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A Populist Political Perspective of the Business Tax Entities Universe: Hey the Stars Might Lie, but the Numbers Never Do

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A Populist Political Perspective of the Business Tax Entities Universe: “Hey the Stars Might Lie But the Numbers Never Do”[†]

John W. Lee^{*}

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[†] Line from Mary-Chapin Carpenter and Don Schlitz “I Feel Lucky” (1992 Columbia).

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I. Introduction

The conventional wisdom presented in Part II holds that the choice of tax entity for a new, closely held or private, small income venture is a passthrough entity. In particular, the Limited Liability Company (LLC), the new kid on the block in the 1990s, is the conventional choice, due to its limitation of liability coupled with its hassle-free single level of federal income taxation.¹ Part III shows that the contrary reality in taxland is that either the regular or Subchapter C corporation ("C Corporation") or the Subchapter S corporation ("S Corporation") tends in most market segments to be the tax entity of choice for small businesses conducted in an entity form rather than as a sole proprietorship. As discussed in Part III, in all but one state new corporation formations (without differentiation between C and S Corporations) outnumber new LLC formations—usually by a margin of 2:1 to 3:1 or greater for 1995-1998.²

Notwithstanding the concern of conventional wisdom over double taxation of C Corporations and shareholders³ (first inside at the corporate level and second outside at the shareholder level), profitable, small income, private C Corporations and their mostly high income, active owners apparently pay less federal income tax at the owner and entity levels combined than they would under direct passthrough taxation with tax-free withdrawal of profits, as in a single level of taxation LLC or S Corporation.⁴ Part III reveals that thirty-seven percent of C Corporations (over 750,000, accounting for five percent of C Corporation income) report, on the average, about \$40,000, which is taxable at fifteen percent (with sixty-one percent reporting no income or a loss).⁵ In sharp contrast, eighty percent of their owners are taxable at the higher individual income brackets (from 31% to 39.6% before phase outs).⁶ Furthermore, a second level of outside shareholder-level taxation on the retained earnings is avoided at

1. See, e.g., Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 393-94 (1996); Don W. Llewellyn & Anne O'Connell Umbrecht, *No Choice of Entity After Check-the-Box*, 52 TAX LAW. 1, 2 (1998); Larry E. Ribstein, *The New Choice of Entity for Entrepreneurs*, 26 CAP. U. L. REV. 325, 331 (1997). For the "new kid on the block" metaphor I am indebted to Jimmy G. McLaughlin, *Commentary: The Limited Liability Company: A Prime Choice for Professionals*, 45 ALA. L. REV. 231, 231 (1993); see also Richard M. Horwood & Jeffrey A. Hechtman, *The Limited Liability Company: The New Kid in Town*, 20 J. CORP. TAX'N 334, 334-35 (1994); Mark Rosencrantz, *Comment: You Wanna Do What? Attorneys Organizing as Limited Liability Partnerships and Companies: An Economic Analysis*, 19 SEATTLE U. L. REV. 349, 359 (1996).

2. See *infra* notes 312-27 and accompanying text.

3. See *infra* notes 88-111 and accompanying text.

4. See *infra* notes 150-51, 156-62, 173-74, 190-97, 200 and accompanying text.

5. See *infra* notes 128-32, 145-49 and accompanying text.

6. See *infra* notes 142-43, 147, 169-71 and accompanying text. Phase-outs of personal exemptions, deductions, and wage taxes can raise the top effective rate to 45%. See *infra* note 148 and accompanying text.

least half the time, when the shareholder holds the small C Corporation private stock (or public C stock received in a tax-free reorganization for such private stock) until her death without receiving dividends.⁷ When the taxation is not avoided, it is greatly reduced on a present value basis by a long-deferred and often installment-reported capital gains sale.⁸

Part III calculates that the splitting of business income between (1) compensation to shareholder-employees taxed at higher individual income graduated rates and (2) profits left in the private C Corporation taxed at the lowest graduated corporate rates⁹ amounted, for 1993, to an annual tax expenditure or subsidy of \$3 to \$4 billion as to such 750,000 profitable *small* income, mostly private C Corporations.¹⁰ For 1993, there was also an at least equal annual tax expenditure benefitting about 33,500 *moderate* income, mostly private C Corporations (average income of around \$2,000,000 subject, on the average, to a flat thirty-four percent corporate income tax), accounting for over ten percent of C Corporation income.¹¹ For this latter segment of private companies the spread is between the flat thirty-four percent inside corporate rate and the highest outside individual rate of forty-five percent federal income and wage taxes combined.¹²

The Statistics of Income Division (SOI) of the Internal Revenue Service projects average annual decreases of 1.12% in 1999-2005 of corporate income Form 1120-A tax returns (filed by the smallest income and asset C Corporations, with gross receipts, total income and assets each not in excess of \$500,000).¹³ This asset category shows disproportionate losses and a very small share of corporate income.¹⁴ Such future decline might turn out to be attributable mostly to a shrinkage in the number of C Corporations reporting no income or a loss (sixty-one percent in 1993)¹⁵ due to the phase-out over this period of the C Corporation tax advantage

7. See *infra* notes 186-87 and accompanying text.

8. See *infra* notes 185-99 and accompanying text.

9. See *infra* notes 137-40, 147-69 and accompanying text.

10. See *infra* notes 166-70 and accompanying text.

11. See *infra* notes 201-03 and accompanying text.

12. See *infra* note 204 and accompanying text.

13. See Frank Zaffino, *Projections of Returns To Be Filed in Calendar Years 1999-2005*, 18 SOI BULLETIN No. 3, at 178, 184 tbl. 1 (1999).

14. For example, for 1993, Forms 1120-A with net income reported \$971,130,000 total net income; \$28,496,000 by C Corporations with zero assets; \$609,994,000 by C Corporations with assets under \$100,000; \$227,187,000 by C Corporations with assets over \$100,000 and under \$250,000; and \$105,453,000 by C Corporations with assets over \$250,000 and under \$500,000. 1993 CORPORATION SOURCE BOOK OF STATISTICS OF INCOME 245 ln.67 (Pub. 1053 rev. Mar. 1993) [hereinafter 1993 CORPORATION SOURCE BOOK]. This was 1.7% of C Corporation income (\$971,130,000 ÷ 571,922,088,000 = 1.7%). See *id.* at ln.67 (col. 1) (providing that the total net income reported on Form 1120-A is \$971,130,000); *id.* at lns.66, 69 (col. 1) (subtracting the total net income reported for all industries with and without net income (\$658,666,005,000) by the amount of total net income reported on Form 1120-S (\$86,743,917,000) to arrive at \$571,922,088,000).

15. See *infra* note 128 and accompanying text.

(in obtaining preferential individual income tax treatment of medical and other fringe benefits provided to shareholder-employees) over passthrough entities and self employers.¹⁶ Thus, choosing a small income, private C Corporation as a tax entity, in order to obtain its inside shelter, might continue during this period. In any event, SOI projects a 1.38% annual increase in returns filed by larger income and larger asset C Corporations during the next six years.¹⁷ Accordingly, use of the inside graduated rate tax shelter by the 33,500 moderate income C Corporations will most likely continue to grow in the future, absent statutory reform.

Based on anecdotal evidence and clues in the literature and the popular press, Part III also speculates as to the reasons for the continued vitality of S Corporations, the entity of choice for 2,450,000 returns in 1997 and the fastest growing type of business tax entity between 1999 and 2005, as projected by the SOI. The SOI predicts that S Corporations will surpass C Corporations in number in 2000¹⁸ and will account for an increasing percentage of the total corporate sector income, which is already up from 11% in 1993 to 17.6% for 1996.¹⁹ LLC commentary predicted to the contrary, largely on the basis of the numerous restrictions and limitations applicable to S Corporations as compared with LLCs. The apparent reasons for the popularity of S Corporations in a check-the-box world, with Service approval of LLCs, range from the practical,²⁰ to the mundane,²¹ and even arcane.²²

Part III also shows that LLCs are, in fact, tending to become the entity of choice for taxpayer market segments involving the SOI categories of (1) real estate industries and (2) professional services industries, which constitute together over fifty-six percent both of LLCs and of *all* partnerships.²³ Real estate businesses tend to be less suited to a C Corporation,²⁴ somewhat less suited to an S Corporation,²⁵ and more suited to an LLC.²⁶ Professional service industries are even less suited than improved real estate businesses to C Corporations, since the C Corporation inside graduated rates are barred to them.²⁷ However, they

16. See *infra* notes 137-49 and accompanying text.

17. See *infra* note 283 and accompanying text.

18. See *infra* note 289 and accompanying text.

19. See *infra* notes 116, 287-89 and accompanying text; Susan Wittman & Robert Grant, *S Corporation Returns, 1996*, 18 SOI BULLETIN 40 (1999).

20. See *infra* notes 234-42.

21. See *infra* notes 243-46 and accompanying text.

22. See *infra* notes 247-72 and accompanying text.

23. See *infra* notes 296-300 and accompanying text.

24. See *infra* notes 206-11 and accompanying text.

25. See *infra* notes 65 and accompanying text.

26. See *infra* note 207 and accompanying text.

27. See *infra* note 212 and accompanying text.

are well-represented in the ranks of S Corporations.²⁸ The same pattern of concentration of real estate businesses and service businesses in all partnerships²⁹ indicates that what Professor Hamill calls the “meteoric pace”³⁰ in the growth of LLCs, which has been the motor driving the increase in the number of all partnerships since 1994, appears to have been more at the expense of other types of partnerships than C and especially S Corporations. This supposition is supported by the fact that while the number of LLCs is continuing to grow at a phenomenal rate, the number of general partnerships has recently declined, and net growth in the number of limited partnerships has been limited.³¹

Part IV maintains that the use of private C Corporations as an inside tax shelter by high income individual owners violates the fundamental tax principles of both horizontal (like amounts of income should be taxed equally) and vertical equity (the effective rate of taxation should increase with ability to pay, *i.e.*, the principle of progressivity).³² This disparity, not the smokescreen of double taxation of close C Corporations, is intolerable from a populist perspective, but is not a surprise. Populism distrusts aggregations of economic power due to their political ability to obtain special privileges such as preferential tax rates.³³

Part V tells the political story of Congress’s intent over the past two decades. Congress’s intent has been that the large income, mostly public C Corporations enjoy lower effective rates of taxation or tax cuts through generous capital recovery and other preferential rules, and small income mostly private C Corporations also enjoy lower effective rates of taxation or tax cuts through increasingly generous inside graduated rates. This concern with reducing effective tax rates was most strikingly illustrated in a ninety-two-to-zero Senate roll call vote in 1981.³⁴ Part V concludes that any hope for congressional enactment of the ideal tax treatment as to private C Corporations³⁵ requires a clear-eyed view of the realities of

28. Wittman & Grant, *supra* note 19, at 43 (reporting that for 1996 26% of net S Corporation income attributable to the services division—business services (\$8.2 billion) and professional services (\$12.1 billion)—accounted for 85.2% of the income of the services division).

29. See *infra* notes 298-99 and accompanying text.

30. Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1454, 1460-61 (1998).

31. See *infra* notes 293-94 and accompanying text.

32. See *infra* notes 349-52 and accompanying text.

33. See *infra* note 342 and accompanying text.

34. See 127 CONG. REC. 16,254 (1981) (deciding in favor of an amendment lowering federal tax rates on incorporated small businesses); see also *id.* at 16,251-54 (presenting the floor discussion of the proposed tax amendment).

35. That is, mandatory passthrough for private corporations as recently called for in Professors George Yin and David Shakow’s ALI Reporters’ Study on the Taxation of Private Business Enterprises. GEORGE K. YIN & DAVID J. SHAKOW, AMERICAN LAW INSTITUTE FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTERPRISES REPORTERS’ STUDY 109-10, 145-46 (1999); see George

choice of tax entity on the ground,³⁶ the potent political support for the private C Corporation inside shelter³⁷ and the powerful small business myth in the political rhetoric.³⁸ The various shibboleths of conventional wisdom constitute conceptual stigmatism clouding vision and precluding any effective appeal to Congress for reform. Past attempts, as in the 1984 Treasury Tax Reform Proposals,³⁹ to eliminate the subsidy of graduated inside rates for small amounts of C Corporation income have resulted instead in it being increased, as in the ensuing Tax Reform Act of 1986.⁴⁰

II. Conventional Wisdom: Avoidance of Double Taxation, Plus Limitation of Liability Without S Corporation Restrictions, Make LLCs the Tax Entity of Choice for Small Business

A. Overview of Entity Taxation

1. *Corporation Taxation.*—A business entity is taxed as a C corporation if it is organized as a corporation under state law⁴¹ or if it is

K. Yin, *ALI Reporters, Study on Taxation of Private Business Enterprises*, TAX NOTES TODAY, Oct. 4, 1999, available in Westlaw at 1999 TNT 191-68 (providing an overview of the Reporter's study); see also John W. Lee, *Entity Classification and Integration: Publicly Traded Partnerships, Personal Service Corporations, and the Tax Legislative Process*, 8 VA. TAX REV. 57, 88-93, 119 (1988) [hereinafter Lee, *Entity Classification*] (arguing that passthrough treatment should apply whenever "the owners of the entity have control over the process of earning the entity's income or control the use and disposition of such earnings"); *Master Limited Partnerships: Hearings Before the House Ways and Means Subcomm. on Select Revenue Measures*, 100th Cong., 1st Sess. 340-42, 348 (1987) (statement of Professor John W. Lee) [hereinafter *MLP Hearing*] (advocating a dual track approach to integration of private and public corporations); John Lee, *President Clinton's Capital Gains Proposals*, TAX NOTES TODAY, June 7, 1993, available in Westlaw at 93 TNT 123-78 [hereinafter Lee, *Capital Gains Proposals*] (proposing mandatory passthrough of income or loss as to private C Corporations and mark-to-market accrual taxation of shareholders of public C Corporations). Some economic thought similarly believes that limited liability should be afforded only where ownership and management are separated. See Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 262, 262-63 (1967) (noting several justifications for limited liability and hypothesizing that "limited liability is probably an essential aspect of a large corporate system with widespread participation"). See generally Lawrence E. Mitchell, *Close Corporations Reconsidered*, 63 TULANE L. REV. 1143, 1148 (1989) ("[S]hareholders should only be permitted to acquire the traditional corporate characteristics . . . when ownership and control are separated to a significant degree.").

36. See *infra* notes 291-343 and accompanying text.

37. See *infra* notes 422-38, 445 and accompanying text.

38. See *infra* notes 446-56, 458-72, 475-92 and accompanying text.

39. See *infra* note 456 and accompanying text.

40. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.). Similarly, President Jimmy Carter's campaign promise to repeal the individual capital gains preference that was uniting the pressure groups in opposition led instead to an increase in the preference by the Revenue Act of 1978. See *infra* note 432. President Carter also proposed corporate shareholder integration; however, the Revenue Act of 1978 cut inside corporate tax rates at all brackets. See *infra* notes 435-36 and accompanying text.

41. See Treas. Reg. § 301.7701-2 (as amended in 1999); *Hearings on H.R. 1658, H.R. 2571, H.R. 3397, and H.R. 4448 Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 99th Cong. 27-28 (1986) [hereinafter *Passthrough Entities Hearings*] (statement of

either organized as some other entity, such as a business trust or LLC, and elects under the recent check-the-box regulations to be taxed as a C Corporation.⁴² Form thus controls. A C Corporation is taxed inside as a separate entity when it earns profits (or distributes appreciated property), and its shareholders are not taxed directly as to such profits or losses.⁴³ Rather, the shareholders are taxed "outside" at their individual rates when and if the C Corporation's profits are (1) distributed (a) in the form of ordinary income dividends or (b) in redemption of a shareholder's stock or in liquidation of the corporation, or (2) realized indirectly through a stock sale to a third party.⁴⁴ In a redemption, liquidation, or sale of stock, the "outside" taxes are usually assessed at the capital gains rate.⁴⁵ This is the classic double taxation scenario.⁴⁶ Part III of this Article shows (1) that the actual inside tax rates for most small and moderate income private C Corporations are far less than the owner's outside marginal rate would be on such income if taxed directly, and (2) that the second tax is easily escaped or long deferred.⁴⁷

2. *Passthrough Entity Taxation.*—A partnership, including an LLC, is not treated as a separate taxpayer for Federal income tax purposes, and thus is not taxed on its profits.⁴⁸ Rather, the partnership's income is taxed to the partners. Items of income, gain, loss, deduction, and credit are generally allocated to them in accordance with the partnership agreement.⁴⁹ A partner's basis, or cost in her ownership interest in the

J. Roger Mentz, Assistant Secretary for Tax Policy) (suggesting, in an effort to promote certainty, that a business entity organized under state law as a corporation should generally be respected as a corporation for federal income tax purposes, even if the enterprise may more closely resemble another form of business organization).

42. See Treas. Reg. § 301.7701-3 (as amended in 1999). An entity formally formed as a corporation is recognized as a C Corporation so long as it is not a sham without business purpose or activity. See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 1.05[1][b] (6th ed. 1998). An S Corporation and its shareholders must properly elect passthrough status under § 1362. See *id.* at ¶ 6.03. Check-the-box allows a taxpayer not formally organized as a corporation to obtain passthrough treatment under the partnership rules if there is more than one owner. See generally Hamill, *supra* note 30, at 1482-83. A publicly traded partnership is also treated as a C Corporation if it does not carry on a qualifying passive activity. See I.R.C. § 7704 (1994).

43. See BITTKER & EUSTICE, *supra* note 42, at ¶¶ 1.02, 2.10.

44. See TREASURY REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 2 (January 1992) [hereinafter TAXING BUSINESS INCOME ONCE].

45. See BITTKER & EUSTICE, *supra* note 42 at ¶ 1.02.

46. See *id.* ¶¶ 1.02, 1.03.

47. See *infra* notes 141-62, 172-98 and accompanying text.

48. See I.R.C. § 701 (West Supp. 1999); Robert A. Schnur, *Ensuring LLCs Are Taxed as Partnerships*, 67 WIS. LAW. 18, 18 (1994). See generally STAFF OF THE JOINT COMM. ON TAXATION, REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES (JCS-6-97), Apr. 8, 1997 (noting that passthrough taxation applies to LLCs).

49. See I.R.C. § 702, 704 (West Group 1999).

partnership, is increased by an amount equal to her share of such items.⁵⁰ A partner is not taxed on pro rata distributions from the entity except to the extent that cash distributions exceed the basis of her ownership interest.⁵¹ Partnership income is thus subject to only one level of Federal income tax.⁵²

S corporations, like partnerships, are generally (but not always) treated as conduits, or passthroughs, for tax purposes.⁵³ The income of an S corporation is taxed directly to its shareholders, whose stock basis is increased by such income and decreased by losses, deductions, and nondeductible expenses that pass through to the shareholder.⁵⁴ In turn, distributions to a shareholder from an S Corporation are generally taxable only to the extent that they exceed the shareholder's basis in stock.⁵⁵ This

50. See I.R.C. § 705(a)(1) (West Group 1999).

51. See *id.* § 731(a)(1). Distributions of property are generally tax free, with carry-over basis adjustments. See *id.* § 732. Disproportionate distributions of property or money may trigger recognition to the distributee and other partners. See *id.* § 751(b).

