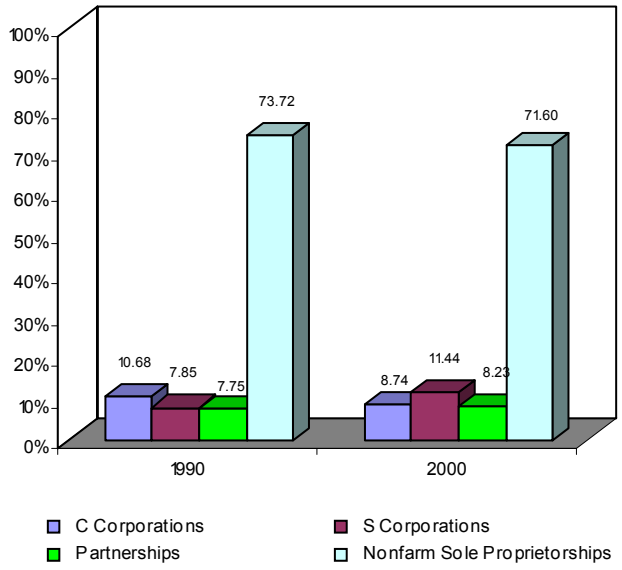
Data in this paper were collected in annual statistical studies by SOI and published in Table 1 (Number of Businesses, Business Receipts, Net Income, and Deficit by Form of Business, Tax Years 1990-2000).

Trends in the Number of Businesses

This segment of the paper places the spotlight on the number of entities and financial data for the 1990-2000 period.

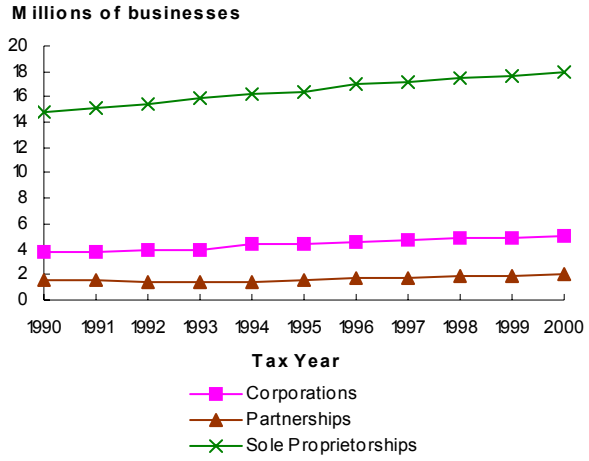
Over the decade of the 1990's S corporations displayed the largest percentage increase of all entities, representing 7.85 percent of all entities in 1990 and 11.44 percent in 2000 (Figure B). The increase in the S corporation percentage of all entities can be attributed to the large number of C corporations that elected to become S corporations after both TRA86 and the SBJPA of 1996. Over the same time period, the percentage of both C corporations and sole proprietorships, compared to all entities, declined. C corporations declined 1.94 percent during the same 10- year period, from 10.68 percent to 8.74 percent.

Figure B. Percent of Entities by Type, Tax Years 1990 and 2000



Number of Entities. Figures C-E present data on the number of entities. Figure C provides a picture of the number of entities by organizational type over time. Figure D displays the total number of entities for C corporations and S corporations. Figure E focuses on the number of entities by type of partnership.

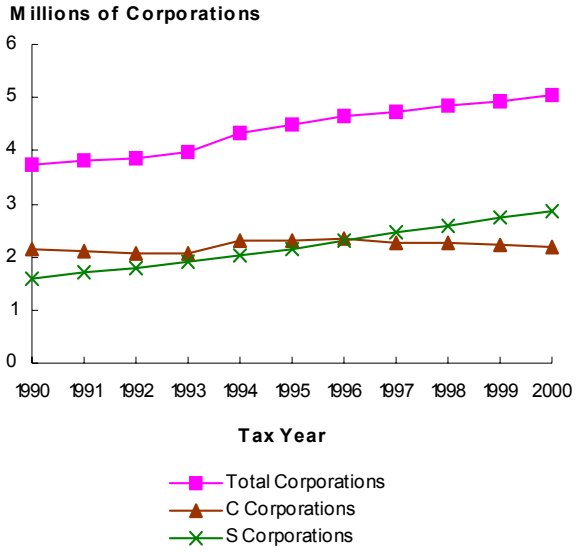
Figure C. Number of Corporations, Partnerships, and Nonfarm Sole Proprietorships, Tax Years 1990-2000



In the 1990's, sole proprietorships had the largest number of entities, (Figure C). Also, the overall growth of sole proprietorships in the 1990's was greater than the growth of corporations and partnerships, both of which grew 1.3 million and .5 million, respectively, compared to an increase of 3.1 million for sole proprietorships. Sole proprietorships grew on an average of 1.9 percent per year throughout the 1990's, with the largest increase of 3.2 percent taking place in 1996.

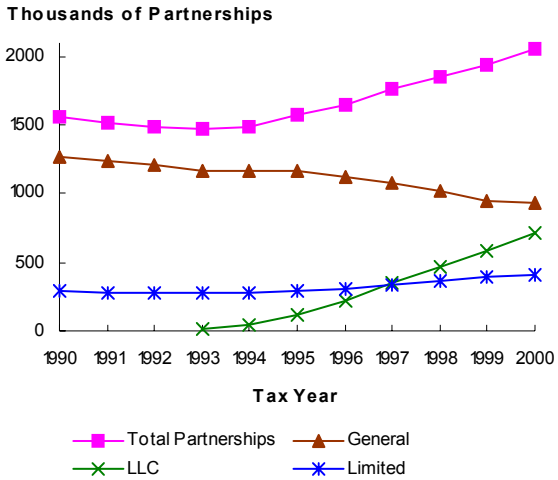
The number of S corporations is plotted in Figure D, which also shows C corporations and total corporations. S corporations are the single largest corporate entity type accounting for 56.7 percent of all corporations in 2000. The number of S corporations has steadily increased since TRA86 and surpassed C corporations in 1997 when the number of C corporations started to steadily decrease. The SBJPA of 1996 also played a role in the growth of S corporations over this time period.

Figure D. Number of Corporations by Type, Tax Years 1990-2000



General partnerships, the most prevalent of all partnership forms (45 percent of the total), have consistently declined since 1990, decreasing from 1.2 million to .9 million, or 26 percent. Limited liability corporations (35 percent of the total) have grown significantly since they first appeared on the partnership tax form in 1993, surpassing limited partnerships on 1997. Figure E shows an increase of nearly .7 million LLC's. Limited partnerships (20 percent of the total) have shown an overall gain of 46 percent since 1993. Prior to that time, limited partnerships displayed an annual decrease since the 1970's.

Figure E. Number of Partnerships by Type, Tax Years 1990-2000



Business Receipts. Figures F-H display data on business receipts by organizational type. Business receipts are plotted in Figure F for all organizational form types. Figure G focuses on corporations, while Figure H focuses on partnerships.

Business receipts for C corporations have always far outweighed receipts for partnerships ($2.1 trillion) and sole proprietorships ($1 trillion). Both show slight growth; and in 1996, partnerships passed sole proprietorships for the first time, as shown in Figure F.

Business receipts for C corporations have always surpassed S corporations, and, in the 90's, the gap has been growing progressively for C corporations from $6.7 trillion to $10.5 trillion, as shown in Figure G. Even though business receipts for C corporations have increased by 70.2 percent for the 90's, the number of C corporations has only increased 2.0 percent over the same period. S corporation business receipts have likewise increased by 123.8 percent while the number of S corporations has increased significantly, 81.9 percent. S corporations now comprise 20.1 percent of the total business receipts, compared to 14.3 percent for the beginning of the decade.

Figure F. Business Receipts of Corporations, Partnerships, and Nonfarm Sole Proprietorships, Tax Years 1990-2000