52. See JOINT COMM. ON TAXATION STAFF, *supra* note 48, at 10.

53. See I.R.C. § 1363, 1366, 1374, 1375 (1994). See generally Joint Committee on Taxation Staff, *Present Law and Proposals Relating to Subchapter S Corporations Home Office Deductions*, TAX NOTES TODAY, May 25, 1995, available in Westlaw at 95 TNT 102-23 (noting that S corporations pass corporate items of taxable income and loss through to shareholders). For discussion of the entity and aggregate aspects of taxation of partnerships and S Corporations see *Passthrough Entities Hearings*, *supra* note 41, at 8 (statement of Treasury Assistant Secretary for Tax Policy J. Roger Mentz) (describing a continuum (based on the work of Eustice, *infra*) from entities, such as sole proprietorships and grantor trusts, whose separate existence is for most purposes ignored, to entities such as C Corporations, which are generally treated as separate persons); Glenn E. Coven & Amy Morris Hess, *The Subchapter S Revision Act: An Analysis and Appraisal*, 50 TENN. L. REV. 569, 622, 622-44 (1983) (analyzing the treatment of S Corporations under the Revision Act, whereby "an S corporation is still subject to a unique pattern of taxation, neither entirely borrowed from corporate entity concepts nor entirely embracing the partnership conduit approach"); and James S. Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals)*, 39 TAX L. REV. 345, 353-54, 362-67, 372-78, 381-94, 396-400, 404-10, 433 (1984). Between the two extremes are entities such as partnerships and S Corporations, "the taxation of which reflect both aggregate and separate entity principles." see *Passthrough Entities Hearings*, *supra* at 8; see also Glenn E. Coven, *Subchapter S Distributions and Pseudo Distributions: Proposals for Revising the Defective Blend of Entity and Conduit Concepts*, 42 TAX L. REV. 381, 382-83 (1987) (arguing that the distribution rules are unsatisfactory and that S Corporations should be taxed like partnerships); Lee, *Entity Classification*, *supra* note 35, at 88-93 (explicating, based on the legislative histories of Subchapter K and the Passive Activity Loss limitations of section 469, Professor Eustice's continuum model with a separation of entrepreneurial risk-activities and ownership model).

54. See I.R.C. § 1366, 1367(a)(1) (West Supp. 1999); see also Joint Committee on Taxation Staff, *supra* note 53.

55. See *id.* § 1368(b). If an S Corporation has C Corporation earnings and profits (because it was formerly a C Corporation or is a survivor of a merger with a C Corporation), the amount of a distribution to shareholders that is income tax free is dependent upon an accumulated adjustments account. See Joint Committee on Taxation Staff, *supra* note 53, at 8. Due to the inside and outside tax upon liquidation of a C Corporation under §§ 311, 336, 302, and 331, C Corporation to S Corporation conversions are usually the only practical alternative for going from a C Corporation to a passthrough entity. See Symposium, *Check-the-Box and Beyond: The Future of Limited Liability Entities*, 52 BUS. L. 605, 631-32 (1997) (comments of Professor Glenn E. Coven, Jr.) (discussing conversion

is also a single taxation level regime.⁵⁶

Unlike partnerships, including LLCs, an S Corporation must meet certain requirements as to its capital structure and the identity of its shareholders.⁵⁷ An S Corporation may neither have more than seventy-five shareholders nor more than one class of stock.⁵⁸ The one class of stock limitation, coupled with the requirement that all items of income or loss be allocated "pro rata" among outstanding shares of stock determined on a daily basis,⁵⁹ preclude for S Corporations the partnership flexibility of allocating items of income or loss to different investors. In particular, S Corporations cannot allocate losses disproportionately to, for example, a capital partner and then follow with a charge back of income.⁶⁰ Also, only individuals (other than nonresident aliens), estates, and limited types of trusts may be shareholders in an S Corporation.⁶¹ Furthermore, S Corporation liabilities are not included in a shareholder's basis in her stock interest, which serves as a ceiling on current deductibility of passthrough S Corporation losses.⁶² In contrast, partners can take deductions supported by partnership liabilities.⁶³ Shareholder loans to an S

considerations as a factor contributing to the survival of S Corporations). For a brief discussion of traditional tax reasons for such conversions and the extent of such conversions in recent years (25% to 60% of new S Corporation elections, depending on the year) see *infra* notes 214-26 and accompanying text.

56. See Karen C. Burke, *The Uncertain Future of Limited Liability Companies*, 12 AM. J. TAX POL'Y 13, 22 (1995) (noting that S Corporations offer a single level tax); Craig J. Langstraat & K. Dianne Jackson, *Choice of Business Tax Entity After the 1993 Tax Act*, 11 AKRON TAX J. 1, 4 (1995).

57. See Joint Committee on Taxation Staff, *supra* note 53, at 11 (differentiating between partnerships and S Corporations).

58. See I.R.C. § 1361(b)(1)(A) and (D) (West Supp. 1999) (amending I.R.C. § 1361 (1994)) (outlining the requirements for S Corporation eligibility).

59. See I.R.C. §§ 1366(a)(1), 1377(a)(i) (1994 & West Supp. 1999).

60. Compare I.R.C. § 1366(a)(1) (West Supp. 1999) (amending I.R.C. § 1366 (1994)) (describing methods of determining shareholder tax liability in an S Corporation); *id.* § 1377(a)(1) (1994 & West Supp. 1999) (defining a shareholder's "pro rata share" for purposes of tax liability), with Treas. Reg. § 1.704-1(b)-(c) (explaining how to determine a partner's distributive share and how to account for contributed property). See also Joint Committee on Taxation Staff, *supra* note 53 (explaining that S Corporations do not offer the flexibility of partnerships with respect to allocations of income and losses to different investors); FRANKLIN A. GEVURTZ, *BUSINESS PLANNING* 70, 373(2d ed. 1995) (observing that pro-rata distributions of profits and losses to S Corporation shareholders limits the flexibility of S Corporations, relative to partnerships); William J. Rands, *Passthrough Entities and Their Unprincipled Differences under Federal Tax Law*, 49 SMU L. REV. 15, 18-19 (1995) (describing the flexibility of partnership tax law in terms of the partners' ability to reallocate income and losses to reduce the tax burden).

61. See I.R.C. § 1361(b)(1)(B) (West Supp. 1999) (amending I.R.C. § 1361 (1994)) (defining the eligible shareholder for an S Corporation).

62. See I.R.C. § 1366(d)(1) (West Supp. 1999) (amending I.R.C. § 1366 (1994)) (explaining that loss deductions taken by shareholders in an S Corporation cannot exceed the shareholders' adjusted basis in the stock and debt of the S Corporation); *id.* § 1367 (West Supp. 1999) (amending I.R.C. § 1367 (1994)) (listing items included in shareholder basis, and omitting liabilities of an S Corporation from the list).

63. See Joint Committee on Taxation Staff, *supra* note 53.

Corporation support a loss deduction for that shareholder only, unlike the partnership rules, where such debt (except nonrecourse debt) is "shared," by all partners like any other debt.⁶⁴ These differing liability sharing rules are thought to impact heavily on an entity's choice between Subchapter S and Subchapter K for holding depreciable real estate.⁶⁵

One of the most significant choice of tax entity differences between Subchapters S and K (applicable to partnerships including LLCs) is that an S Corporation can not make inside basis adjustments to its assets upon the death of a shareholder or a transfer of her interest, as partnerships can.⁶⁶ Because the outside basis in the deceased shareholder's stock (a capital asset) is stepped, usually up, to its date of death fair market value, carefully timed sales (or distributions to the decedent's successor) of the S Corporation's capital assets, followed in the same tax year by liquidation of the S Corporation or redemption of the deceased shareholder's interest, can yield the same practical tax result as partnership inside basis adjustments.⁶⁷ The decedent's successor can thereby offset her share of the inside capital *gain* triggered by the sale or distribution with the resulting outside capital *loss* on the stock, since its basis will have been increased by her share of the inside gain above fair market value and above

64. See I.R.C. §§ 8, 752(a) (1994) (explaining how debt is allocated among partners and treating a partner's share of an increase as a "constructive" cash contribution); *id.* § 722 (providing for a basis increase in the partner's interest for cash contributions); Rands, *supra* note 60, at 19-20 (explaining the difference in basis calculations between S Corporations and partnerships). For a description of the arcane and somewhat counterintuitive rules pertaining to shareholder guarantees of S Corporation debt and shareholder basis, see generally Susan Kalinka, *Shareholder Guarantees and Subchapter S Basis: Investment in the Corporation*, 63 TEMPLE L. REV. 659 (1991).

65. See Patrick J. Mullaney & Richard D. Blau, *An Analytic Comparison of Partnerships and S Corps as Vehicles for Leveraged Investments*, 59 J. TAX'N 142, 143-44 (1983) (illustrating that the differing liability-sharing rules may make the use of a partnership advantageous when the entity assumes a liability, and discussing means by which S corporations can avoid such disparate results); Jerald D. August & Mark L. Silow, *S Corporation vs. Partnership for Real Estate Ventures*, 1 J. OF TAX'N OF INVESTMENTS 91, 119-20 (1984) (explaining that shareholders in an S Corporation are more limited in their ability to increase their basis); Eugene Chester & William H. Whitedge, *Partnership or Subchapter S Corporation: Which Provides the Greater Tax Benefits?*, 10 TAX'N FOR LAW. 177-79 (1981) (comparing the sharing of liabilities among partners with the rules disallowing the sharing of liabilities among S Corporation shareholders). Cf. Warren Paul Kean, Comment: *After the Facelift, Is Subchapter S Any More Attractive?*, 46 LA. L. REV. 87, 123 (1985) (noting that Congress is "disinclined" to extend the liberal basis adjustment rules available for partnerships when such provisions have induced the creation of many perceived abusive tax shelters").

66. See I.R.C. §§ 743, 754 (1994) (allowing the basis of partnership property to be adjusted if the partnership has formally elected an optional adjustment policy); Martin J. McMahon, Jr., *Optional Partnership Inside Basis Adjustments*, 52 TAX LAW. 35, 35 (1998) (explaining that a Subchapter K entity can make adjustments to inside basis upon the death of a partner if so elected under § 754). See *infra* note 239 for a comparison of Subchapters K and S regarding inside basis adjustments.

67. See I.R.C. § 1014(a) (West Supp. 1999) (amending I.R.C. § 1014 (1994)) (describing how to calculate the basis of inherited property); *id.* § 302, 331 (both stating that the amount received by a shareholder in a complete or partial liquidation distribution shall be treated as exchanged for the stock).

the proceeds actually distributed.⁶⁸ This somewhat Byzantine technique does not work, however, for inside ordinary income realizations such as sales of inventory items. In this situation, the gain inside will be ordinary and the loss outside will be capital and can offset only \$3,000 of ordinary income annually, assuming no capital gains.⁶⁹ (Partners too, however, can not obtain an inside basis adjustment as to an ordinary income asset if it constitutes "Income in Respect of a Decedent".⁷⁰) Conversely, S Corporations are not subject to the partnership mandatory allocation to the contributing partner of built-in gain or loss in contributed property.⁷¹

There are other, usually less significant, differences between taxation of S Corporations and their shareholders and taxation of partners. For example, there are differences in (1) receipt by service partners of a profits share; (2) transfers of property to the entity when liabilities exceed the transferor's basis; (3) varying ownership interest rules; (4) nonpartner-employee capacity transactions with the entity; (5) retirement payments to former principals; and (6) debt-equity lore when appreciated property is transferred to lock in the character of gain.⁷² It would be nice in the two or three person owner-entrepreneur venture to be able to elect the simplified, more rationalized conduit rules proposed by the ALI Reporters in *Taxation of Private Business Enterprises*.⁷³

68. See I.R.C. § 1367(a) (West Supp. 1999) (amending I.R.C. § 1367 (1994)) (explaining how to adjust a shareholder's basis for gains or losses).

69. See I.R.C. § 1211(b) (1994) (explaining that capital losses may only be used to offset \$3,000 of ordinary gains).

70. See generally, Susan Kalinka, *Death of a Member of an LLC*, 57 LA. L. REV. 451, 456 (1997) (describing the method of adjusting an LLC member's basis on death and explaining that Income in Respect of a Decedent reduces the basis amount).

71. See I.R.C. § 704(c) (1999) (requiring that any income, gain, loss, or deduction due to contributed property be shared among partners in a specific way).

72. See John Lee, *Partnership Profits Share for Services: An Aggregate Exegesis of Revenue Procedure 97-27*, 94 TAX NOTES TODAY, available in Westlaw at 94 TNT 61-27 (1994) (noting differences in receipt by service partners of a profits share); James Edward Maule, *Report on the Comparison of S Corporations and Partnerships* (pt.2), 44 TAX LAW. 813, 858-59 (1991) (describing the treatment of payments to a retiring partner and observing that "[n]o analogous rules exist in the S corporation context"); Rands, *supra* note 60, at 20 n.29; Alan R. Sumutka, *Selecting a Form of Business*, CPA JOURNAL, Apr. 1997, at 24, 24 (noting differences in nonpartner-employee capacity transactions with the entity).

73. YIN & SHAKOW, *supra* note 35, at 125-30. The Reporters correctly point out that the most irrational entity features of the current S Corporation derive from the decision to allow tax-free C to S conversions. See *id.* at 12; see also Lee, *Entity Classification*, *supra* note 35, at 91 (stating that the Subchapter S "pass through separate entity approach" was likely designed to encourage C to S Corporation conversions). President Clinton's proposals to treat C to S conversions as a liquidation have gone nowhere. See Jerald David August, *Benefits and Burdens of Subchapter S in a Check-the-Box World*, 4 FLA. TAX REV. 278, 323 n.166 (1999) (reporting that Clinton's February 1997 budget proposals recommended that a C to S conversion be treated as a deemed liquidation if the value of the C Corporation exceeded \$5 million, but noting that the proposal was later abandoned).

B. *Limitation of Liability*

Shareholders in C and S Corporations are, in theory, not liable for contractual or tort obligations of their corporation,⁷⁴ except to the extent of unpaid stock subscriptions.⁷⁵ In contrast, general partners are jointly and severally liable for partnership liabilities.⁷⁶ Limited partners in limited partnerships have much the same shield against the partnership's liabilities as shareholders in a private C Corporation, but aside from the difficulty of obtaining a general partner willing to be personally liable, a limited partnership is an awkward vehicle where the limited partners want to play an active management role.⁷⁷ The common answer of using a corporate general partner (often an S Corporation sometimes owned by the limited partners) once raised intense tax questions now largely put to bed by the check-the-box classification regulations.⁷⁸ The other problem, active limited partners, is partially obviated by the Revised ULPA, but some difficulty may still remain if the limiteds actually manage the enterprise.⁷⁹ LLCs provide a limited liability shield much like private corporations while permitting, but not requiring, owners to actively manage the entity.⁸⁰

The advantages of limitation of liability in using the private corporation or LLC may be more apparent than real. The corporate veil is pierced in litigation almost as often as not⁸¹ (*i.e.*, liability is extended

74. See Joint Committee on Taxation Staff, *supra* note 48 ("A primary reason for incorporating in many cases has been the fact that corporate form shields the shareholders of the corporation from liabilities of the business."). For an argument that limitation of liability in private C Corporations, as well as in LLCs, is a chimera, see *infra* notes 81-84 and accompanying text.

75. See 18A AM. JUR. 2d *Corporations* § 863, at 739 (1985) (noting that "a shareholder is liable to corporate creditors to the extent his stock has not been paid for").

76. See Uniform Partnership Act § 15 (1914), 6 U.L.A. 454 (1995) (stating that all partners are jointly and severally liable for everything chargeable to the partnership and for all its debts and obligations); Uniform Partnership Act § 306 (1997), 6 U.L.A. 62 (Supp. 1997) (providing that all partners are jointly and severally liable except for liabilities incurred before a partner joined the partnership and for liability arising while the partnership was an LLP). See generally Donald J. Weidner & John W. Larson, *The Revised Uniform Partnership Act: The Reporters' Overview*, 49 BUS. LAW. 1 (1993) (providing an overview of the Revised Uniform Partnership Act (1992) and assessing its major contributions); Susan Kalinka, *The Limited Liability Company and Subchapter S: Classification Issues Revisited*, 60 U. CIN. L. REV. 1083, 1094 (1992) (stating that at least one member of a partnership must be liable for its debts).

77. See GEVURTZ, *supra* note 60 at 254-55.

78. See *id.* at 80-82.

79. See *id.* at 80-82, 238-39, 254-55 ("Section 303(b) . . . [of the Revised U.P.A.] provides a safe harbor of enumerated activities which limited partners may undertake.").

80. See Burke, *supra* note 56, at 31-32 (describing the typical management of an LLC and discussing the effects of limited liability on the management of an LLC); Langstraat & Jackson, *supra* note 56, at 6; Fallany O. Stover & Susan Pace Hamill, *The LLC Versus LLP Conundrum: Advice for Businesses Contemplating the Choice*, 50 ALA. L. REV. 813, 817 (1999) (explaining that LLC members have the option of either formally appointing managers or managing the entity themselves).

beyond the corporate entity). Such veil piercing is commonly thought to apply equally to LLCs, and the case law is beginning to agree, creating just the same unpredictable results as in corporate veil piercing.⁸² Additionally, owners of private business entities are frequently personally liable because they usually must endorse entity borrowing or personally commit torts or supervise those who do commit torts.⁸³ In short, the nontax advantages of private C Corporations and LLCs appear dubious at best.⁸⁴

C. *Conventional Wisdom—Death of Private C Corporations and Non-LLC Passthroughs*

"The report of my death was an exaggeration."⁸⁵ Most recent commentators on choice of tax entity for small business over-promote

("[M]ost decisions to pierce find their real justification in wrongs committed by the defendant in his or her dealings with the plaintiff or abusive dealings by the defendant with the corporation's assets."); Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 38 (1995) ("Most veil-piercing arguably amounts to either liability for misrepresentations to third parties about the extent of capitalization or the nature of the entity, or to a kind of fraudulent conveyance liability."); Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1048, 1058 (1991) (finding that piercing occurred more frequently in contracts cases than in tort cases, and that courts "pierced the veil in about 40% of reported cases"). Self-selection by plaintiffs in litigation probably contributes to their relatively high success rate.

82. See, e.g., David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?*, 51 OKLA. L. REV. 427, 429 (1998) (applying the current law of veil-piercing to LLCs); Eric Fox, Note, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143, 1145 (1994) (arguing that some aspects of traditional veil-piercing analysis should apply to LLCs). Compare *Water, Waste & Land, Inc. v. Lanham*, 955 P.2d 997, 1001 (Col. 1998) (holding that an agent for an LLC was personally liable for failure to disclose that he was acting on behalf of the entity), with *Ditty v. Checkrite*, 973 F. Supp. 1320, 1335 (C.D.D. Utah 1997) (recognizing that the piercing doctrine probably applies to LLCs, but refusing to apply it to the defendant LLC in the case); *Resolution Trust Corp. v. Latham & Watkins*, 909 F. Supp. 923, 930 (S.D.N.Y. 1995); (stating that the corporate veil will not be penetrated unless it is shown that the corporation was organized for some fraudulent or other improper purpose) and *Marina, LLC v. Walker*, No. CA 97-1013, 1998 WL 240364, at *6-7 (Ark. Ct. App. May 6, 1998) (affirming the trial court's refusal to pierce the veil of the defendant LLC).

83. See GEVURTZ, *supra* note 60, 1998 SUPPLEMENT at 9; Richard A. Booth, *Limited Liability Companies: Profit-Seeking, Individual Liability, and the Idea of the Firm*, 73 WASH. U. L.Q. 539, 549 (1995) (arguing that limited liability is a myth); Robert A. Kessler & Gail Levin Richmond, *Has Congress Made the C Corporation Obsolete for Small Business?*, 7 CORP. L. REV. 293, 294 (1984) ("The principal nontax advantage of the corporation is the limited personal liability of the business participants for business debts."); Robert A. Kessler & Edward Yorio, *Choosing the Appropriate Form for the Small Business*, 1 CORP. L. REV. 291, 302-04 (1978) (outlining partnership agency rules and liability for tort damages); Rands, *supra* note 60, at 26 ("The concept of limited liability also does not insulate shareholders, members, or anyone else from personal liabilities for any torts that they themselves commit while working for the business.").