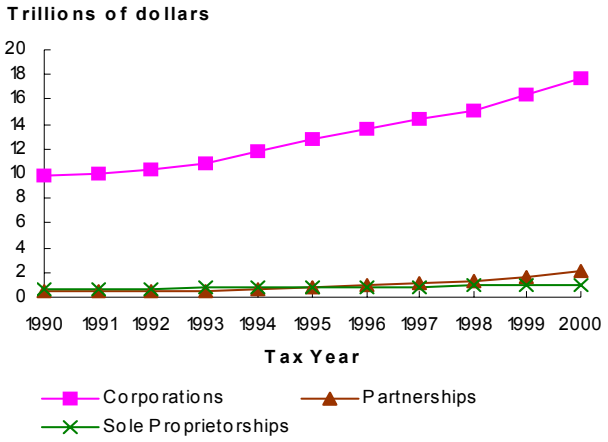
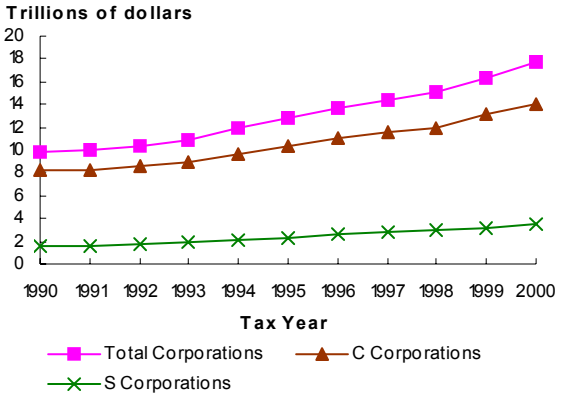
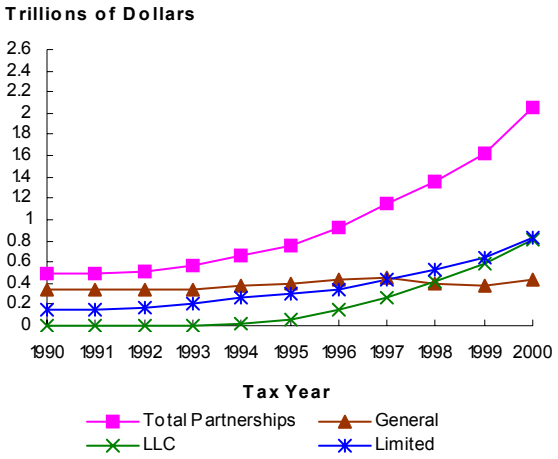


Figure G. Business Receipts by Type of Corporation, Tax Years 1990-2000



The growth of partnership business receipts is primarily due to the inception of LLC as a partnership entity choice, as shown in Figure H. In 2000, LLC's represented $805.5 billion (39.1 percent) of the $2,061.7 billion in partnership business receipts reported. Partnership business receipts have increased at an average annual rate of 33.4 percent since LLC's were first recognized on the tax form in 1993, or 267.5 percent over the 8-year period. Limited partnerships now account for more than $830.4 billion of partnership business receipts, or 40.2 percent, while barely representing one fifth of all partnerships, 402.2 thousand. General partnerships, the largest partnership entity, represent only $425.7 billion of total partnership business receipts, or

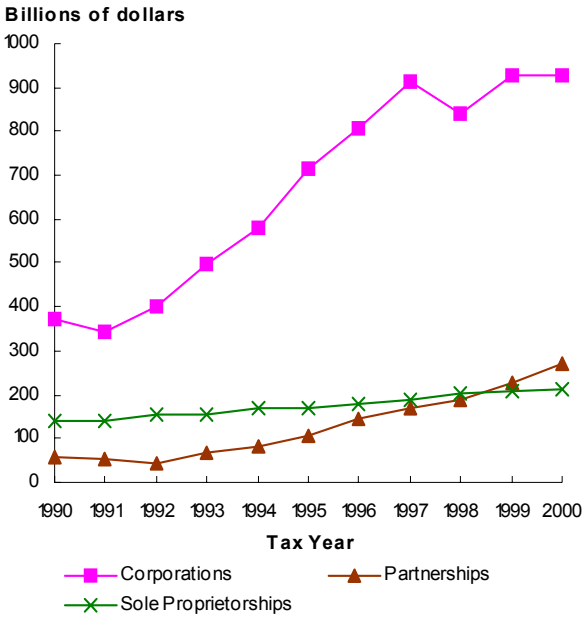
Figure H. Business Receipts by Type of Partnerships, Tax Years 1990-2000



20.6 percent. In 1998, Limited and LLC's surpassed General partnerships for the first time.

Net Income (less deficit). Figures I-K show overall trends in net income (less deficit) or profits by organizational type. Net income (less deficit) is displayed in Figure I for all business form types. Figures J and K focus on corporations and partnerships, respectively.

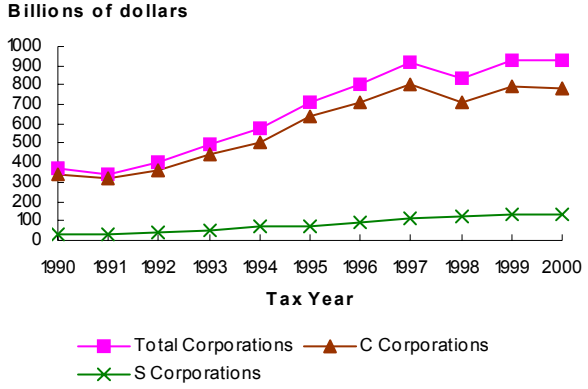
Figure I. Profits of Corporations, Partnerships, and Nonfarm Sole Proprietorships, Tax Years 1990-2000



Profits for corporations are now at $927.5 billion, compared to partnerships at $269 billion and sole proprietorships at $214.7 billion. Even though corporations dominate, the percentage decreased from 70 percent to 56 percent of the total for all business entities, due to an increase in deficit returns for C corporations. Over the decade, there has been a smaller increase for sole proprietorships, while partnerships have been progressively gaining in profits, and actually bypassing sole proprietorships in 1999 for the first time, as shown in Figure I. Partnerships, which started the decade at 3 percent of the total and grew to 19 percent, reached a new level at $269 billion in 2000. Sole proprietorships ended the decade at $214.7 billion, decreasing from 27 percent of the total in 1990 to 15 percent by 2000.

Corporate profits have grown steadily since 1991, peaking in 1997, with a slight downturn in 1998, but bounced back to near-1997 levels in 1999, and flat growth in 2000 (Figure J). Net income returns for both C and S corporations have grown steadily over the decade, peaking in 2000, with C corporations greater than S corporations in the entire decade. However, S corporations started the decade with 12.3 percent of the total and increased to 15 percent of the total by the end of the decade, due to the increase in the number of deficit returns for C corporations, from an average of $140 billion from 1990 through 1997, to $207 billion in 1998, $250 billion in 1999, and $348 billion by 2000.

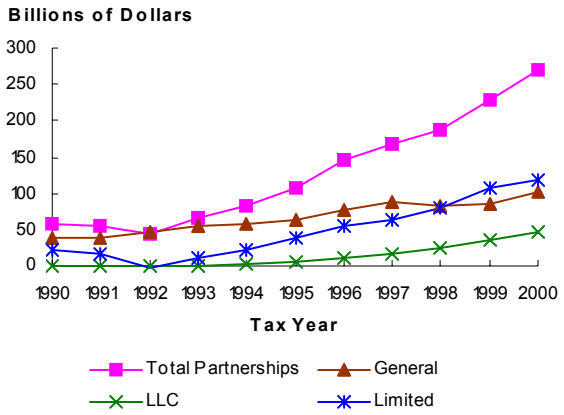
Figure J. Profits of Corporations by Type, Tax Years 1990-2000



Limited partnerships (LP's) accounted for the majority of growth seen in partnership profits (net income less deficit) during the 1990's, as shown in Figure K. Prior to 1993, LP's had been consistently decreasing.

Then, in 1993, LP's surpassed LLC's in profits and surpassed general partnerships by 1999. Net income returns for limited partnerships first surged ahead of general partnerships, with net income returns in 1998 accounting for the overall growth in all returns (net income and deficit return) by 1999. In 2000, profits continued to grow for LP's, accounting for $119.5 billion of the $268.9 billion in total profits reported by all partnerships, while still only representing one fifth of all partnerships. Over the decade, the profits of LP's grew at an average annual rate of 46.5 percent, displaying a steady stream of positive profits through the 1990's. While limited partnerships had the largest number of net income returns by the end of the decade, LLC's experienced an increase in the number of deficit returns, bypassing general partnerships in 1998 and limited partnerships by 2000.

Figure K. Profits by Type of Partnerships, Tax Years 1990-2000



▶ Conclusions

Sole proprietorships began and ended the decade with the largest percentage and number of business entities. However, the percent of the total dropped from 73.4 percent to 71.6 percent. S corporations had been steadily increasing since 1990, and by 1997 surpassed C corporations, which had been decreasing since 1994. Partnerships have gained in the decade, due to the growth of LLC's since their inception in 1993. During the same

time, general partnerships have been on a gradual downward turn.