84. See Dennis J. Carlin, *Partnership vs. Corporation: Non-Tax-Shelter Business Enterprise*, 34 N.Y.U. INST. ON FED. TAX'N 741, 784 (1976) ("The partnership form offers many advantages not offered by a corporation.").

85. Mark Twain so wrote in a June 1, 1897 note to the London correspondent of the *New York Journal* which published it the next day. JOHN BARTLETT, *FAMILIAR QUOTATIONS* 528 (Justin Kaplan

LLCs.⁸⁶ Conventional wisdom as to choice of small business tax entity holds that in light of the recent regulatory check-the-box elective tax classification (allowing taxation as a C Corporation, an S Corporation, or as a tax passthrough, including an LLC) and the 1986 statutory repeal of the *General Utility* shield against inside corporate level tax on gain realized in a distribution of appreciated capital assets in a liquidation or bulk sale pursuant to a timely liquidation,⁸⁷ the LLC is the wave of the future for new small business ventures.⁸⁸ The theme of "death" of the private C Corporation and of the traditional passthrough entities, such as limited partnerships, general partnerships, and S Corporations, runs throughout recent academic and practitioner tax literature replete with funereal subtitles.⁸⁹

86. See Alan R. Sumutka, *supra* note 72, at 24 ("Recently touted as a virtual panacea in business entity planning and selection, the case for the limited liability company (LLC) appears to be oversimplified and overpromoted. In fact, a C or S corporation is probably the optimum entity for many small businesses."). For factors commonly used in determining the appropriate tax entity, see generally James Edward Maule, *Report on the Comparison of S Corporations and Partnerships* (pts. 1-2), 44 TAX LAW. 483 (1991); Dudley M. Lang, *Comparison of S Corporations, C Corporations and Partnerships*, 48 N.Y.U. INST. ON FED. TAX'N 9-1 (1990).

87. See I.R.C. § 311 and 336 (1994); H.R. CONF. REP. NO. 99-841, vol. II, at 199-204 (1986), reprinted in 1986 U.S.C.C.A.N. 4075, 4287-92 (containing Conference Report comments on the implication of, and intention behind, the repeal of the *General Utility* doctrine); Denise Roy, *Tax Costs and Opportunities in Exiting a Closely Held Business*, 22 WM. MITCHELL L. REV. 1281, 1346 (1996) (asserting that in the majority of situations C Corporation tax treatment will be a business's last choice because of the second tax on exit); Victor E. Fleischer, Note, "If It Looks Like a Duck": *Corporate Resemblance and Check-The-Box Elective Tax Classification*, 96 COLUM. L. REV. 518, 529 n.62 (1996) ("The repeal of General Utility by I.R.C. § 311 . . . makes the entity-level tax a real burden even to shareholders of closely-held corporations."). Check-the-box certainty of partnership status for LLCs may have some effect on choice of tax entity. See *infra* notes 278-81 and accompanying text.

88. See Richard A. Booth, *The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships*, 32 WAKE FOREST L. REV. 79 (1997) (describing the LLC as the "form of choice for closely held businesses in the United States"); Corey E. Fleming, *LLCs Get Enormous Boost*, LAW. WKLY. U.S.A., May 20, 1996, at 1 (predicting that LLCs will increasingly displace corporations in the aftermath of check-the-box); Jerold A. Friedland, *Tax Considerations in Selecting a Business Entity: The New Entity Classification Rules*, 9 DEPAUL BUS. L.J. 109 (1996) (noting that LLCs provide the same state law protection against creditors as an S Corporation, but are generally a more flexible business form); Note, *Recent Legislation*, 110 HARV. L. REV. 553, 556-57 (1996) (describing the advantages of LLC over S Corporation status).

89. See, e.g., *Home Office Deduction and Subchapter S Corporation Reform: Hearing on S. 327, S. 758, and H.R. 1215 Before the Subcomm. on Taxation and IRS Oversight of the Senate Comm. on Finance*, 104th Cong. 26 (1995) ("[F]uture businesses, I would predict, are going to overwhelmingly choose the limited liability company, rather than an S corporation." (Statement of Professor Susan Hamill)). The general partnership has, however, been supplanted by LLCs. See Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. 387, 391 (1991) (characterizing the LLC as the "survivor of the continuing controversy over the appropriate classification of entities for federal income tax purposes"); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 408 (1992) (predicting that LLCs may ultimately replace limited partnerships, close corporations and even general partnerships "for most purposes"); Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of*

Professor Larry Ribstein, a leading proponent of a law and economics analysis of choice of tax entity, maintains that the traditional corporate route to limited liability bears the costs of (a) "the extra tax burden associated with 'two-tier' taxation of corporate income," and (b) rules such as centralized management, extensive fiduciary duties of directors to shareholders, and nondiscrimination within classes of stock.⁹⁰ Thus, in his view, the two-tier corporate tax penalizes limited liability.⁹¹ Professor Ribstein asserts that the LLC alternative "provides an opportunity to test firms' preference for limited liability in the absence of regulatory and tax constraints."⁹² He predicts that "[t]he move toward LLCs will come at the expense of other, more costly, limited liability business forms for closely held firms, including limited partnerships, statutory close corporations, and Subchapter S Corporations."⁹³ However, Part III shows that in fact, for most small businesses conducted in entity form with small positive income after payment of compensation to principals and a need for retention of capital (*e.g.*, for expansion), the tax constraints currently run in favor of the C Corporation and against the passthrough form.⁹⁴ This may be even more true for many capital intensive, moderate income private C Corporations.⁹⁵

Professor Susan Pace Hamill fabricates an interesting law and economics construct as to LLCs. She posits that the intolerable inequities of imposing the corporate tax on small asset private C Corporations will cause many private small businesses to choose the LLC form over the private C Corporation form without examining the LLC's business benefits or detriments:⁹⁶ "[I]t is impossible to tell whether or not the LLC offers material business advantages over the close corporation."⁹⁷ Professor Hamill therefore calls for corporate shareholder integration for private corporations (presumably mandatory passthrough) because

Partnership, 70 WASH. U. L. Q. 417, 417 (1992) ("After a transitional period, partnership will survive, if at all, as a residual form for firms that have no customized agreement."); Walter D. Schwidetzky, *Is It Time to Give the S Corporation a Proper Burial?*, 15 VA. TAX REV. 591, 637-38 (1996) (proposing repeal of subchapter S because of the superiority of the LLC and arguing that the availability of LLC status makes the "demise of the S corporation inevitable"); *infra* note 293 and accompanying text.

90. Ribstein, *supra* note 89, at 419-20. This Article does not address the latter "burden." Clearly the LLC is more flexible than the C Corporation in this respect.

91. *See id.* at 457 (noting that "despite the availability of single-tier taxation for limited-liability firms, the two-tier tax continues to penalize limited liability").

92. *Id.* at 426.

93. *Id.* at 474.

94. *See infra* subpart III(A).

95. *See infra* subpart III(A).

96. *See* Hamill, *supra* note 1, at 399, 432-33.

97. *Id.* at 399.

[o]nly after lawmakers integrate close corporations, thus removing the tax advantage LLCs currently enjoy, can new businesses choose between the LLC and the closely held corporation without regard to tax consequences; and only then will it be possible to determine if the LLC's business provisions truly offer a superior combination of the corporate and partnership forms.⁹⁸

Assuming that sophisticated small asset private C Corporations avoid double taxation by paying out profits as deductible compensation to shareholder-employees, Professor Hamill argues that only unsophisticated small asset private C Corporations are taxed more than once.⁹⁹ She claims that "[f]ocusing on the corporate tax paid by the smallest corporations, the revenue cost for integrating the small-asset corporations would likely be between \$2 billion and \$3 billion."¹⁰⁰ Therefore, "by bringing the inequities between the incorporated and unincorporated forms out of the closet, the rise of the LLC form should compel lawmakers to integrate small closely held businesses as soon as possible."¹⁰¹ Part V rebuts Professor Hamill's argument by recounting that in fact small business pressure groups view the separate taxation of small income private C Corporations as a \$3 to \$5 billion a year *boon* worth fighting for, not a \$3 billion a year *burden* to be repealed.¹⁰² The historical record sketched there shows that Congress supports the small business pressure groups in their battle with corporate tax reformers over inside graduated corporate rates.¹⁰³

Professors Don Llewellyn and Anne O'Connell Umbrecht argue that passthrough treatment is economically preferable to taxation as a private C Corporation in most cases, so that for any new entity, other than one formed as or likely to become publicly traded, an LLC taxed as a pass-through should be the tax entity of choice.¹⁰⁴ They perform present value calculations of a hypothetical corporation generating income taxed at thirty-four percent and then selling its assets after five years and liquidating, with the net to the shareholders being taxed at twenty percent as a long-term capital gain.¹⁰⁵ They then contrast this with a hypothetical passthrough whose owners are taxed at a flat 39.6% "[t]o give the C

98. *Id.* at 433.

99. *Id.* at 415-18, 430.

100. *Id.* at 432 n.187.

101. *See id.* at 432.

102. *See infra* notes 457-59 and accompanying text.

103. *See infra* notes 458-68.

104. *See* Llewellyn & Umbrecht, *supra* note 1, at 2.

105. *See id.* at 6-7.

corporation option a fighting chance."¹⁰⁶ With these assumptions they demonstrate that on a present value basis a passthrough entity is economically preferable.¹⁰⁷ Part III reveals that they have, in effect, tied both hands behind the back of the small income C Corporation in the choice of tax entity fight. In reality, ninety-eight percent of C Corporations are taxed at lower than thirty-four percent, and the second tax is often avoided or long deferred.¹⁰⁸ They are, however, correct that most owners of private C Corporations would be taxed at marginal rates of 39.6% or higher on additional income.¹⁰⁹

In short, most (but not all) commentators predict that LLCs will soon render obsolete both the private C Corporation and the traditional pass-through entities (partnerships, limited partnerships, and S Corporations) as tax entities for new private business ventures.¹¹⁰ For the reasons stated in Parts IV and V below, in an ideal (or even a moderately rational, apolitical) tax world most, if not all, of this would come to pass, although probably not for conventional wisdom's reasons. Of course, in an ideal

106. *Id.*

107. *See id.* at 7.

108. *See infra* notes 128-32 and accompanying text.

109. *See infra* notes 141-42 and accompanying text.

110. In addition to the authorities already cited in notes 86-89, and 101 see William E. Elwood, *The Limited Liability Company in Seven Easy Lessons: A Tax Executive's Primer*, 46 TAX EXECUTIVE 388 (Sept. 1994) (describing LLCs as the "hottest new business structure in decades"); Hamill, *supra* note 1, at 405 (arguing that the explosive rate of increase in formation of LLCs compared with the small percentage increase in the formation of corporations and decrease in partnerships, indicates that the LLC "may in fact become the entity of choice in the future"); G.A. Shareef, *New Form of Organizing Aids Business*, COURIER-JOURNAL (Louisville, Ky.), Sept. 1, 1996, at E-3, available in 1996 WL 6360434 ("The LLC has become the business entity of choice for smaller, privately held companies. . . . For many businesses, the LLC alternative is not only a smart choice, it is the only choice available to obtain personal protection from business debts, tax simplicity and financial flexibility."); Vasilios T. Nacopoulos, Note, *Whither (Wither) Subchapter C? The Effect of the Double-Tax System's Progeny (the LLC, Check-the-Box and Subchapter S)*, 17 J. L. & COMM. 159, 173 (1997) (suggesting that the C Corporation may survive, but only due to "corporate inertia" and the ignorance of practitioners who give advice to new business clients). Here too, as shown in the Appendix, the facts on the ground are not so convincing. *See infra* notes 273-309 and accompanying text. Contrary voices include Burke, *supra* note 56, at 20-22 (providing an interesting public choice analysis of origins of state LLC legislation) and Rands, *supra* note 60, at 32-33 ("No matter what the merits of the limited liability company (and in my opinion they are modest), its emergence is an example of badly formulated tax law."). Cf. Susan Saab Fortney, *Seeking Shelter in the Minefield of Unintended Consequences: The Traps of Limited Liability Law Firms*, 54 WASH. & LEE L. REV. 717, 762 (1997) (warning that "the current limited liability rules can negatively impact [law] firm insiders and persons who deal with the firms"). For a list of constituencies supporting the LLC movement see Wayne M. Gazur, *The Limited Liability Company Experiment: Unlimited Flexibility, Uncertain Role*, 58 LAW & CONTEMP. PROBS. 135, 179-81 (1995) (detailing the roles of business lobbies, tax and business lawyers, accountants and the IRS in pushing for LLC legislation); Hamill, *supra* note 30, at 1463-66, 1517-18 (including independent oil explorers, real estate developers, and business ventures expecting to consistently recognize taxable income as groups with an interest in supporting the LLC movement).

world the current multiplicity, confusion, and misunderstanding as to choice of small business tax entity—all grossly violating the tax principle of simplicity¹¹¹—could never have arisen.¹¹²

III. Reality of Inside Shelter for Small Income Private C Corporations and Perceived Residual Advantages of S Corporations

A. Inside Shelter of Small Income Private C Corporation

1. *Statistics of Income Data.*—The 1993¹¹³ corporate income tax distribution manifests a long-standing pattern of income concentration in large asset, mostly publicly traded corporations.¹¹⁴ The approximately

111. Simplicity is a fundamental tax policy criterion. See Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 572-73 (1965) (providing a seminal definition of "practicality" as a tax policy criterion). It is thought to be a keystone to a tax system that relies on taxpayer self-assessment. See Edward Yorio, *The President's Tax Proposals: A Major Step in the Right Direction*, 53 FORDHAM L. REV. 1255, 1256 (1985) (noting that a system that relies on self-assessment must be simple, "[o]therwise . . . taxpayers may find it difficult or impossible to compute their tax liability correctly"); Joint Committee on Taxation Staff, *Issues in Simplification of the Income Tax Laws*, 95th Cong., 1st Sess. 10 (1977) [hereinafter Joint Committee on Taxation Staff, *Simplification I*] (stating that simplification is required in order for individuals to be able to complete their own tax returns). But see Joint Committee on Taxation Staff, *Overview of Present Law and Issues Relating to Individual Income Taxes*, TAX NOTES TODAY, Apr. 14, 1999, available in Westlaw at 1999 TNT 73-24 (citing the Joint Committee on Taxation Staff Report JCX-18-99, Apr. 14, 1999) [hereinafter JCT, *Simplification II*] ("On the other hand, simplicity in a tax system may involve sacrifices of equity and efficiency."). The practical keystone for individual taxation is withholding and the standard deduction. See Joint Committee on Taxation Staff, *Simplification I*, supra; Amy Hamilton, *Rossotti Heeds Advice, Doesn't Fix What Isn't Broken*, TAX NOTES TODAY, Apr. 29, 1999, available in Westlaw at 1996 TNT 82-4 ("[I]nformation reporting and employment tax administration are the cornerstones of the voluntary tax compliance system."). Only 39% of the returns filed in 1999 claimed itemized deductions. Of these itemizers, roughly 68% had family income greater than \$50,000. See JCT, *Simplification II*, supra at tbl.4. For 1999, this was 39 million taxpayers. See *id.* The itemized returns, however, account for over 50% of reported individual income. See Joint Comm. on Taxation Staff, *Selected Materials Relating to the Federal Tax System under Present Law and Various Alternative Tax Systems*, TAX NOTES TODAY, March 15, 1996, available in Westlaw 1996 TNT 53-8 [hereinafter Joint Comm. on Taxation Staff, *Federal Tax System*].

112. Cf. Allan W. Vestal, "Assume a Rather Large Boat . . .": *The Mess We Have Made of Partnership Law*, 54 WASH. & LEE L. REV. 487, 488 (1997) (discussing "our collective failure with respect to partnership law").

113. Although 1996 corporate statistics of income are now available (1995 SOI data as to such statistics was the latest available when this article was submitted), this article relies primarily on 1993 corporate statistics of income because only for that year is additional data available (from the Joint Committee on Taxation Staff) as to the number of profitable C Corporations below and above certain critical tax rate breakpoints and the percentage of corporate income that such groups of corporations report. See *infra* notes 128, 130. Without that Rosetta Stone I was only able to estimate based upon corporate statistics of income that the large public corporations (\$100 million + in adjusted basis assets) reported 80% of corporate sector income; S Corporations, 10%; and private C Corporations, 10%. See Lee, *Capital Gains Proposals*, supra note 35. I would now estimate as of 1993 the income share of the large public C Corporations roughly at 74%; S Corporations, 11%; small income private C Corporations, 5%; and moderate income or middle market private C Corporations, 10%. See *infra* note 201.

four thousand profitable corporations with assets (adjusted basis) from \$100 million to \$250 million paid 6.2% of all corporate income taxes; the approximately two thousand profitable corporations with assets from \$250 million to \$500 million 5.3%; and the approximately two thousand profitable corporations with more than \$500 million 71.2%.¹¹⁵ Thus, the largest eight thousand profitable corporations (out of almost four million C and S Corporations) paid 83.7% of corporate income taxes. These large corporations were nearly all C Corporations, since the largest C Corporations (.01%, or roughly the two thousand profitable C Corporations with assets of more than \$500 million) subject to the flat 35% rate reported 79% of taxable C Corporation earnings for 1993,¹¹⁶ and there were only 295 S Corporation returns with more than \$100 million in assets, with just 226 reporting a profit.¹¹⁷ Roughly two million S Corporations reported 11.1% of net income of all corporations in 1993.¹¹⁸ Thus 79% of C Corporation earnings is about the same as 68% of all corporate earnings.

At the same time, the overwhelming numbers of C Corporations (and even more so with S Corporations) are small asset taxpayers. (This article assumes that small asset C Corporations are small income and private C Corporations and vice versa although "there is not an ironclad correspondence between the size of the business and the form of organization."¹¹⁹)

assumed that because the number of public corporations roughly corresponded with the number of C Corporations with \$100,000,000 or more in assets, they were the same. Professor Hamill cleverly shows that they are not. See Hamill, *supra* note 1, at 417 n.122, 415 n.110. I agree with her surmise that the lack of an exact correlation at the large asset level probably reflects large private corporations with high levels of debt (thus indicating to me a leveraged buyout of a formerly public firm) and suspect that she is correct as well that the small asset public corporations may reflect postbankruptcy shell corporations. See Hamill, *supra* note 1, at 420 n.131, 415 n.110, respectively. In any event, the overlap between asset size and public and private C Corporations is sufficient to treat them as *tending* to be the same for purposes of this Article.

115. See Joint Comm. on Taxation Staff, *Federal Tax System*, *supra* note 111, at tbl. C-22. These figures include S Corporations (total returns were 3,965,000), although very few of them have assets in this range. See *infra* notes 117-18 and accompanying text. The figures as to percentages of taxes paid by different classes of corporations by size of assets probably do not vary that much from figures as to portion of taxable income, since around 75% of C Corporation income is subject to the 35% rate and over 10% is subject to the 34% rate. See *supra* note 113. Effective tax rates may show greater variation.

116. See Joint Comm. on Taxation Staff, *Impact on Small Business of Replacing the Federal Income Tax*, TAX NOTES TODAY, Apr. 24, 1996, available in Westlaw at 96 TNT 81-16; see also *infra* note 201.

117. See 1993 CORPORATION SOURCE BOOK, *supra* note 14, at 481, 497.

118. See Joint Comm. on Taxation Staff, *supra* note 53, at 2 ("S corporations tend to engage in non-capital intensive businesses and in 1993 held only 4 percent of all corporate assets. In addition, S corporations reported 16.5 percent of all business receipts. . . ." (using 1993 statistics of income data)).

119. Joint Comm. on Taxation Staff, *supra* note 116, at 51.

When businesses are classified by asset size, one can see that there are a significant number of C corporations of small size. Almost 816,000 have assets under \$50,000, nearly 40 percent of the total. For both S corporations and partnerships, slightly over

Nearly a third of partnerships report assets less than or equal to zero, which is much higher than for either C Corporations or S Corporations.¹²⁰

The pattern of concentration of corporate income in a handful of public corporations is long-standing,¹²¹ even existing in microcosm in the mid-1930s heyday of tax populism. Then there were 450,000 corporations (fifty-five percent reporting a profit) and 1.5 million sole proprietorships and partnerships; the gross sales of corporations was \$142 billion; the gross sales of individuals and partnerships was \$30 billion.¹²² About 214,000 of the corporations had net income under \$10,000; 43,000 corporations had net income above \$10,000.¹²³ Out of this universe, five hundred to six hundred corporations with \$1 million or more net income reported about half of the total corporate net income.¹²⁴ Multiplying all of these numbers by ten gives a rough picture of the pattern today—fifteen million sole-proprietors and 1.5 million partnerships, four million small and middle income corporations and six thousand big corporations that report over half of the corporate earnings.¹²⁵

one-half have assets under \$50,000. The concentration of assets differs among the three forms. C corporations have the largest disparity in asset holding—firms with over \$100 million in assets, which represent two-thirds of one percent of C corporations, hold over 90 percent of the assets in C corporations. By comparison, a similar share of partnership returns (those with assets over \$50 million) holds just under one-half of the assets in partnerships and a similar share of S corporation returns (those with assets over \$10 million) hold about one-third of S corporation assets.

Id.; see also David L. Brumbaugh, *Federal Taxation of Small Business: A Brief Summary*, Apr. 14, 1994, at 2, available in 1994 WL 637320 (“[W]hile the connection between income and size is not perfect—large corporations can have small profits and small firms can earn large incomes—there is nonetheless a relationship. Relatively small firms tend to earn smaller profits than large ones.”).

120. See Joint Comm. on Taxation Staff, *supra* note 116 at tbls. 4-6 (comparing the 31.59% of partnerships with assets less than or equal to zero to the 6.7% of S Corporations and 5.42% of C Corporations with assets less than or equal to zero).

121. In 1963, the Treasury estimated that there were 467,500 corporations with income of less than \$25,000 (90% of all corporations); 54,000 with income from \$25,000 to \$50,000; 25,000 with income from \$50,000 to \$100,000; 25,500 with income from \$100,000 to \$1,000,000; and 4,000 with income of \$1,000,000 and over. *President's 1963 Tax Message: Hearings Before the House Comm. on Ways & Means* (Part 1), 88th Cong., 1st Sess. 70 (1963) [hereinafter *1963 House Hearings*]. In 1984, the 3,663 corporations with more than \$250 million in assets reported 60% of corporate sector income. See Lee, *Entity Classification*, *supra* note 35, at 100-01 n.169.

122. See *Hearings on H.R. 12395, Revenue Act, 1936, Before the Senate Finance Comm.*, 74th Cong., 2d Sess. 890 (1936) [hereinafter *1936 Senate Hearings*] (statement of Treasury General Counsel Herman Oliphant).

123. See *id.* at 12 (statements of Commissioner Guy T. Helvering and A.S. McLeod, Treasury Statistician); *id.* at 30 (statement of George C. Haas, Treasury Director of Research and Statistics).

124. See [Confidential] *Hearings on H.R. 12395 (Revenue Act, 1936) Before the Senate Finance Comm. (Part 4)*, 74th Cong., 2d Sess. 29 (1936) (Executive Session) [hereinafter *1936 Confidential Senate Hearings*] (statement of Deputy Commissioner Charles T. Russell). According to Senator Robert La Follette, Jr., R-Wis., “the figures show that 67 corporations in 1933 had about one-third of the total corporate income of the country.” *1936 Senate Hearings*, *supra* note 122, at 32.

125. See *supra* text accompanying notes 113, 115-16; *infra* notes 290, 405-06.

Most commentators on corporate and shareholder integration have focused on the large income corporate taxpayers,¹²⁶ where the bulk of the income is,¹²⁷ but in initial choice of tax entity the context almost invariably is small income private business, where the bulk of the taxpayers are. The Joint Committee Staff's invaluable factual study, *Impact on Small Business of Replacing the Federal Income Tax*, using Internal Revenue Service data from 1993 on C Corporations, concluded that sixty-one percent of all C Corporations reported no income¹²⁸ and thirty-seven percent¹²⁹ (or 763,356 C Corporations¹³⁰), accounting for 5.3% of C Corporation income, reported less than the \$335,000 ceiling on the phase-out of lower graduated rates on retained corporate income.¹³¹ I calculate the average taxable income of such small income private C Corporations as \$39,708, which for the average such corporation would be taxed at the fifteen percent rate applicable to the first \$50,000 of C Corporation earnings.¹³²

126. See TAXING BUSINESS INCOME ONCE, *supra* note 44, and commentators cited therein.

127. See *supra* note 115.

128. Joint Comm. on Taxation Staff, *supra* note 116, at 5 n.8. My initial premise, based upon the literature, see authorities collected in Lee, *Entity Classification*, *supra* note 35, at 91 n.130, and my anecdotal experience in practice, was that this very large number of no income C Corporations mostly reflected a practice of paying out net profits as deductible items on the assumption that firms with initial operating losses were organized as S Corporations to pass the losses through to owners. This, too, is the picture Professor Hamill paints of sophisticated small asset (private) C Corporations avoiding double taxation by paying all of the profits out as deductible compensation. See Hamill, *supra* note 1, at 430. The substantial deficits (equal to 24% of total net income), particularly at the smaller asset corporations levels, suggest that operating losses are a prime cause as well. See CORPORATE SOURCE BOOK, *supra* note 14, at 9. For 1993, at the zero asset level the aggregate deficits exceeded the aggregate net income; at the under \$100,000 of assets level, deficits equal about 72% of net income; and at the between \$100,000 and \$250,000 range, deficits equal approximately 60% of net income. See *id.*

129. Data from the Internal Revenue Service from 1993 on C Corporations, by taxable income category, indicated that 61% of C Corporations reported no taxable income, and another 37% reported taxable income less than \$355,000 [*sic*, \$335,000]. See Joint Committee on Taxation Staff, *supra* note 116, at 5 n.8. Those C Corporations reported only 5.3% of the total taxable income of C Corporations, so that the remaining 94.7% of taxable C Corporation income came from 2% of C Corporations (and 79% of taxable income came from the 0.1% of C Corporations subject to tax at a flat rate of 35%). See *id.* The reference to \$355,000 is surely a typo—the amount should be \$335,000. For a C Corporation with taxable income between \$75,000 to \$100,000 the rate is 34%, and \$100,000 to \$335,000 the rate is 39%. See I.R.C. § 11(b) (1994); *infra* note 168.

130. The 1993 CORPORATION SOURCE BOOK, *supra* note 14, at 1, 481, reveals that for 1993 there were 3,964,629 active corporations, including 1,901,505 S Corporations. Thus, there were 2,063,124 active C Corporations. $2,063,124 \times .37 = 763,356$.

131. See Joint Committee on Taxation Staff, *supra* note 116, at 5 n.8.

Corporations are taxed as separate entities, at 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 and 34 percent. The benefit of graduated rates below 34 percent is phased out for corporations with taxable income between \$100,000 and \$335,000. Thus, a corporation with taxable income between \$335,000 and \$10,000,000 is effectively subject to a flat rate of 34 percent.

Id. at 4. I.R.C. § 11(b) (1994).

132. See I.R.C. § 11(b)(1)(A) (1994). 1993 CORPORATION SOURCE BOOK, *supra* note 14, at 245

Other particular circumstances of shareholders may militate towards selection of a small income private C Corporation over a passthrough entity. Early commentators pointed out that LLCs offered a tax advantage over S Corporations,¹³³ which prohibit stock ownership by a nonresident alien.¹³⁴ While this is true, a private C Corporation may offer even greater advantages. A nonresident alien may hold stock in a domestic corporation accumulating income used in United States business expansion and sell that stock at a capital gain without incurring the thirty percent at the source tax on income connected with a United States business.¹³⁵ In contrast, a nonresident alien member of an LLC conducting a United States business is subject to a United States income tax on her distributive share of such income.¹³⁶

A private C Corporation paying out all of its business income either as compensation or deductible fringe benefits may be utilized to obtain deductions for certain fringe benefits, including premiums paid for health and accident insurance and group-term life insurance, which are paid on behalf of its shareholder-employees, received tax free by such shareholder-employees, and then deducted by the corporation.¹³⁷ Currently, lesser amounts of health and accident insurance premiums paid

\$571,922,088,000 (\$658,666,005,000-\$86,743,917,000). (Recall that the 61% of C Corporations reporting no income or a deficit were already accounted for so net income C Corporations is the relevant universe.). Since 5.3% of income for all active C Corporations reporting net income is \$30,311,870,000 (5.3% x \$571,922,088,000), the average net income of these 763,356 C Corporations is \$39,708 per corporation (\$30,311,870,000 ÷ 763,356 = \$39,708). For some indications of the dispersion of the aggregate income among this group of small income C Corporations, which affects the inside rate, see *infra* text following note 168.

133. See, e.g., Andrew Wecker, *O.R.C. Chapter 1705—Ohio's New Statute on Limited Liability Companies*, 56 OHIO ST. L.J. 951, 955 (1995) (noting that the LLCs may have foreign members).

134. See I.R.C. § 1361(b)(1)(C) (1994).

135. See I.R.C. § 871(a)(1) (1994). Since such a corporation is a United States person, it is not subject to the flat 30% withholding at the source under § 1441, but is instead subject to United States income taxation. See Joint Comm. on Taxation Staff, *Description and Analysis of Present-law Rules Relating to International Taxation*, TAX NOTES TODAY, June 29, 1999, available in Westlaw at 1999 TNT 124-8 ("The United States imposes tax on nonresident alien individuals and foreign corporations (collectively, foreign persons) only on income that has a sufficient nexus to the United States. In contrast, the United States imposes tax on U.S. persons on all income, whether derived in the United States or in a foreign country."). I am grateful to R. Braxton Hill, III, Esq., one of my Co-Editors of the Virginia Tax Conference, and Professor William J. Turnier, both members of the Virginia Tax Study Group, for bringing this niche to my attention. Brax further explained to me that the inside corporate income tax often was avoided since these ventures were often start ups with § 174 research and development expenditures offsetting income, directly or through net operating losses carried forward under § 172, until sufficient market share was obtained to sell the stock profitably.

136. See I.R.C. § 871(b)(1) (1994).

137. See *id.* § 79, 106, 162(a); see also Susan Kalinka, *Limited Liability Companies: Assignment of an Interest in a Limited Liability Company and the Assignment of Income*, 64 U. CIN. L. REV. 443, 470-71 n.157 (1996) (emphasizing that one advantage of forming a corporation is that fringe benefits given by the corporation to its employees can be deducted by the corporation while being received by the shareholder-employee tax free).

either by an LLC on behalf of a member-employee, or by an S Corporation on behalf of a two percent or more shareholder-employee, are deductible.¹³⁸ These tax rules may explain in part the very large percentage of active C Corporations breaking even—reporting neither income nor loss. The phase-in from 1997 through 2007 (or sooner) of the deduction for health insurance costs of self-employed individuals,¹³⁹ ending the horizontally preferential treatment of private C Corporation employee-shareholders, may be expected to reduce the attractiveness of private C Corporations, particularly when they are used to pay out all profits as (deductible) compensation and fringe benefits. Such a result would be consistent with the SOI projections for an annual decline between 1999 and 2005 in the number of smallest income (mostly private) corporation returns, Form 1120-A.¹⁴⁰

2. *Business Entity Ownership by High Income Individuals.*—The literature shows that the active owners of small corporations are, on the average, high income individuals¹⁴¹ (e.g., those taxed at marginal (and usually effective) rates of 31% and mostly above, up to the 39.6%

138. See I.R.C. § 162(l)(1) (1994) (providing that 60% is deductible for 1999); Booth, *supra* note 83, at 547 (noting that the possibility of deducting health insurance payments made on the firm level is one of the attractions of the corporate form).

139. Section 162(l) currently is phased-in between 1997 and 2007. See I.R.C. § 162(l) (1994 & Supp. III 1997).

140. See Zaffino, *supra* note 13, at 179 fig. A.

141. See Lee, *Entity Classification*, *supra* note 35, at 58-59 n.7 (noting that stock ownership in closely held corporations has been concentrated among high-income taxpayers for some time); John W. Lee, *Critique of Current Congressional Capital Gains Contentions*, 15 VA. TAX REV. 1, 41 n.148 (1995) (citing data indicating that the top 1% of families own 49% of publicly held stock and 62% of business assets). The top 1% of families by income number 700,000 with "family economic income" beginning at \$350,000. *Id.* at 41-42; see also CONGRESSIONAL BUDGET OFFICE, PERSPECTIVES ON THE OWNERSHIP OF CAPITAL ASSETS AND THE REALIZATION OF CAPITAL GAINS 7 tbl. 1, 9 tbl. 2 (1997) (66.3% of the top 1.2% of families with adjusted gross income over \$200,000 owned business property and 60.7% owned stock). Note that these studies use somewhat different definitions and sources. Based on analogy to the S Corporation and partnership data, most private C Corporations probably have no more than 1 to 4 shareholders (who, based on anecdotal experience, may often be members of the same family). See Joint Comm. on Taxation Staff, *supra* note 53 ("S corporations continue to be predominately held by three or fewer shareholders. In 1993, half of all S corporations [had] one shareholder; these firms [held] 31 percent of all S corporation assets. Fewer than one-sixth of S corporations [had] more than three shareholders. Over 90% of S corporation assets are in firms with 10 or fewer shareholders."). This same pattern continued for 1995 and 1996. See Susan M. Wittman, *S Corporation Returns, 1995*, 17 SOI BULLETIN (No. 4) 43, 45 (1998) (showing that in 1995, 52% of S Corporations had 1 shareholder; 30%, 2 shareholders; 7.6%, 3 shareholders; and 7.6%, 4 to 10 shareholders); Wittman & Grant, *supra* note 19, at 43 (showing that in 1996, 53.3% of S Corporations had 1 shareholder; 29.9%, 2 shareholders; 7.7%, 3 shareholders; and 8.3%, 4 to 10 shareholders); see also Symposium, *supra* note 55, at 623 (recording Professor George Yin's observation that partnerships follow a similar pattern with 50% having only 2 partners; 75%, 4 or fewer partners; and 90%, 10 partners or fewer). George tells me this is based upon unpublished SOI data, some prepared personally for him by very helpful Service staff.

marginal rate (or even 45% in some cases)).¹⁴² In contrast, the first \$50,000 of taxable corporate earnings is taxed at only 15% (just like the working poor) and the next \$25,000 at 25% roughly comparable to the middle income class 28%; from \$75,000 to \$100,000 a 34% rate applies and then from \$100,000 to \$335,000 a 39% rate applies to “phase out” the tax benefit of the lower rates on the first \$75,000 of C corporation net income.¹⁴³

The Congressional Research Service (CRS) assumes that the benefits of this inside rate preference are concentrated at higher *individual* income levels:

The graduated rates encourage the use of the corporate structure and allow some small corporate businesses that might otherwise operate as sole proprietorships or partnerships to provide fringe benefits. They also encourage the splitting of operations between sole proprietorships, partnerships, and corporations. Most businesses are not incorporated; only a small fraction of firms are affected by this provision.

This provision is likely to benefit higher-income individuals who are the primary owners of capital

. . . .

Most analyses of capital income taxation suggest that such taxes are likely to be borne by capital given reasonable behavioral assumptions. Capital income is heavily concentrated in the upper-income levels. For example, the Congressional Budget Office reports that 36.2 percent of capital income is received by the top one percent of the population, 53.7 percent is received by the top 5 percent, and 62.3 percent is received by the top 10 percent. The distribution across the first nine deciles is: 0.3, 0.8, 1.7, 2.8, 3.8, 4.8, 6.2, 7.1, and 9.8. Corporate tax expenditures would, therefore, tend to benefit higher-income individuals.¹⁴⁴

CRS expressly recognizes that the amount of this graduated inside rate preference thus depends upon the shareholder’s outside ordinary marginal tax rate.¹⁴⁵ CRS elsewhere estimates that

142. See I.R.C. § 1 (1994). Taking account of the various phase-outs results in a top marginal rate of 41.5% or so, depending on the taxpayer’s dependency exemptions and personal deductions. See Langstraat & Jackson, *supra* note 56, at 26-27. The uncapped portion of the FICA taxes can add another 2.9% to nonpassive income. See *infra* note 246 and accompanying text. So the top outside federal rate can reach around 45%, or 30 points above the lowest inside graduated corporate rate.

143. See I.R.C. § 11(b) (1994).

144. CONGRESSIONAL RESEARCH SERVICE, TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS, 254 & 5-6 (Senate Budget Committee S. Print 103-101 Dec. 1994 103rd Cong., 2d Sess.) (prepared using Joint Committee on Taxation data) (citations omitted) [hereinafter TAX EXPENDITURES COMPENDIUM].

[f]amilies that owned small businesses were found to have eighty percent more income and over five times the wealth of the average family. Their wealth is similar to that of stockholders in large corporations. In general, the top 10 percent of households by wealth own about 80 percent of both types of businesses. The incomes of small business owners tend to be somewhat below that of owners of corporate stock—the top 2 percent of households with highest incomes own 70 percent of large firms and 45 percent of small firms.¹⁴⁶

3. *Splitting Income Between Private C Corporation and Entrepreneur.*—The above data suggests that a high income owner or operator of a business venture may tend to use the private C Corporation as a separate tax entity to “split income”¹⁴⁷ from the venture between compensation to such owner and retained earnings that are taxed at lower rates (down to 15%) than if taxed directly to the high income bracket owner (taxed at up to 39.6% or even 45%). As Jane Gravelle put it in a CRS Report, given the passthrough S Corporation (and LLC) alternative, the main reason for choosing the private C Corporation is “tax avoidance,”¹⁴⁸ employing this inside C shelter to split income from the

146. Jane G. Gravelle, *Small Business Tax Subsidy Proposals*, TAX NOTES TODAY, March 15, 1993, available in Westlaw at 93 TNT 61-12. Yin and Shakow, *supra* note 35, at 141-42, concludes, on the basis of IRS statistics for 1994, that individual participants in partnerships and S Corporations were, on the average, in higher income tax brackets than individual filers in general, with almost two-thirds in the 28% bracket or higher, but with a surprising one-third in the lower bracket or zero income due, most likely, to pass through of tax losses from the entity.

147. See Lee, *supra* note 141, at 83-84 (stating that, due to income-splitting between compensation to the entrepreneur and retained earnings by the corporation, there is often less income tax of corporate earnings than would be imposed if the entrepreneur were taxed directly for that amount); John W. Lee, *Capital Gains Exception to the House's General Utilities Repeal: Further Indigestions From Overly Processed Corn Products*, TAX NOTES TODAY, Mar. 31, 1986, available in Westlaw at 86 TNT 63-96 (explaining the method by which use of the low graduated corporate rates and reinvestment of corporate profits can be advantageous to the high-income entrepreneur); Leonard Sloane, *Your Money; S Corporations: A New Luster*, N.Y. TIMES, Nov. 8, 1986, § 1, at 38, available in LEXIS, News Library, NYT File (noting that the first \$50,000 of a corporation's earnings will be taxed at 15%, as opposed to the 28% marginal rate for individuals); cf. William A. Klein & Eric M. Zolt, *Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?*, 66 U. COLO. L. REV. 1001, 1015 n.40 (1995) (observing the incentive that exists for taxpayers to split their activities into smaller entities to take advantage of the low tax rates available to the first \$50,000 of corporate earnings).