The most obvious reason for the increase in LLC's is their advantages over other business entity types. All members of LLC's have the same limited liability protection; by comparison, a partnership must have at least one general partner that does not have limited liability. LLC's offer flexible management and flexible ownership, allowing members to participate in the LLC's management without exposing themselves to possible personal liability. LLC's offer several advantages over S corporations since there is no limitation on the number of owners, type of owners, or on the allowable types of interest. S corporations are limited to seventy-five shareholders, none of which can be nonresident aliens, and may only have one class of stock. The flexibility that an LLC offers helps attract a broader range of business investors than is possible with an S corporation.

The business receipts of corporations outdistanced partnerships and sole proprietorships due to the dominance of C corporations. However, C corporations have dropped from 86 percent of the total receipts of all corporations to 83 percent by the end of the decade. General partnerships have been decreasing since 1997, and by 1998 were surpassed by LLC's and limited partnerships.

For net income (less deficit) returns, C corporations are the largest of all entities, but dropped from 64 percent to 56 percent by 2000. Net income rose for all corporations due to C corporations, with the gap in the growth rate widening over S corporations. Partnership income also rose due to the steady increase in income for limited partnerships that surpassed general partnerships by 1999.

For C corporations, there has been a 68-percent increase in deficit returns since 1998. Likewise, for partnerships, losses have been increasing since 1994. General partnerships were surpassed by LLC's in 1998, and by limited partnerships by 2000.

Two factors accounted for the growth in S corporations and LLC's. In 1994, the number of States, 36, that permitted the formation of LLC's commenced a 7-year rise in the number of partnerships. The passage of the Small Business Job Protection Act (SBJPA96) increased the number of allowable shareholders from 35 to 75, and contributed to the growth of S corporations over C corporations, especially in the smaller asset categories. Both of these factors allowed income to be passed on to the individual and taxed at the lower individual rate rather than at the corporate rate.

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Table 1. Number of Businesses, Business Receipts, Net Income, and Deficit by Form of Business, Tax Years 1990-2000

[All figures are estimates based on samples--returns are in thousands, money amounts are in millions of