148. Gravelle, *supra* note 146. Cf. Glenn E. Coven, *Corporate Tax Policy for the Twenty-First Century: Integration and Redeeming Social Value*, 50 WASH. & LEE L. REV. 495, 496-98 (1993) (providing a historical overview of selected tax reforms and their implications); Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717, 723 (1981) (describing options available to the individual business owner and detailing their tax ramifications). Comparison between the top marginal individual shareholder rate and the bottom graduated corporate rate is more relevant for choice of entity than the comparison of top individual and corporate effective rates that Professor Hamill makes. See Hamill, *supra* note 30, at 1509-12. The

business venture. The Joint Committee Staff's conclusion as to choice of tax entity in *Impact on Small Business of Replacing the Federal Income Tax* supports this story in its traditionally careful and impartial manner.

In some instances, if a C corporation anticipates deductions that may result in a relatively low tax at the corporate level for a significant period, the fact that corporate rates are lower than the top individual rates might encourage use of a C corporation rather than a pass-through entity, particularly if investors anticipate the ability to reduce shareholder level tax on earnings by realizing the value of retained earnings in the form of capital gains on sale of the shares. . . . The top marginal rate applicable to individuals under present law (39.6 percent) is higher than the top marginal rate applicable to corporations (35 percent) [and substantially higher than the graduated inside rates of 15 percent and 25 percent on smaller amounts of corporate income]. However, the graduation of the corporate and individual rate schedules and the division of corporate income among shareholders may mean that the average and marginal tax rates for the individual shareholders under present law may be lower than the rates applicable to corporations. *The relative tax rates applicable to corporations and individuals (and the extent to which business earnings are reinvested in the enterprise) are important considerations in determining whether or not subchapter C status is desirable.*¹⁴⁹

Popular tax journalism expresses this thought concretely. Comparing the applicable rates for a small income private C Corporation with those of an individual filing a joint income tax return and claiming two dependents, one trade journal concluded: "If a business did generate net income of \$154,790, the optimum tax result would be achieved by splitting the income between the individual and the corporation—\$75,000 to the corporation and the excess to the individual."¹⁵⁰

corporate effective rate mostly turns on the effective rate of large mostly public C Corporations, since they report over 80% of the C Corporation income, which is largely dependent on the capital recovery rules, whereas the effective rate of private C Corporations turns more on the graduated tax rates. See *supra* notes 114-16; *infra* note 446 and accompanying text. Choice of new entity usually involves smaller asset and income entities.

149. Joint Comm. on Taxation Staff, *Small Business*, *supra* note 116, at 8 & n.11 (combined in text) (emphasis supplied); Joint Comm. on Taxation Staff, *supra* note 53, at 6 n.6; see also Klein & Zolt, *supra* note 147, at 1002-03 (noting that the corporate tax regime can produce savings over partnership taxation, depending on the relative individual, corporate, and capital gains tax rates); Eric M. Zolt, *Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C. L. REV. 839, 840, 851-52 (1988) (analyzing the pre-1986 "retained earnings strategy" in which a corporation avoids higher individual tax rates by not paying out dividends).

150. Mark E. Battersby, *Which Structure is Best?*, GRAPHIC ARTS MONTHLY, Apr. 1988, at 58, 60; accord, Allen Fishman, *Fit the Form of Your Business to Your Special Circumstances*, ST. LOUIS

Unless there is a partner who has not exhausted the 15% tax bracket with his or her other income, it will always be advantageous for the graphic arts business to operate as a regular [C] corporation, accumulate the first \$75,000 of taxable income and pay out the balance in the form of owner salaries.¹⁵¹

Prior to the advent of the LLC literature extolling the virtues of avoiding double taxation while obtaining the purported benefits of limitation of liability, the tax advantages of the "inside" corporate tax shelter (of low graduated rates) were widely extolled in the practitioner tax literature.¹⁵² Tax writing committee members were informed of this tax sheltering technique. In many Congressional tax writing committee hearings, including House Ways & Means Chair Wilbur Mill's famous tax revision hearings in the 1950s and the House and Senate hearings on President Jimmy Carter's 1978 tax proposals, including corporate-shareholder integration, witnesses testified to the use of small income private C Corporations by high income shareholders as inside tax shelters.¹⁵³ While capital formation (*i.e.*, encouraging equity over debt

determining the best legal form is that a private C Corporation is taxed as a separate entity paying 15% on the first \$50,000 of net income and 25% on the next \$25,000. *See id.*; *see also* I.R.C. § 11(b)(1) (1994) (providing the graduated corporate income tax scale). "Thus, for businesses with earnings below \$75,000, the C-corporation offers reduced tax rates, providing more after-tax income that can be used for such things as expansion or retiring debt. The higher the individual's tax bracket, the greater tax advantages to a C-corporation for a business doing under \$75,000 a year in profit." Fishman, *supra*, at 22 (quoting a partner in a local CPA firm). Such a business is usually "doing" at least \$75,000 to \$100,000 a year more in profit before payment of compensation to the principal.

151. Battersby, *supra* note 150, at 60.

152. *See generally* Jerald A. Fink, *Is There Still Life For Professional Corporations?*, 9 REV. OF TAX'N OF INDIVIDUALS 123, 128 (1985) (noting the advantages of lower corporate tax rates for high income individuals); Frank E. Watkins, Jr. & Fred A. Jacobs, *Closely Held Businesses: Tax Planning after ERTA*, 13 TAX ADVISER 516 (1982) (developing a taxation decision model that acknowledges the potential benefits of the "inside" corporate tax shelter); Robert W. Wood, *Incorporation of Professionals Still Offers Benefits*, 64 TAXES 38, 41-42 (1986) (exploring the potential tax savings from splitting income between an individual and a corporate entity).

153. *See Federal Tax Policy for Economic Growth and Stability: Hearings Pursuant to Sec. 5(a) of Public Law 304, 79th Congress, Before the Subcomm. on Tax Policy of the Joint Comm. on the Economic Report*, 84th Cong. 526, 551, 586 (1956) (statements of Rep. Curtis; Chair Mills, questioning Dr. James K. Hall; and statement of Dr. Hall, respectively) (all asserting that the pre-1978 tax code discriminated in favor of high-income corporate shareholders); *Income Tax Revision: Panel Discussion Before the House Comm. on Ways & Means*, 86th Cong. 844-46, 863-64 (1960) (statement of Dr. Carl S. Shoup and colloquy with Rep. Byrnes) (discussing the undertaxation of high-income stockholders who invest in growth corporations that pay out very few cash dividends); *id.* at 854-55, 860-61 (statement of Paul Ziffren) (proposing that all corporations be taxed as partnerships to solve the problem of double taxation and to introduce progressivity); *id.* at 866-69 (statement of Rep. Alger) (referring to the limited credit against individual income tax for dividends received by individuals and to the exclusion of \$50 of such dividends under §§ 34 and 116 of the 1954 Tax Code, Pub. L. No. 83-591, 68A STAT. 13, 37); *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the House Comm. on Ways & Means*, 95th Cong. (Part 6) 3516-33 (1978) (statement of Professor Dennis J. Gifford) (advocating mandatory partnership pass-through of income, at least as to private C

financing) did drive the various Congressional corporate-shareholder integration debates:¹⁵⁴

[t]he desirability of close C corporation graduated rates, meant to encourage or subsidize capital formation in small businesses (even if only via increased retained earnings) was discussed in each integration debate. The graduated rates generated the economic inefficiencies of horizontal disparity as to businesses conducted in partnership form and vertical disparity as to wage earners in general Under the close C corporation graduated rates, the corporate-shareholder structure yielded less revenue on earnings than direct taxation would have, leaving the double tax system vulnerable to a “briar patch” argument used by defenders of the status quo. The real issue is not whether a “double” tax is collected, but whether Treasury will collect the equivalent of even a single tax.¹⁵⁵

Double taxation as to private C Corporations has sadly continued to be a “Briar Patch” argument that ensnares most recent commentators.

In my Small Business Planning course, I present a hypothetical of a firm earning \$250,000 before paying compensation to Alice, the sole and active owner. Assume that Alice files a joint return and that her spouse earns an amount just equal to all deductions, exemptions, etc. Ignore phase-outs and wage taxes. Thus, were Alice to report the entire \$250,000 as taxable income on a joint return, her federal income taxes would be \$77,485 and her marginal rate from, for example, \$150,000 to \$250,000, would be thirty-six percent.¹⁵⁶ Now assume that the firm is a C Corporation and pays Alice compensation of only \$150,000, while retaining \$100,000 in earnings. The inside federal corporate income tax on \$100,000 of taxable income, is \$22,250.¹⁵⁷ This contrasts with the \$36,000 in individual federal income taxes Alice would have had to pay on this \$100,000, had it been passed through to her.¹⁵⁸ Due to the inside

Senate Comm. on Finance, 95th Cong. 155-56, 190 (1978) (statement of Treasury Secretary W. Michael Blumenthal) [hereinafter *1978 Senate Hearings*] (discussing the existence and use of various tax shelters). I repeated this message in 1987 hearings before the House Ways and Means Subcommittee. See *MLP Hearings*, *supra* note 35. I had no expectation that it would have any immediate impact since it was tangential to the topic of the hearings but had hoped that it and the resulting article, Lee, *Entity Classification*, *supra* note 35, might be taken into account in any subsequent integration or classification debate. Fundamental errors by most in the LLC literature, particularly accepting the “Briar Patch” argument of double taxation, might have been avoided had that more frequently been the case. Happily the exemplary *Taxation of Private Business Enterprises* did consider this article. See YIN & SHAKOW, *supra* note 35.

154. See Lee, *Entity Classification*, *supra* note 35, at 66-67 and authorities collected therein.

155. *Id.* at 67-69 (footnotes omitted).

156. See I.R.C. § 1(a)(1) (West 1999).

157. $\$50,000 \times 15\% = \$7,500$; $\$25,000 \times 25\% = \$6,250$; and $\$25,000 \times 34\% = \$8,500$. See I.R.C. § 11(b) (1994). $\$7,500 + \$6,250 + \$8,500 = \$22,250$.

graduated federal corporate income tax rates (fifteen percent on the first \$50,000 of taxable corporate income; twenty-five percent on the next \$25,000; and thirty-four percent on the next \$25,000¹⁵⁹), the spread between the inside rate and the outside rate increases at lower amounts of retained or taxable corporate earnings. If the small corporation retained \$75,000, the inside tax would be \$13,750 versus \$27,000; if passed through, and on retainings of \$50,000, the inside tax would be \$7,500, as compared to \$18,000 if passed through.¹⁶⁰ The spread also would be increased if the hypothetical is changed to \$250,000 paid as compensation with \$100,000 retained. The outside passthrough marginal rate would increase to 39.6%.¹⁶¹ This hypothetical probably does not exaggerate the potential tax savings of close to half of the profitable private C Corporations, since the top two percent of families by income (who are at the 39.6% marginal rate *before* phase-outs of exemptions, and reduction of itemized deductions, and imposition of wage taxes) hold forty-five percent of small private businesses.¹⁶²

4. *Inside Private C Shelter as Tax Expenditure.*—The widespread use of a private C Corporation with small income as an inside tax shelter can also be deduced from the Staff of the Joint Committee on Taxation's calculations of federal tax expenditures. The Joint Committee Staff annually prepares lists of "tax expenditures" or "reductions in individual and corporate income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers."¹⁶³ These

159. See I.R.C. § 11(b)(1) (1994).

160. The inside corporate graduated income tax on \$75,000 is \$13,750, computed as follows: \$50,000 x 15% = \$7,500; \$25,000 x 25% = \$6,250; \$7,500 + \$6,250 = \$13,750. See I.R.C. § 11(b)(1)(A) and (B) (1994). The individual joint return income tax on taxable income from \$175,000 to \$250,000 is \$27,000, computed as follows: \$50,000 x 36% = \$18,000. See *id.* § 1(a). The inside corporate graduated income tax on \$50,000 is \$7,500, computed as follows: \$50,000 x 15% = \$7,500. See I.R.C. § 11(b)(1)(A) (1994). The individual joint return income tax on taxable income from \$200,000 to \$250,000 is \$18,000, computed as follows: \$50,000 x 36% = \$18,000. See *id.* § 1(a).

161. The 39.6% bracket commences at \$250,001 of taxable income for married individuals filing a joint individual income tax return. See I.R.C. § 1(a) (1994).

162. See *supra* notes 141-43 and *infra* notes 145-46 and accompanying text.

163. Joint Committee on Taxation, *JCT Estimates Federal Tax Expenditures for 1999-2003*, TAX NOTES TODAY, Dec. 15, 1998, available in Westlaw at 98 TNT 240-4 [hereinafter *JCT Estimates Federal Tax Expenditures for 1999-2003*] (citing the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1999-2003*, JCS-7-98, Dec. 15, 1998, which predicts the future effect of current tax policy).

Special income tax provisions are referred to as tax expenditures because they may be considered to be analogous to direct outlay programs, and the two can be considered as alternative means of accomplishing similar budget policy objectives. Tax expenditures are most similar to those direct spending programs that have no spending limits, and that are available as entitlements to those who meet the statutory criteria established for the programs.

Id. For an enlightening sampling of the literature see P. CARON ET AL., *FEDERAL INCOME TAX*

special tax provisions can take the form of exclusions, credits, deductions, *preferential tax rates*, or deferrals of tax liability.¹⁶⁴ The Joint Committee Staff calculates the tax expenditure attributable to the inside shelter of the inside graduated small income corporate rates as \$3 billion a year; and the one-point spread from thirty-four percent to thirty-five percent as a \$1 billion a year tax expenditure.¹⁶⁵

The Joint Committee measures the tax expenditure attributable to the inside graduated corporate rates by comparing them with the top inside corporate rate of thirty-five percent (prior to 1993, thirty-four percent).¹⁶⁶ The true comparison should be between the inside graduated corporate rates and the outside individual income rates that would apply if the small private C Corporation income were taxed directly to the (active) owners. The amount of the tax expenditure or subsidy would probably be at least as large as the Joint Committee estimates if the lower inside graduated corporate rates were measured against the applicable outside federal ordinary income tax rates of the individual shareholders. Eighty percent of small income private C Corporation stock is held by the top ten percent of individual taxpayer families by income; the top two percent hold forty-five percent.¹⁶⁷ The top one and two percent of families are subject to the 39.6% rate on additional income; the top five percent at least to the thirty-six percent rate on additional income; and the top ten percent at least

ANTHOLOGY 296-312 (1997) (offering articles by Stanley S. Surrey explaining "tax expenditure analysis" and its role in legislative processes).

164. See Joint Committee on Taxation, *supra* note 163.

165. The Joint Committee Staff explains:

The income of corporations (other than S corporations) generally is subject to the corporate income tax. The corporate income tax includes a graduated tax rate schedule. The lower tax rates in the schedule are classified by the Joint Committee staff as a tax expenditure (as opposed to normal income tax law) because they are intended to provide tax benefits to small business and, unlike the graduated individual income tax rates, are unrelated to concerns about ability of individuals to pay taxes.

Id. Technically the Joint Committee does not split the tax expenditure as to the inside graduated rates between 34% and 35% as I do in the text, but the historical record supports my conclusion. Reduced rates on the first \$10,000,000 of corporate taxable income are estimated for 1999-2002 at \$4.4 billion, and for 2003 at \$ 4.5 billion. See *id.* The tax expenditure for 1993 as to the first \$75,000 of corporate taxable income (prior to enactment of the 35% bracket which commences at \$10 million) was estimated at \$3.1 billion. See Joint Comm. on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1993-1997*, TAX NOTES TODAY, April 24, 1992, available in Westlaw at 92 TNT 89-30.

166. Joint Committee on Taxation, *supra* note 163 (implying that the correct measure of the tax expenditure for the inside graduated corporate rates is the difference between the highest rates and the lower rates).

167. See CHARLES BROWN ET AL., EMPLOYERS LARGE AND SMALL 17 (1990); see also CONGRESSIONAL BUDGET OFFICE, *supra* note 141. Similarly, the top 2% of families received over 60% of S Corporation income. See David S. Hilzenrath, *Income Tax Hike Stirs a Debate On Jobs Impact: Administration Rejects Claims Small Business Would Be Hurt*, WASH. POST, June 24, 1993, at B-9, available in 1993 WL 2185133 (stating that "[t]axpayers with incomes of \$200,000 or more

to the thirty-one percent rate on additional income.¹⁶⁸ Accordingly, I assume that for the most part the spread is between 15% inside and 36% to 39.6% outside (before taking account of phase-outs and wage taxes).

Comparison of (1) the \$3 billion a year tax expenditure (as calculated by the Joint Committee on Taxation Staff) attributable to the fifteen percent inside rate on the first \$50,000 of small C Corporation income and the twenty-five percent rate on the next \$25,000¹⁶⁹ with (2) the \$30 billion in taxable income I estimate is attributable to the profitable small income C Corporations as a class for 1993¹⁷⁰ suggests that the tax expenditure or preference is about ten percent of the corporate income for this class. The fact that the spread between these graduated rates and the top inside corporate income tax rate of thirty-five percent is twenty percentage points on the first \$50,000 and ten percentage points on the next \$25,000 (the basis for the Joint Committee's calculations) suggests that a substantial number of the more than 750,000 small income C Corporations report income from \$75,000 to \$100,000, where the preference is only one percentage point, as calculated by the Joint Committee Staff, or from \$100,000 to \$335,000, where there is no preference so calculated. The remaining profitable small income C Corporations perforce have lower incomes, on the average, than the almost \$40,000 average¹⁷¹ for the group. Nevertheless, I expect that there is still sufficient inside shelter overall for a large number of private C Corporations to drive the choice of tax entity where earnings in excess of compensation to principals can or need be left in the business.

5. *Avoidance of Second Level of Shareholder Taxation.*—Important, but not essential, to this private C Corporation as an inside shelter scenario is the assumption that the dreaded second level shareholder taxation on distribution of private C corporate retained income is mostly avoided through well-known tax techniques.¹⁷² First, private C Corporations

168. I am assuming that the top 1% and 2% of American families have "income" of at least \$250,000; the top 5%, at least \$140,000; and the top 10%, at least \$110,000. See Lee, *supra* note 141, at 42 (providing 1995 Treasury estimates of family "economic income," which already include imputed private C Corporate income). The rates in the text are based upon the breakpoints for married individuals filing joint returns. See I.R.C. § 1(a) (1994).

169. See *supra* note 159 and accompanying text.

170. See *supra* note 126-30 and accompanying text.

171. See *supra* note 132 and accompanying text.

172. See *Passthrough Entities Hearings*, *supra* note 41, at 22 (prepared statement of J. Roger Mentz, Assistant Secretary for Tax Policy) (stating that, especially as to private C Corporations, "the double tax is, in practice, to some extent mitigated"); Booth, *supra* note 88, at 80 (contending that Treasury was willing to allow LLCs to be taxed as partnerships because double taxation of corporate income rarely occurs in practice). This literature is referring to techniques which pay out profits in deductible form to principals. I am referring to retaining small amounts of earnings inside to be taxed at the graduated inside private corporate rates, while avoiding or reducing outside shareholder level

rarely distribute earnings (in excess of payment of compensation to principals) formally as dividends,¹⁷³ but instead usually retain them for expansion.¹⁷⁴ Transaction costs of this technique may be high for audited private C Corporations. Many of the complexities in corporate taxation, such as the accumulated earnings tax, personal holding company tax, and the collapsible corporation provisions, were developed in an attempt to curtail use of a private C Corporation as a tax shelter.¹⁷⁵ Successfully

173. When there are passive and active owners in private C Corporations, conflicts of interest as to payment of dividends arise with some frequency in state court litigation. See GEVURTZ, *supra* note 60, at 365. Most small C Corporations probably have no more than one or two owners. See *supra* note 141.

174. See, e.g., *Passthrough Entities Hearings*, *supra* note 41, at 22 (prepared statement of J. Roger Mentz, Assistant Secretary of Tax Policy) (discussing how "double taxation encourages corporations to retain rather than distribute income, so as to defer the second level of tax"); Lee, *Capital Gains Proposals*, *supra* note 35. If the accumulations are not used for expansion or other business purposes, then accumulated earnings problems generally arise once the minimum credit for the accumulation of earnings is exceeded. See generally I.R.C. § 531 (1994) (imposing an additional 39.6% tax on the "accumulated taxable income" of a corporation where a tainted purpose for such accumulations is met); *id.* § 535(c)(2) (providing a minimum credit of \$250,000 to most C Corporations). The accumulated earnings tax is generally imposed on corporations that are "formed or availed for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed." *Id.* § 532(a). Accumulated taxable income is taxable income with adjustments, the determinative one usually being the "accumulated earnings credit" equal to the reasonable needs of the business, or, if greater, a "minimum credit" of \$250,000. *Id.* § 535(a), (c). Accumulated taxable income is also reduced by federal income taxes paid by the corporation. *Id.* § 535(b)(1). The federal corporate income tax on a hypothetical C Corporation with \$50,000 in taxable income is \$7,500 (\$50,000 × 15%). *Id.* § 11(b)(1)(A). Thus, accumulated taxable income for such a C Corporation with \$50,000 in taxable income would increase \$42,500 (\$50,000 - \$7,500) annually. Accordingly, assuming no business needs for accumulations, such a C Corporation's minimum accumulated earnings credit of \$250,000 would be reached after six years (6 × \$42,500 = \$255,000). Since the business needs defense includes "reasonably anticipated needs," Treas. Reg. § 1.537-1, and the tainted purpose of avoidance of shareholder level taxation is not met to the extent accumulated earnings are tied up in bricks-and-mortar, inventory, etc., see *Smoot Sand & Gravel Corp. v. Commissioner*, 274 F.2d 495 (4th Cir.), *cert. denied*, 362 U.S. 976 (1960), the accumulated earnings tax is not now, nor has it ever been, effective. See JOINT COMM. ON INTERNAL REVENUE TAXATION, 69TH CONG., REPORT ON EVASION OF SURTAXES BY INCORPORATION § 220, at 48-56 (Comm. Print 1927) (noting that the accumulated earnings provision has not been applied by the Bureau of Internal Revenue to large, private corporations investing enormous surpluses in expansion or purchase of related industries; as of 1927 no taxes had as yet collected under the almost decade old accumulated earnings tax); *1936 Confidential Senate Hearings*, *supra* note 124 at 69 (statement of Acting Chief Counsel Arthur H. Kent) ("[I]t is very hard to convince the Board of Tax Appeals [predecessor to the Tax Court] that there are not some legitimate business reasons for retaining a substantial portion of the earnings and surpluses." The Government had considerable success, however, where large accumulations were "loaned" to dominant, large shareholders); JEROLD L. WALTMAN, POLITICAL ORIGINS OF THE U.S. INCOME TAX 108 (1985) (only incompetent advisers fail to enable corporations to escape this tax since justifications such as future expansion are difficult to challenge); Jeffrey L. Kwall, *Subchapter G of the Internal Revenue Code: Crusade Without a Cause?*, 5 VA. TAX REV. 223, 235-37 & n.69, 260-61 (1985) (tracing from 1918 through the end of the 1954 Code, inefficiencies of the accumulated earnings tax in deterring private corporations from accumulating income to obtain benefits of inside and outside rate differentials).

175. See *Passthrough Entities Hearings*, *supra* note 41, at 22 (prepared statement of J. Roger Mentz, Assistant Secretary of Tax Policy) (stating that "current law attempts to restrict avoidance or

avoiding these pitfalls requires attention, effort, and when the accountants and tax lawyers are finally called in, money. Also, a shareholder must delay realizing the proceeds of her investment, especially if she wants to maximize the advantages of deferring the outside tax. Wealthy shareholders are in the best position to do so. Less wealthy owners of private C Corporations, however, may be forced to obtain funds to live on. They might attempt to do so by drawing a higher salary from the corporation (taxed as ordinary income and possibly beyond the scope of the corporation's deduction for salaries, which is limited to "reasonable . . . compensation for personal services actually rendered"¹⁷⁶), by selling property to the corporation (which might be characterized as a contribution to the capital of the corporation, particularly if sold for a note, so that the payments received are taxed as ordinary income dividends) or by borrowing money from the corporation (giving rise to imputed interest or recharacterization as disguised dividends).¹⁷⁷

Assume a small business making \$350,000 leaves \$100,000 in the corporation to be taxed at lower inside rates (fifteen percent on the first \$50,000, twenty percent on the next \$25,000, and thirty-four percent on the next \$25,000¹⁷⁸) and pays out \$250,000 as compensation to the principal. If the Service can recharacterize \$50,000 of that \$250,000 as a "constructive" dividend it will still be taxed outside at thirty-six percent, but inside that \$50,000 will not be deductible and will therefore be taxed at thirty-nine percent, because from \$100,000 to \$335,000 an inside corporate rate of thirty-nine percent applies before falling back to a flat thirty-four percent.¹⁷⁹ The leading Code Section in audit of all business taxpayers is section 162 and the related provisions of sections 263 or 274.¹⁸⁰ Not surprisingly, given the above tax stakes, the leading section 162 audit issue for small and moderate income C Corporations is

postponement of the double tax on corporate income"); Lee, *Entity Classification*, *supra* note 35, at 107 (arguing that the inside tax shelter for small C Corporations is "subject to substantial transactional costs, which create most of the complexity in tax practice as to small business"); *Revenue Act, 1936: Hearings Before the House Comm. on Ways and Means*, 74th Cong. 658-59 (1936) [hereinafter *1936 House Hearings*] (statement of Herman Oliphant, Treasury Counsel) (discussing the history of provisions designed to prevent evasion of surtaxes through the use of corporations, and the resulting 1934 "straight tax on personal holding companies"). My first article dealt with an aspect of the shareholder loans versus constructive dividend controversy. See John W. Lee, *Shareholder Withdrawal—Loan or Dividend: Repayments, Estoppel, and Other Anomalies*, 12 WM. & MARY L. REV. 512 (1971).

176. See I.R.C. § 162(a)(1) (West Supp. 1999).

177. See *MLP Hearings*, *supra* note 39, at 348 (statement of Lee).

178. See I.R.C. § 11(b) (West Supp. 1999).

179. See I.R.C. § 11(b)(1) (West Supp. 1999).

180. See General Accounting Office, *Tax Administration, Recurring Issues in Tax Disputes Over Business Expense Deductions*, (GAO/GDD-95-232 1995) Sept. 26, 1995, at 10 (identifying the most common issues raised in disputes between the IRS and small and large businesses over the business expense deduction).

deductibility of "reasonable" compensation.¹⁸¹ This has been the case for over two decades.¹⁸² The fact that taxpayers win most of the litigated reasonable cases, which Professor Hamill documents,¹⁸³ overlooks the substantial transaction costs in audits, since litigation is only the tip of the audit iceberg.¹⁸⁴ Even when a taxpayer wins in audit or a lawsuit, she loses due to the transaction costs.

The second, more serious risk of double income taxation is thought to be triggered by the entrepreneur's exit from her private corporation.¹⁸⁵ This seems to be (1) avoided at least half the time¹⁸⁶ by holding the private corporation stock until death (thereby obtaining a stepped up basis in her estate's hands¹⁸⁷) or merging it tax-free into a public corporation¹⁸⁸ and then holding its stock until her death, or (2) largely

181. See *id.* (noting that the most common issue for small and medium sized C Corporations is reasonable compensation).

182. See Joint Comm. on Taxation Staff, *Simplification I*, *supra* note 111, at 32-33 (listing "compensation" as one of the eight most significant issues at the IRS appellate level for the past 20 years).

183. See Hamill, *supra* note 1, at 415-16 (finding that since the 1970s, the IRS success rate has been about 30-45%). A pattern of auditors raising tax issues which are settled at the appeals level or often lost in litigation is to be expected when auditors are evaluated only on the amounts of increased taxes proposed and not on the ultimate outcome. See General Accounting Office, *Tax Administration: Compliance Measures and Audits of Large Corporations Need Improvement*, (GAO/GGD-94-70 1994) Sept. 1, 1994, available in 1994 WL 10576 (reporting that a key measure of the Service's audit function is the amount of additional taxes recommended per audit hour, while the appeals function is measured by the number of cases settled without litigation, and also recommending consideration of the amount of dollars collected in each audit as well).

184. Roughly 1,000,000 audits a year yielded only 30,000 litigated cases a year prior to the reorganization of the Internal Revenue Service. Compare General Accounting Office, *Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements, Overview of the Financial Statements*, (GAO/AIMD-94-120 1994) June 15, 1994, at 55 (stating that in 1993 only .9% of individual taxpayers and 3.1% of corporations were audited), with Ann Reilly Dowd, *Win More at the New IRS; Congress Is Finally Getting Serious about Fixing the IRS*, MONEY 82 (Jan. 1998) (stating that only 31,000 individual taxpayers "choose to take the IRS to any federal court").

185. See *supra* note 87.

186. See Lee, *supra* note 141, at 15 (citing a collection of literature that concludes that 50% of stock owned by individuals is held until death). That literature considers public stock. The political rhetoric set forth by William Blatt must rest on the assumption that a large percentage of private stock is held until death. See William Blatt, *The American Dream in Legislation: The Role of Popular Symbols in Wealth Tax Policy*, 51 TAX L. REV. 287, 340-44 & n.319 (1996) (recounting historical arguments against inheritance-based taxes, which he claims hurt small businesses).

187. See I.R.C. § 1014 (1994). The revenue loss from such a step up was expected (before the most recent stock market run up) to increase from \$14 billion to \$20 billion a year from 1995-99. See TAX EXPENDITURES COMPENDIUM, *supra* note 144, at 243.

188. In the past few years, American mergers have primarily been stock acquisitions in which the parties used a pooling of interests accounting method. This method allowed the acquiring company to avoid the "goodwill" costs associated with mergers (where companies pay, in stock, a value that exceeds the target's tangible assets) by simply adding together the accounting ledgers of the two companies. Under a new merger accounting method recently implemented by the Financial Accounting Standards Board, the acquiring company must record goodwill costs on its balance sheet and then gradually write them off against profits, which could "[penalize] a company's earnings growth for

diluted by deferring sales of such stock for a number of years, with ultimate realization at preferential capital gains rates.¹⁸⁹ When the inside tax rate is 15% and the outside tax rate is 20% (the maximum individual capital gains rate¹⁹⁰), the after tax income is greater than it would be after direct taxation at 39.6%.¹⁹¹ If, as is usually the case, realization of the outside capital gain is deferred, its present value is decreased so that the spread between the private C Corporation and direct taxation is increased. And, of course, for many, the direct taxation marginal rate is more like 45% than 39.6%.¹⁹²

Section 1202 allows individuals a fifty percent exclusion of capital gains from certain small business C Corporation stock sold after a five-year holding period. This stock otherwise is subject to a twenty-eight percent rate and hence, theoretically, a fourteen percent rate.¹⁹³ This provision is unlikely to constitute a major factor in choice of tax entity due to the interplay of this preference with the Alternative Minimum Tax (AMT), which results, in most cases, in a twenty percent rate still being applicable.¹⁹⁴

several years." See Daniel Bigler, *Little Goodwill for Merger Rule Reform Plans*, FINANCIAL TIMES (LONDON), Apr. 23, 1999, at 6, available in , available in LEXIS, News Library, London Times File; *Accounting Shift Could Accelerate Mergers*, BOSTON GLOBE, Apr. 22, 1999, at D2, available in LEXIS, News Library, Bglobe File; *Accounting Board Votes to End Pooling*, N.Y. TIMES, Apr. 22, 1999, at C22, available in LEXIS, News Library, New York News Source File (explaining that under "purchase accounting" the premium above tangible assets must gradually be written off). The Financial Accounting Standards Board has voted to repeal pooling of interests accounting effective January 1, 2001, which many think may accelerate mergers short term but reduce merger activities after that date in market segments where pooling is now typically used, like in financial institutions and technology industries. See *id.* But see Robin Sidel, *Accounting Rules to Change on Mergers*, CHI. TRIB., Apr. 22, 1999, available in 1999 WL 2865709 (noting that most merger experts do not expect a slowdown in merger activity). I thank Bob Eveleigh, Esq., a former student, for bringing this development to my attention.

189. See David S. Hulse & Thomas R. Pope, *The Effect of Income Taxes on the Preference of Organizational Forms for Small Businesses in the United States*, J. SMALL BUS. MGMT., 24-25 (1996) (explaining that small business owners doing business in the corporate form can receive a return on their investment by selling their stock rather than declaring a dividend, and by so doing defer the "second tier" of corporate double taxation and also reduce the amount of that "second tier" tax by qualifying for capital gains treatment). Indirect support for much longer average holding periods for private C Corporations can be found in the fact that the holding periods for partnerships and S Corporations are, on the average, much longer than for corporate stock (the realizations of which I believe are overwhelmingly public stock). See CONGRESSIONAL BUDGET OFFICE, *supra* note 141, at 11, tbl. A-15; Lee, *supra* note 141, at 11, 16, 25-6 n.101.

190. See I.R.C. § 1(h)(1)(c) (West Supp. 1999).

191. Assume \$100 taxed at 15% = \$85 x 80% [100% - 20%] = \$68 after inside and outside tax; \$100 x 61.4% [100% - 39.6%] = \$61.40 after a single level of tax.

192. See *supra* note 142 and accompanying text.

193. See I.R.C. § 1202(a) (West Supp. 1999).

194. See I.R.C. § 55(b)(3)(D) (West 1999). I thank Professor Turnier for showing me that I needed to include a discussion of § 1202. But for the AMT aspect, § 1202 would tend towards selection of the private C Corporation over an S Corporation or an LLC.

In conclusion, "double taxation" is either an unwitting or "briar patch" argument¹⁹⁵ in most cases. In any event, some believe that the tax cost of exiting is not taken into account by clients at the time of choice of tax entity¹⁹⁶ (leading to surprises¹⁹⁷ and perhaps recriminations upon exiting). A few significant contexts, such as business reasons, idiosyncratic investor preferences,¹⁹⁸ or a near-term goal of going public,¹⁹⁹ may induce selection of a C Corporation, even when initial losses are anticipated, foregoing the income tax savings of a passthrough entity.

B. Inside Shelter for Moderate Income Private C Corporations

Moderate income private C Corporations (income from \$335,000 to less than \$10,000,000) subject to the flat 34% inside corporate tax rate also provide inside shelter (34% versus 39.6% before phase-outs and wage taxes) on considerable amounts of income, to the extent that their very high income shareholders avoid the second level of individual income tax by holding stock in that or a successor public corporation until death.²⁰⁰ I assume that this entire group was around 33,490 C Corporations in 1993.²⁰¹ This group reported for 1993 around 11.7% of C Corporation

195. See Lee, *Entity Classification*, *supra* note 35, at 69 (analogizing corporate shareholders to "rabbits" in the 1954 Code "briar-patch" being caught in double-tax "thorns"). I am indebted for this simile to my colleague Professor Charles Koch, as acknowledged therein. He has been my chief sounding board for over a dozen years. This article, as well as many others, and scholarship and governance in general at our law school owe a lot to him.

196. Compare *Hearing Before the Senate Finance Subcomm. on Taxation and Debt Management*, 99th Cong., 1st Sess. 328 (1985) (statement of Professor Sam Thompson) (arguing that most businesses would choose not to incorporate due to the proposed bill's effects on taxation at exit) *accord id.* at 246-47 (statement of Professor Edwin Cohen) (arguing that the "double tax" proposal would negatively affect incorporated entities, especially smaller corporations that own appreciated property and whose only way of avoiding higher taxes would be to sell their assets to another, larger corporation); *id.* at 326-27 (statement of Professor Edward J. Roche) (contending that many more businesses would elect to form partnerships in order to avoid the unfavorable tax consequences of C Corporations), *with id.* at 262-63, 273-81, 327-28 (statements of Peter Faber, Esq.) (arguing that small companies choosing a business form generally choose whether to incorporate or not based on immediate concerns, such as limited liability or initial taxes, rather than exit costs).

197. See Laura Saunders, *S, C or Me?* FORBES, Dec. 5, 1994, at 168 (commenting that when the seller of a private C Corporation "hears about the double tax, he is shocked" (quoting John Evans, an accountant for Arthur Anderson)).

198. See Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1766 (1994) (making the point that investors may have nonmonetary benefits as investment goals).

199. See Llewellyn & Umbrecht, *supra* note 1, at 9 (stating that if interests in a business will be "publically traded," C Corporation status "is probably mandatory"). Even here, it might be more tax advantageous to use an S Corporation to pass through losses and then terminate the election when the going-public stage of relatively high annual earnings is attained. See *id.* at 22 (favoring an S Corporation when an eventual exchange for corporate stock is anticipated).

200. See *supra* notes 187-88 and accompanying text.

201. The entire group of profitable C Corporations with taxable income above \$335,000 is 2% of all C Corporations, according to the Joint Committee. See *supra* notes 129-30 and text

income with an average income of \$1,998,056.²⁰² Assuming that moderate income correlates (sufficiently) with moderate assets, perhaps ninety percent of these moderate income C Corporations are private according to Professor Hamill's helpful studies.²⁰³

While the tax expenditure as to moderate income private C Corporations is only one percentage point under the Joint Committee's calculations (thirty-four versus thirty-five percent), the true subsidy for these "moderate income" private C Corporations where the outside tax can be avoided is up to eleven percent of their substantial income (forty-five percent maximum outside rate less thirty-four percent inside rate).²⁰⁴ I suspect that the aggregate subsidy to 33,490 moderate income private C Corporations may equal or exceed the aggregate subsidy to twenty times as many small income private C Corporations. A populist perspective would anticipate just that result.²⁰⁵

C. Factors Outweighing Inside Shelter of Private C Corporations

I. Factors Militating in Favor of LLC as Choice of Entity.—The above discussion has shown the inside tax shelter reason that the small income private C Corporations (and some moderate income private C Corporations) still remain a practical entity of choice where the entity generates small (and sometimes even moderate) amounts of net profits after payment of compensation to principals, which are retained in the entity for expansion. There are, however, two significant market segments in which the inside shelter of private C Corporations is less useful or not available at all to significant percentages of the SOI industrial groups. Not surprisingly, it turns out that these two segments account for over seventy

profitable large asset (and income) C Corporations leaves 33,490 moderate asset profitable C Corporations (the loss C Corporations—large, moderate, and small asset—are included in the 61% no income or loss corporations). See Joint Comm. on Taxation Staff, *Federal Tax System*, *supra* note 111, at 60; 1993 CORPORATION SOURCE BOOK, *supra* note 14, at 497, line 1.

202. For 1993, C Corporations with assets of \$100 million and above reported \$474,691,920,000. See 1993 CORPORATION SOURCE BOOK, *supra* note 14, at 245 (line 66 less line 69). All C Corporation income amounted to \$571,922,088,000, *see supra* note 14. Therefore, such large asset C Corporations reported 83% of C Corporation income for 1993 ($\$474,691,920,000 \div \$571,922,088,000 = 83\%$). Small asset C Corporations reported 5.3% of C Corporation income. See *supra* note 131. Therefore, moderate income and moderate asset C Corporations reported 11.7% of C Corporation income. [$100\% - 83\% - 5.3\% = 11.7\%$] All C Corporation income amounted to \$571,922,088,000. $11.7\% \times \$571,922,088,000 = \$66,914,884,300$. $\$66,914,884,300 \div 33,490 = \$1,998,056$.