Form of business	Tax Year 1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
All Industries											
Number of businesses	20,053	20,499	20,849	21,281	21,990	22,488	23,240	23,645	24,113	24,449	25,007
Business receipts	11,074,423	11,161,332	11,612,309	12,183,715	13,330,389	14,353,781	15,418,578	16,473,256	17,285,224	18,899,109	20,719,321
Net income (less deficit)	528,640	507,822	598,877	721,211	826,282	990,291	1,128,474	1,270,285	1,227,179	1,365,385	1,411,206
Net income	830,475	811,635	865,707	976,024	1,078,273	1,251,080	1,415,081	1,590,638	1,615,164	1,811,173	1,991,803
Deficit	301,835	303,813	266,830	254,813	251,991	260,788	286,608	320,353	387,985	445,788	580,597
Corporations											
Number of businesses	3,717	3,803	3,869	3,965	4,342	4,474	4,631	4,710	4,849	4,936	5,045
Business receipts	9,860,400	9,965,600	10,360,400	10,865,500	11,883,600	12,785,800	13,659,500	14,460,900	15,010,300	16,314,000	17,636,600
Net income (less deficit)	370,600	344,900	402,000	498,100	577,300	714,200	806,500	915,400	838,200	929,000	927,500
Net income	552,500	535,800	570,400	658,600	739,500	880,700	986,800	1,117,800	1,091,100	1,229,300	1,336,600
Deficit	181,900	190,900	168,400	160,500	162,200	166,500	180,300	202,400	252,900	300,300	409,100
C corporations											
Number of businesses	2,142	2,105	2,084	2,063	2,318	2,321	2,327	2,258	2,261	2,210	2,185
Business receipts	8,272,300	8,310,100	8,569,600	8,897,600	9,710,200	10,419,300	11,087,500	11,620,300	12,006,200	13,071,200	14,078,900
Net income (less deficit)	338,400	315,800	355,800	444,000	503,300	637,300	713,300	803,700	713,400	791,600	788,400
Net income	484,600	469,800	490,800	571,900	632,500	765,600	854,200	963,100	920,100	1,041,900	1,136,800
Deficit	146,200	154,000	134,900	127,900	129,200	128,300	140,900	159,400	206,700	250,300	348,400
S corporations											
Number of businesses	1,575	1,698	1,785	1,902	2,024	2,153	2,304	2,452	2,588	2,726	2,860
Business receipts	1,588,100	1,655,500	1,790,800	1,967,900	2,173,400	2,366,500	2,572,000	2,840,600	3,004,100	3,242,800	3,557,700
Net income (less deficit)	32,200	29,100	46,200	54,100	74,000	76,900	93,100	111,700	124,800	137,400	139,100
Net income	67,900	66,000	79,600	86,700	107,000	115,100	132,500	154,700	171,100	187,400	199,800
Deficit	35,700	36,900	33,500	32,600	33,000	38,200	39,400	43,000	46,300	50,000	60,700
Partnerships											
Number of businesses	1,553	1,515	1,485	1,468	1,494	1,581	1,654	1,759	1,855	1,937	2,058
Business receipts	483,417	483,164	514,827	560,999	656,159	760,618	915,844	1,141,963	1,356,656	1,615,762	2,061,764
Net income (less deficit)	16,610	21,407	42,917	66,652	82,183	106,829	145,218	168,241	186,705	228,438	268,991
Net income	116,318	113,408	121,834	137,441	150,928	178,651	228,158	262,373	297,874	348,468	409,973
Deficit	99,708	92,002	78,918	70,788	68,745	71,822	82,939	94,132	111,171	120,030	140,982
General											
Number of businesses	1,268	1,245	1,214	1,174	1,162	1,163	1,121	1,081	1,016	951	937
Business receipts	334,184	333,190	336,912	348,350	375,033	395,396	430,893	450,835	399,306	382,760	425,752
Net income (less deficit)	37,771	38,109	46,194	55,029	58,721	63,626	77,447	88,235	82,766	85,767	101,786
Net income	81,903	78,331	81,314	85,129	87,681	92,587	106,074	113,265	107,710	108,488	127,059
Deficit	44,132	40,222	35,119	30,100	28,959	28,961	28,627	25,030	24,943	22,720	25,272
Limited ([1])											
Number of businesses	286	271	271	276	284	299	312	328	369	397	402
Business receipts	149,233	149,975	177,914	205,554	257,887	302,337	338,916	423,969	534,249	644,247	830,430
Net income (less deficit)	-21,161	-16,702	-3,278	11,360	21,411	38,320	55,458	62,946	79,329	107,937	119,512
Net income	34,415	35,078	40,521	51,238	59,545	76,030	97,722	109,036	131,493	157,245	170,929
Deficit	55,576	51,780	43,798	39,878	38,134	37,710	42,263	46,090	52,165	49,308	51,417
LLC											
Number of businesses	N/A	N/A	N/A	17	48	119	221	349	471	589	719
Business receipts	N/A	N/A	N/A	7,095	23,239	62,885	146,036	266,990	423,101	588,755	805,582
Net income (less deficit)	N/A	N/A	N/A	263	2,051	4,884	12,313	17,060	24,609	34,734	47,692
Net income	N/A	N/A	N/A	1,073	3,702	10,035	24,362	40,072	58,672	82,736	111,984
Deficit	N/A	N/A	N/A	810	1,651	5,151	12,048	23,013	34,063	48,002	64,292
Nonfarm Sole Proprietorship											
Number of businesses	14,783	15,181	15,495	15,848	16,154	16,433	16,955	17,176	17,409	17,576	17,905
Business receipts	730,606	712,568	737,082	757,215	790,630	807,364	843,234	870,392	918,268	969,347	1,020,957
Net income (less deficit)	141,430	141,516	153,960	156,459	166,799	169,262	176,756	186,644	202,275	207,947	214,715
Net income	161,657	162,427	173,473	179,983	187,845	191,729	200,124	210,465	226,190	233,405	245,231
Deficit	20,227	20,911	19,512	23,524	21,046	22,467	23,368	23,821	23,915	25,458	30,515

N/ANot applicable

[1] For Tax Years 1993-1995, Limited Partnerships include Limited Partnerships, General Limited Liability Partnerships, and Limited Liability.

For Tax Years 1998-1999, Limited Partnerships include Limited Partnerships and Limited Liability.

For Tax Year 2000, Limited Partnerships include Domestic Limited Partnerships and Domestic Limited Liability.