203. See Hamill, *supra* note 1, at 422 n.145 (calculating that approximately 10% of medium asset corporations are publically traded, thereby implying that the other 90% are privately held). While our definitions of "moderate" might not exactly correspond because Hamill is using asset size and I am estimating from income shares, I expect the results would not vary much. See *supra* note 119.

204. See *supra* text accompanying note 143.

205. See *infra* text accompanying notes 327-43.

percent of the growth in LLCs. These two segments are (1) insurance, financial, and real estate industries and (2) services industries.²⁰⁶

If initial losses are expected in a beginning real estate venture, then a passthrough entity is usually recommended.²⁰⁷ Even if the real estate is not generating current deductions in excess of rental income, a systemic pattern of selling real estate investment after a relatively short period (less than ten years) and distributing the proceeds would trigger a double tax.²⁰⁸ Moreover, improved real estate has historically appreciated, or at least had its basis reduced (by depreciation)²⁰⁹ below the sales price, which would generate an inside tax on sale or distribution in kind to the shareholders with no inside capital gains advantage.²¹⁰

As to service businesses, the inside shelter of graduated rates on small income is not available to certain personal service corporations.²¹¹ Moreover, in service businesses not subject to the loss of such graduated inside corporate income tax rates, there is also less likely a need to accumulate earnings than in other market segments, since most service businesses are less capital intensive.²¹² If the principals intend to withdraw most of the profits from the venture, then a passthrough tax entity is also indicated. These professional services and real estate premises are confirmed by the statistics of income for partnerships, S

206. See *infra* note 296 and accompanying text.

207. See Melvin N. Greenberg, *Forms of Organization for Holding and Developing Real Estate*, 29 N.Y.U. INST. ON FED. TAX'N 1129, 1134, 1148 (1971) (listing the fact that losses are passed through to each partner as a reason to organize real estate ventures as partnerships); see also *supra* note 65 and accompanying text. Such losses may not be currently taken by the owners except to the extent of passive activity income or material participation in non-real estate businesses or real estate rental businesses by real property business operators. See I.R.C. § 469 (West Supp. 1999).

208. See *infra* note 210. Exceptions to this pattern would be large real estate firms and real estate investment trusts seeking public financing and small income real estate firms with taxable income of less than \$100,000 after compensation to principals. See J. Donald Dial, Jr., *When to Put Real Estate in a Corporation—Tax Considerations*, 32 S.C. L. REV. 319, 328-29 (1980) (discussing how corporations holding real estate can avoid double taxation).

209. See I.R.C. §§ 168 (West Supp. 1999), 1016 (Supp. 1997); Christian C. Day, *Corporate Investment in Real Estate Ventures—Special Considerations for Special Allocations Under Section 704: 'The Price is Right,'* 10 J. CORP. L. 313, 315 (1985).

210. See I.R.C. §§ 311, 336 (1994). A sale of appreciated real estate (not held primarily for sale to customers in the ordinary course of business) by an S Corporation or LLC would be taxed at a preferential capital gains rate to an individual shareholder or member under §§ 1221, 1231 and 1(h), whereas a C Corporation would not obtain any rate advantage upon a similar sale under § 1201. See *id.* §§ 1221, 1231, 1(h), 1201 (1994).

211. See I.R.C. § 11(b)(2) (1994) (excluding qualified personal service corporations from graduated rate eligibility). The definition of qualified personal service corporation includes "health, law, engineering, architecture, accounting, actuarial science, performing arts, [and] consulting." I.R.C. § 448(d)(2)(A) (1994). See generally Lee, *Entity Classification*, *supra* note 35, at 82-83 (stating that "[t]he new PSC inside tax rate is starkly simple: PSCs are not eligible for section 11(b)(1) graduated inside corporate rates").

212. Cf. Wittman, *supra* note 141, at 50 (showing that the services industry ranked fourth in total

Corporations, and C Corporations discussed below, and validate law and economics theory, which assumes that more or less rational tax strategies drive choice of tax entity.²¹³

2. *Factors Militating in Favor of S Corporations and C to S Corporation Conversions.*—Prior to the Tax Reform Act of 1986, the tax literature and hearings presented a paradigm tax life cycle of a private corporation, beginning with an S election during the initial loss first stage. Once the profitable second stage was reached, the S election was then terminated and the organization operated as a C Corporation (S to C conversion) to accumulate earnings that would be taxed at lower graduated inside corporate rates.²¹⁴ Historically, the third and last stage, C to S conversion, occurred when a private C Corporation approached unreasonable compensation or accumulated earnings problems, or perhaps unexpectedly began to incur losses, which would benefit the owner-entrepreneur if passed through.²¹⁵ Consistent with the first stage of initial passthrough of operating losses, newly formed S Corporations reported an average loss of \$5,921 for 1987, while established S Corporations reported average income of \$20,262, and newly converted S Corporations reported average income of \$71,986.²¹⁶ In contrast, and consistent with the third stage, 68.1% of C to S conversions for 1987 reported positive income (almost two-thirds of the remaining C to S conversions reporting a loss in 1986 also reported a loss in 1987).²¹⁷ This indicates that perhaps a third of C to S conversions are made in order to pass through operating losses otherwise trapped in a C Corporation. This is likely a problem of substantial magnitude since sixty-one percent of C Corporations for 1993 reported no income or incurred losses.²¹⁸

213. "Economic analysis of law traditionally posits a world in which decisions are based on rationality, not on emotion." Melinda J. Branscomb, *Labor, Loyalty, and the Corporate Campaign*, 73 B.U. L. REV. 291, 359 n.339 (1993) (citing RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 3-10 (2d ed. 1997)). As indicated at *infra* notes 282-84 and accompanying text, the Service estimates that from 1999-2005, the rate of increase in C Corporation returns will decline. To the extent that this does occur, and is based on the conventional but erroneous wisdom of double taxation of private C Corporations, perceptions rather than reality will be driving some choices of tax entity. The widespread prediction that LLCs will supplant C Corporations thus may become a self-fulfilling prophecy rather than an explanation of rational factors leading to that result. The prediction that they will also supplant S Corporations shows no signs of occurring in the near-term future.

214. See, e.g., Fishman, *supra* note 150 ("The most common forms of business are sole proprietorships, partnerships (limited or general), regular C-corporations, and S-corporations. These forms may be used in combination or a different form may be used at various stages of a business."); Lee, *Entity Classification*, *supra* note 35, at 91 n.130.

215. See Lee, *Entity Classification*, *supra* note 35, at 91 n.130.

216. See Susan M. Wittman & Amy Gill, *S Corporation Elections After the Tax Reform Act of 1986*, 17 SOI BULL., No. 4, at 82, 83 (1998).

217. See *id.*

218. See *supra* note 126 and accompanying text.

C to S conversions make up a substantial number of new S elections each year. This is the second choice of tax entity story. Of the over 268,000 returns filed by new S Corporations for 1996, 71.6% were filed by newly incorporated businesses and 28.4% were filed by C to S conversions;²¹⁹ of nearly 270,000 returns filed by new S Corporations for 1995, 70.7% were filed by newly incorporated businesses, the rest by C to S conversions;²²⁰ of 250,000 returns filed by new S Corporations for 1994, forty-one percent were filed by newly incorporated businesses, the rest by C to S conversions;²²¹ of 255,600 returns by new S Corporations for 1993, seventy-five percent were filed by newly incorporated businesses, the rest by C to S conversions;²²² and of 241,600 returns by new S Corporations for 1992, two-thirds were filed by newly incorporated businesses, the rest by C to S conversions.²²³ In the last four of these years, the number of new S elections each year exceeded, by 125,000 to 150,000, the total annual increase in S Corporation returns,²²⁴ probably reflecting the substantial failure rate in small businesses²²⁵ and perhaps some second stage S to C conversions. Third stage C to S conversions do raise the complexity level of S Corporation taxation considerably. In addition, built-in gain tax on preconversion appreciation in assets held by

219. See Wittman & Grant, *supra* note 19, at 40.

220. See Wittman, *supra* note 141, at 43.

221. See Susan M. Wittman, *S Corporation Returns, 1994*, 16 SOI BULL., No. 4, at 38, 38 (1997).

222. See Amy M. Gill & Susan M. Wittman, *S Corporation Returns, 1993*, 15 SOI BULL., No. 4, 27, 28 (1996).

223. See Amy M. Gill, *S Corporation Returns, 1992*, 14 SOI BULL., No. 4, 73, 74 (1995). The highest rate of C to S conversion during these years was in 1994 after the outside rates had been retroactively raised at the highest individual brackets for 1993, and thus the pain of a return reflecting such increases arose on about April 15, 1994. See I.R.C. § 6072 (1994) (setting the due date for calendar year individual income return at the 15th day of April following the close of the calendar year).

224. For 1993, the increase from the prior year of total S Corporation returns was 116,134; for 1994, the increase was 122,249; for 1995, the increase was 129,365; and for 1996, the increase was 151,297. See Gill & Wittman, *supra* note 222, at 29; Wittman, *supra* note 221, at 39; Wittman, *supra* note 141, at 44; Wittman & Grant, *supra* note 19, at 41.

225. The literature indicates a 50% to 75% failure rate during the first five years. See, e.g., Ellen P. Aprill, *Caution: Enterprise Zones*, 66 S. CAL. L. REV. 1341, 1357 (1993) ("Small businesses . . . have high rates of failure."); Gary D. Burton, *Incubators as a Small Business Support in Russia: Contrast of University-Related U.S. Incubators with the Zelenograd Scientific and Technology Park*, J. OF SMALL BUS. MGMT., Jan. 1998, at 92 (citing the U.S. Small Business Administration Office of Advocacy (1992) for the proposition that "the failure rate for a small business is typically between 55 and 65 percent during the first four to six years of existence"); Phillip F. Zeiderman, *Franchising: Who Needs It? The Role of Small and Medium-Sized Companies*, J. FIN. COMMITTEE ON FRANCHISING, Winter 1984, at 11 (noting that over half of all small business startups fail within five years). Many of these businesses start up again under the same ownership. See G. Richard Shell, *Substituting Ethical Standards for Common Law Rules in Commercial Cases: An Emerging Statutory Trend*, 82 NW. U. L. REV. 1198, 1238 (1988) ("Statistics show that many small businesses emerge from Chapter 11 under the same ownership as before bankruptcy.").

the C Corporation and subsequently realized by the S Corporation is significant in the literature, but perhaps less so on the ground.²²⁶ Most C to S conversions, new S Corporations, and existing S Corporations were in the services industrial group, and, to a lesser extent, the retail trade group.²²⁷ Such C to S conversions also reduce the number of C Corporations and thus require more newly formed private C Corporations to maintain the same net number of C Corporations.

The Tax Reform Act of 1986, with its (1) dramatic lowering of outside individual rates below the top inside corporate tax rate, its (2) elimination of the capital gains preference, and also its (3) repeal of the *General Utilities* doctrine, had a sea-change effect on electing S Corporations. The number of S Corporations surged from 826,214 in 1986 to 1,127,905 in 1987, a 36.5% increase.²²⁸ Forty-three percent of the increase is attributable to C to S conversions,²²⁹ continuing a pattern of growth commencing with the Subchapter S Revision Act of 1982.²³⁰ From 1987 through 1992, the numbers of S Corporations and C Corporations converged, as S Corporation numbers increased while C Corporation numbers decreased.²³¹ Notwithstanding the Revenue

226. Compare Eustice, *supra* note 53, at 389-90 ("Conversions between C and S status . . . have no significant entity level tax consequences.") (written prior to the built-in gain tax), with Kalinka, *supra* note 76, at 1168-69 (noting the problems of conversions from C to S due to built-in gain). In 1995, the built-in gains taxes paid by S Corporations were \$141,218,000, as compared with \$99,128,672,000 in net income (about 78% from trade or business, 19% from portfolio income, and 2.3% from rental real estate). See Wittman, *supra* note 141, at 48-49. Of course, such built-in gain occurs only in converted S Corporations and S Corporation successors (by merger) to a C Corporation, which are a fraction of all S Corporations, albeit probably a significant fraction by now since such conversions have been running at 75,000 or so a year, and these converted companies are older and less likely to fail after election than a newly formed S Corporation.

227. See Wittman & Gill, *supra* note 216, at 83-85.

228. See Paula Karvonis & Nina Shumofsky, *Corporation Income Tax Returns, 1989*, 12 SOI BULL., 41 Fig. C (1992).

229. See Gill, *S Corporation Returns, 1992*, *supra* note 223, at 73, 74.

230. See Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 1016 n.152 (1989) (noting a 61% increase in S Corporations from 1981-1984, in contrast to a 12% increase in all corporate returns for the same period).

231. See Tom Peska, *Taxes and Organizational Choice: An Analysis of Trends, 1985-92*, 15 SOI BULL., 86, 90 (1996). SOI data suggest that due to the Tax Reform Act of 1986, the relative importance of Subchapter S Corporations increased. "In the 15 years from 1978 to 1993, the number of S corporation returns filed nearly tripled, with three-quarters of the increase coming after 1986 . . . [with the] most rapid increase in . . . [1987-1990]." Joint Committee on Taxation Staff, *Subchapter S*, *supra* note 53, at 3. "Since then, the annual growth rate in the number of S corporations returned to rates comparable to those of the early 1980's." *Id.* While the number of S corporation returns increased after 1986, the number of C Corporation and partnership returns decreased, resulting in S Corporations representing 48.4% of all corporations by 1993. See *id.* at 31.

By contrast, in 1986, S corporations were only 24.1 percent of all corporations. In 1990, the number of S corporations surpassed the number of partnerships for the first time. While there has been a relative shift between partnerships, C corporations, and S corporations, the predominant form of organization [in numbers] throughout the period has remained the sole proprietorship.

Reconciliation Act of 1993's increase in the top outside individual rate above the top inside corporate rate, such increase "has apparently not slowed the rate of growth in the number of S Corporation returns filed."²³² This might indicate that the C to S conversions after 1993 were more for the traditional unreasonable compensation and accumulated earnings problems rather than simply a desire to withdraw profits with a single level of taxation.

D. S Corporations Versus Other Passthrough Entities

1. *Conventional Wisdom.*—Commentators typically point to the S Corporation restrictions on capital structure (for example, one class of stock and strict pro rata allocations of income and loss) and identity of shareholders (preclusion of nonresident aliens, and corporate investors, or prior to 1996, employee stock ownership plans (ESOPs)²³³) as nonlevel playing field barriers to raising capital not present in LLCs or other partnerships.²³⁴ The stock ownership patterns in S Corporations suggest that these restrictions have scant impact at the time of formation, although were the S Corporation ever to acquire many more shareholders (which seldom happens) the restrictions might have more of an impact. Over fifty percent of S Corporations have only one shareholder.²³⁵ Another thirty percent have only two shareholders.²³⁶ In light of this ownership pattern, some state entity statutes might in fact impose greater restrictions on availability of LLCs than federal law imposes on S Corporations. A handful of jurisdictions still require that an LLC have two or more members,²³⁷ although with check-the-box most now permit single member LLCs.²³⁸ Initially I surmised that lower LLC-to-corporation

232. Wittman, *supra* note 141, at 43.

233. Under the Small Business Job Protection Act of 1996, Pub. L. No. 104-88, § 1316, 110 Stat. 1758, 1785, a qualified retirement plan trust is able to hold S Corporation stock under § 1361 (b)(1)(B) and (b)(6). I.R.C. §§ 1361(b)(1)(B) & (c)(6). Passthrough income was treated as unrelated business income under § 512(e) as enacted, but the Taxpayer Relief Act of 1997 retroactively amended this to exclude ESOPs. See I.R.C. § 512(e)(3) (1997); H.R. CONF. REP. NO. 105-220, at 744-45 (1997), reprinted in 1997 U.S.C.C.A.N. 1129, 1556-57. As a practical matter, due to the limitation on holdings of investments in employer securities under ERISA § 407, Pub. L. 93-406, 88 Stat. 829, 880 (1974), and its exception for ESOPs, only ESOPs may hold substantial amounts of S Corporation stock of the sponsoring employer. See 29 U.S.C. § 1107 (1994).

234. See Hamill, *supra* note 1, at 408 ("Commentators asserted that without reform S corporations would be unable to compete for capital with LLCs." (citing Robert J. Wells, *S Corp. Simplification Bill To Be Introduced Soon*, *Senate Aides Say*, 93 TAX NOTES TODAY 160-62, May 10, 1993, available in Westlaw at 93 TNT 100-2)).

235. See *supra* note 141 and accompanying text.

236. See *supra* note 141 and accompanying text.

237. See, e.g., ARK. CODE ANN. § 4-32-1313 (Michie 1996); CAL. CORP. CODE § 17050 (West Supp. 1999); D.C. CODE ANN. § 29-1301(16) (1996); MASS. GEN. LAWS ANN. ch. 156C § 2(5) (West Supp. 1999); WYO. STAT. ANN. § 17-15-106 (Michie 1999).

238. See, e.g., ALASKA STAT. § 10.50.155(b) (Michie 1997); COLO. REV. STAT. § 7-80-203

formations ratios might exist in the holdover jurisdictions since the majority of small businesses have just one owner,²³⁹ but Professor Glenn Coven pointed out to me that this limitation is probably largely offset by the ease of bringing in a minority owner such as a family member.

The most significant distinction between Subchapters K and S entities is the inability to step up the basis of inside S Corporation assets upon the death of a shareholder or redemption of her stock interest, as can be done to the inside basis of partnership or LLC assets upon the death of a partner or liquidation of her partnership interest under a Section 754 election.²⁴⁰ This problem may often be overlooked in the initial choice of an entity since it usually would not surface until years in the future. Some suggest that the partnership aggregate approaches of inside step up provisions and mandatory allocations of built-in gain are far too complicated for many small business practitioners and taxpayers.²⁴¹ This may well be true for the smallest business entities, particularly if more tax sophisticated practitioners are unavailable due to cost or location. I find convincing

CODE ANN. § 14-11-101(12) (1998); HAW. REV. STAT. § 428-202 (1999); 805 ILL. COMP. STAT. ANN. 180/5-1(b) (1999); IOWA CODE § 490A.102 (1997); KAN. STAT. ANN. § 17-7605 (1998 revised); KY. REV. STAT. ANN. § 275.015(8) (Michie 1998); LA. REV. STAT. ANN. § 12.1301(10) (1999); MINN. STAT. § 322B.11 (West 1998); MISS. CODE ANN. § 79-29-103(h) (1998); N.H. REV. STAT. ANN. § 304-C:1.V. (1997); N.J. STAT. ANN. § 42.2B-2 (West 1999); N.D. CENTURY CODE § 10-32-06 (revised 1999); OKLA. STAT. tit. § 2001.11 (1998); ORE. REV. STAT. § 63.001(13) (1997); R.I. GEN. LAWS § 7-16-2(m) (1999); S.C. CODE ANN. § 33-44-202(a) (Law. Co-op. 1998); S.D. CODIFIED LAWS § 47-34A-202.1(a) (Michie 1999); TEX. REV. CIV. STAT. Art. 1528n. art. 4.01.A (1999); 11 VER. STAT. ANN. tit. 11, § 3022(a) (1997); VA. CODE ANN. § 13.1-1.002 (Michie 1998); W.VA. CODE § 31B-2-202 (1999).

239. See Symposium, *supra* note 55, at 623 ("In 1993, about seventy-five percent of the roughly twenty-one million businesses in this country were organized as sole proprietorships . . . [A]bout fifty percent of all S corporations in 1993 had only a single shareholder In 1994, about fifty percent of all partnerships had only two partners.").

240. See Burke, *supra* note 56, at 28 (contrasting the rules governing corporations' and partnerships' recognition of gain upon the distribution of appreciated property); Eustice, *supra* note 53, at 354, 387 (discussing generally the discontinuities between Subchapters S and K); John H. Matheson & Brent A. Olson, *A Call for a Unified Business Organization Law*, 65 GEO. WASH. L. REV. 1, 16 (1996) (identifying "the inability to adjust inside basis" as one of the "tax disadvantages" of the S Corporation); Francis J. Mellen, Jr. et al., *Limited Liability Companies and Registered Limited Liability Partnerships in Kentucky: A Practical Analysis*, 22 N. KY. L. REV. 229, 297 (1995) (recommending that companies be organized as LLCs rather than as S Corporations because the former permit a § 754 election); Rands, *supra* note 60, at 20 n.29 (stating that, unlike an S Corporation shareholder, "[a] partner can make a § 754 election which allows a basis adjustment in his or her share of the partnership property in order to reflect the outside basis in his or her partnership interest"); Schwidetzky, *supra* note 89, at 598 ("Another substantial advantage of the partnership over the S corporation is the availability of the 'section 754 election.'").

241. See Martin D. Ginsburg, *Maintaining Subchapter S in an Integrated Tax World*, 47 TAX L. REV. 665, 669-70, 678 (1992) (describing the Subchapter S rules as a surrender of a degree of precision and flexibility in exchange for "absolut[ion] from having to master" the "awesomely complex" partnership tax rules); Yin, *supra* note 35, at 136 n.51 (proposing a simplified tax system for simple private business firms that would avoid inside basis adjustments and special allocation requirements for built-in gain or loss).

Professor Yin's example in *Taxation of Private Business Enterprises* of the two person, very small business partnership needing simplicity.²⁴²

2. *Familiarity Breeds Predilection.*—Conventional wisdom holds that practitioners are more familiar with S Corporations than LLCs or partnerships in general.²⁴³ My anecdotal experience is that nontax expert, small business practitioners (and sometimes their clients²⁴⁴) *think* that they understand Subchapter S but know that they don't understand Subchapter K, much less LLCs. Furthermore, drafting S Corporation documents often involves off-the-shelf documents, while partnership and, in particular, LLC documents require more tailoring and more time educating the client and are hence more expensive.²⁴⁵ This component constitutes a market failure—lack of information—which time and experience may correct.²⁴⁶

242. YIN & SHAKOW, *supra* note 35, at 104-16, 128-31, 162-69, 183-234 and 245-72.

243. See generally, Symposium, *supra* note 55, at 624-25, 629-30 (relating the comments of Professor Carol R. Goforth; Ira Meislik, Esq.; Professor Larry Ribstein; Jude Lemke, corporate counsel; Dale G. Schedler, Esq.; and Irving Schloss, Esq.); accord, GEVURTZ, *supra* note 60, 1998 SUPP. 19-20. Professor Coven similarly believes that practitioners accustomed to the private C Corporation form may prefer S Corporations to LLCs for passthrough treatment of private businesses for at least the near future. See Symposium, *supra* note 55, at 630 (noting an observation by Jude Lemke of Chiquita Brands International, Inc., that subchapter S is more easily understood by nontax specialists and clients than subchapter K); accord, Douglas E. Starcher, *Limited Liability Company May Be Good Incorporation Alternative*, ORLANDO SENTINEL, March 24, 1997, at 32, available in 1997 WL 2764197 ("S corporations, as corporate entities, enjoy the benefits of familiarity."). The SOI data supports this insight. See *infra* note 289 and accompanying text.

244. See Symposium, *supra* note 55, at 624-25 (detailing a discussion between Professor Carol R. Goforth and Ira Meislik, Esq., about inertia among lawyers and clients as a barrier to acceptance of new business forms like LLCs); Jan Norman, *No Stampede—Yet—for Limited Liability*, SACRAMENTO BEE, May 29, 1995, at E1, available in WL, SCRMTO-BEE Database ("Although the art consultant's attorney and accountant recommended the LLC form, 'We felt insecure; we didn't know enough. We formed an S corporation instead, because we were familiar with it.'").

245. See Symposium, *supra* note 55, at 630-31 (presenting the discussion of Jude Lemke, Ira Meislik, Esq., and Dale Schedler, Esq., regarding the additional costs of new forms and "tailor-made" language for LLCs). See generally Phillip J. Baptiste & Tracy J. Monroe, *Negative Aspects to Using LLCs for Operating Companies*, 27 TAX ADVISER 472 (1996) (listing familiarity, drafting, and return preparation expense factors as reasons to avoid LLCs); Cheryl A. Cruz & John E. Karayan, *Should Your Firm Operate as a LLC?*, 21 BUS. F. 16 (1996) (discussing learning curve problems such as the hesitation of accountants and lawyers to set up LLCs until others have done so and the IRS has made rulings). This factor may work for an LLC, at least by attorneys drafting the documents who may be able to charge far more for an LLC than for an S or C Corporation. This was the general sentiment expressed by participants at the Ernst & Young LLP Professional Educators Conference held on March 18-19, 1999 at Tysons Corner, Virginia. Accord, Symposium, *supra* note 55, at 626-27 (William R. Asbell, Esq.; Michael Bamberger, Esq.) (observing that the expense of LLCs makes them less desirable to clients). CPAs, on the other hand, who are getting no fee for drafting may be more likely to recommend an S Corporation (perhaps due to familiarity) according to the participants at the Ernst & Young LLP Professional Educators Conference. That has been my anecdotal experience gleaned from talking to local practitioners and participants in regional tax conferences.

246. See Branscomb, *supra* note 213 (noting that law and economics holds that market failures tend to self-correct). Cf. Symposium, *supra* note 55, at 624-25 (expressing the opinion that lawyer

3. *Wage and Self-Employment Tax Avoidance.*—An apparent reason for the continued popularity of S Corporations as choice of entity, particularly for service businesses, is the perceived advantage of S Corporations in wage or self-employment taxes. The taxes imposed on employers and employees under the Federal Insurance Contributions Act (FICA)²⁴⁷ and on partners and proprietors under the Self-Employment Contributions Act (SECA)²⁴⁸ are sufficiently substantial these days to drive choice of tax entity. One frequently advised, and hence presumably widely used, technique is to split profits in an S Corporation between (1) compensation to the principal or shareholder-employee subject to the FICA 12.4% (employer and employee) old-age, survivor and disability insurance (OASDI) and 2.9% (employer and employee) medicare hospital insurance (MHI), and (2) “dividends” (actually withdrawals of pro rata share of income after payment of compensation to principals) equal to the balance of the profits which it is hoped are not so subject to FICA.²⁴⁹ In contrast, as a sole proprietor or partner, an identical 12.4% OASDI and 2.9% MHI tax is imposed under SECA on the principal’s “net earnings from self-employment.”²⁵⁰ A partner’s or proprietor’s net earnings from self-employment is generally her distributive share from any trade or business, less certain passive income (rents, interests, dividends).²⁵¹ A shareholder in an S Corporation is not required to include for SECA purposes her pro rata share of the S Corporation’s income as net earnings from self-employment, “[r]ather shareholders who perform services for the

Ribstein’s. *See id.* SOI estimates that S Corporations will continue to be more popular than LLCs for some time. *See infra* notes 285, 289 and accompanying text.

247. I.R.C. §§ 3101(a)-(b) (1999) (imposing a wage tax on employees), 3111(a) and (b) (1994) (imposing a wage tax on employers).

248. I.R.C. §§ 1401-02 (1994).

249. *See* Burgess J.W. Raby & William L. Raby, *New Incentive for Avoiding SE and FICA Tax*, TAX NOTES TODAY, Dec. 10, 1998, available in Westlaw at 98 TNT 237-58 [hereinafter Raby & Raby, *Avoiding SE and FICA Tax*] (describing scheming to avoid payroll taxes through S Corporation dividends); Burgess J.W. Raby & William L. Raby, *Shareholder Compensation: How Low Can You Go?*, TAX NOTES TODAY, June 13, 1996, available in Westlaw at 96 TNT 116-62 [hereinafter Raby & Raby, *S Shareholder Compensation*] (examining cases where shareholders received low compensation). *See generally* Baptiste & Monroe, *supra* note 245, at 242-73 (contrasting the treatment in LLCs and S Corporations of 401(k) plans, self-employment tax and payroll withholding); Kirsten Harrington, *Employment Taxes: What Can the Small Businessman Do?*, 10 AKRON TAX J. 61, 70-75 (1993) (outlining the benefits of distributing some S Corporation profits as compensation); Michael P. Watters & Daryl Burckel, *Establishing Reasonableness of Compensation Difficult in IRS Attacks*, 8 AKRON TAX J. 147, 150 (1991) (calculating that taxpayers have won only 20% of inadequate compensation cases, in contrast to 50% of excessive compensation cases). Again, this is what local practitioners and professor-consultants at the 1999 Ernst & Young Conference told me.

250. I.R.C. § 1401(a)-(b) (1994).

251. *See* I.R.C. § 1402(a) (1994) (defining “net earnings from self-employment”); Joint Committee on Taxation Staff, *Description and Analysis of Proposals Relating to Worker Classification and the Tax Treatment of Certain S Corporation Shareholders and Partners*, TAX NOTES TODAY, May 3, 1994, at 19, available in Westlaw at 94 TNT at 85-6 [hereinafter JCT, *Worker Classification*].

S corporation are subject to FICA taxes on the wages paid to them.”²⁵² (A field service advice holding that a Subchapter S Corporation shareholder’s pro rata share may constitute earnings from self-employment unfortunately is erroneous.²⁵³) Therefore, an S Corporation is thought to have a clear wage tax advantage over a partnership or proprietorship in many instances.

Commentators maintain that as long as the compensation paid is in the reasonable range the Service can not treat the pro rata share as compensation for FICA purposes.²⁵⁴ The case law (prior to the 1982 revision of Subchapter S) drew more subtle distinctions. The old Subchapter S treated a shareholder’s share of undistributed S Corporation taxable income as “an amount distributed as a dividend on the last day of the taxable year of the corporation.”²⁵⁵ The Service often attempted, without success, to treat such deemed dividends as wages for FICA where there was no actual distribution (which was income tax free to the extent of previously taxed undistributed income).²⁵⁶ Where the shareholder performed services,

252. JCT, *Worker Classification* *supra* note 251, at 19-20.

253. See IRS Field Service Advice 1999-526, 13 Chief Counsel Advice Serv. (Tax Analysts) No. 3, at 457 (Feb. 1, 1999). The Service concluded that S Corporation distributive shares can be self-employment income (and subject to self-employment tax) if the shareholder’s services are a material income-producing factor, but because the shareholder’s services were not a material income-producing factor, the distributive shares were not self-employment income. “Sections 1.1402(a)-2(f) and (g) of the Income Tax Regulations provide that for purposes of determining net earnings from self-employment, the term ‘partnership’ includes a subchapter S corporation as defined in section 1361 of the Code.” *Id.* The regulation actually refers to a partnership electing to be treated as a domestic corporation under long-repealed Subchapter R, *i.e.*, section 1361 of a very early version of the 1954 Code. See I.R.C. § 1361 (1954), 68A Stat. 3, *repealed by* Act of April 14, 1966, Pub. L. No. 89-389, § 4(b)(1), 80 Stat. 111, 116. Treatment of an S Shareholder as self-employed for wage purposes is sound tax policy, *see infra* note 262 and accompanying text, but contrary to the current statute. See *Ding v. Commissioner*, 200 F.3d 587 (9th Cir. 1999) (explaining that, based on the plain meaning of § 1402 and the fundamental principle of corporate and tax law (that corporation and shareholders are separate persons), “S corporation pass through items are not properly included in determining self-employment tax liability”).

254. See, *e.g.*, Harrington, *supra* note 30, 249, at 71 (discussing what constitutes “reasonable compensation” and noting that recently, “much larger salaries [are] being considered reasonable”); Raby & Raby, *S Shareholder Compensation*, *supra* note 30, 249 (listing methods for preventing compensation from being considered for FICA calculations).

255. I.R.C. § 1373(b) (1954). Now, following the partnership model, a shareholder’s pro rata share of partnership income or loss is simply included in her income for her tax year in which the S Corporation’s tax year ends. See I.R.C. § 1373(b) (1958) (eliminated through revision in 1982).

256. See, *e.g.*, *Gardner v. Hall*, 366 F.2d 132, 135 (10th Cir. 1966) (holding that the Secretary of HEW has no authority to allocate the profit and income of a corporation not distributed in fact); *Letz v. Weinberger*, 401 F. Supp. 598, 602 (D. Col. 1975) (ruling that the Secretary of HEW cannot allocate corporate profits to an applicant for Social Security benefits as long as such funds remain undistributed and unavailable for individual use); *Somers v. Gardner*, 254 F. Supp. 35, 38 (E.D. Va. 1966) (holding that funds from a self-run corporation cannot be used to reduce old age insurance benefits so long as the applicant for such benefits did not receive income from the corporation in any form). For prior law see I.R.C. § 1375(b), (d) (1958) (eliminated through revision in 1982). See generally David F. Shores, *The New Subchapter S Distribution Rules: A Half-Step Forward But a*

took no compensation as such, and actual distributions were made in the form of dividends or loans, however, the courts, under a "substance over form" analysis, allowed agency reclassification of such "dividends" as "wages" for FICA.²⁵⁷ There have been no reported cases where some compensation was paid and the rest of the shareholder's pro rata share was distributed. Moreover, IRS staff has questioned whether the authorities decided under the old Subchapter S still apply.²⁵⁸

Section 482 cases dealing with sole proprietor service businesses which incorporate (as a C Corporation) suggest that the Service can determine under section 482 that the arm's length compensation charged by the S Corporation shareholder for her services (where capital is not a material income producing factor) is essentially equivalent to what she would have received absent incorporation because that is what an uncontrolled taxpayer could demand and obtain.²⁵⁹ In such circumstances, under the majority

Full-Step Back, 4 VA. TAX REV. 49, 50-52 (1984) (describing the effect of the Subchapter S Revision Act of 1982 on constructive, unallocated dividends).

257. See, e.g., *Spicer Accounting, Inc., v. United States*, 918 F.2d 90, 93 (9th Cir. 1990) ("[R]egardless of how an employer chooses to characterize payments made to its employees, the true analysis is whether the payments are for remuneration for services rendered." (citing *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990)); *Fred R. Esser P.C. v. United States*, 750 F. Supp. 421, 423 (D. Ariz. 1990) (holding that the form of payments constituting wages is immaterial); *Ludeking v. Finch*, 421 F.2d 499, 503 (8th Cir. 1970) (distinguishing cases where profits were actually distributed); *Joseph Radke v. United States*, 712 F. Supp. 143 (E.D. Wis. 1989) (holding that dividends paid to a corporation employee amount to wages for the purpose of calculating FICA and FUTA taxes, especially if the employee is the sole shareholder in the corporation and receives no other monetary compensation from the corporation), *aff'd* 895 F.2d 1196 (7th Cir. 1990); *Gale W. Greenlee, Inc. v. United States*, 661 F. Supp. 642, 643 (D. Col. 1985) (declaring that loans made from a corporation to its sole shareholder constituted payment of wages for the purpose of calculating FICA and FUTA taxes).

258. See JCT, *Worker Classification*, *supra* note 251, at 20 n.22 (noting that recent rulings make older rulings unclear); *House Subcomm. on Health of the Comm. on Ways and Means, Report on H.R. 3600*, W.M.C.P. No. 103-25, at 302 n.34 (1994) [hereinafter *Subcomm. Report on Health Security*] ("The present-law validity of this 1974 ruling [Rev. Rul. 74-44] following the substantial revision of the rules that apply to S corporations and their shareholders in 1982 is unclear.").

259. See *Keller v. Commissioner*, 77 T.C. 1014, 1025-26 (1981), *aff'd*, 723 F.2d 58 (10th Cir. 1983). The court there commented that:

Assuming that Keller, Inc.'s share of partnership profits from MAL and its fees from MAL, Inc. continued to be on a par with those payments in the pre-incorporation years, one would expect petitioner, in an arm's-length transaction with an unrelated party, to have bargained for a total compensation package which would approximate the amounts he previously received as a sole proprietor. One would similarly expect that petitioner's total compensation would also reflect any increase in MAL and MAL, Inc.'s earnings over and above the pre-incorporation years. To the extent of any meaningful disparity between these amounts, it is our view that the Commissioner is correspondingly justified in making an adjustment in petitioner's income to properly reflect the true taxable income he earned in his capacity as Keller, Inc.'s employee.

The Commissioner lost in *Keller* because the professional services corporation paid all of its earnings out as compensation or contributions to a qualified retirement plan. *Id.* at 1028-29. Congress' unhappiness with the "result" in *Keller* led to Section 269A. See H.R. CONF. REP. NO. 97-760, at 634 (1982), *reprinted in* 1982 U.S.C.C.A.N. 1190 (stating that Congress intended these provisions would "overturn the results reached in cases like *Keller v. Commissioner*, 77 T.C. 1014 (1982), where

approach the Service can reallocate income from the S Corporation to the shareholder as an arm's length charge (compensation) for her services.²⁶⁰ Such reallocation would impact FICA wage taxes.²⁶¹ Section 482 might not apply to under-compensation for wage tax purposes under the rationales that it is (1) limited to clearly reflecting income for *income* tax purposes or is (2) predicated on the shareholder-employee not working exclusively for the services corporation. If so, the theory that the Section 482-deemed arm's length charge for services is the substantial equivalent to what the shareholder-employee would have received as a sole proprietor (including subsequent increases in profits), should be extendible to fix what is reasonable compensation for wage tax purposes.²⁶² The sensible answer,

the corporation served no meaningful business purpose other than to secure tax benefits which would not otherwise be available"). That provision is limited to reallocations between a personal service corporation and shareholder-employee where the corporation performs substantially all of its services for one other entity. See Mary LaFrance, *The Separate Tax Status of Loan-Out Corporations*, 48 VAND. L. REV. 879, 904, 919 (1995) (describing the government strategy to oppose service industry tax avoidance). Keller supports the practice of C Corporations (particularly professional corporations) paying out all profits as compensation and fringe benefits (especially health insurance). See *supra* notes 137-38 and accompanying text.

260. Cases conflict as to whether the shareholder and the corporation are two commonly controlled businesses for purposes of § 482 under which the Service may reallocate income between two or more businesses owned or controlled by the same interests if necessary to clearly reflect income. See *Fogelson v. Commissioner*, 691 F.2d 848, 851 (7th Cir. 1982) ("[Section 482] . . . should not apply, however, to one who does work exclusively for his corporation") (emphasis omitted), *rev'd*, 77 T.C. 1102 (1981) (explaining that § 482 is applicable because the threshold requirement that there be at least two organizations, trades or businesses was met because there was an employee and a corporation). The Service properly refuses to follow this holding. See Rev. Rul. 88-38, 1988-1 C.B. 246 (asserting that in determining whether § 482 applies, the term "organizations, trades or businesses" should be broadly construed "to include a kind of equity or enterprise that had independent tax significance"); Ronald H. Jensen, *Schneer v. Commissioner: Continuing Confusion Over the Assignment of Income Doctrine and Personal Service Income*, 1 FLA. TAX REV. 623, 667-68 (1993) (describing how § 482 is unimpaired by *Fogelson* because the common law assignment of income doctrine can achieve the same result). See generally Elliott Manning, *The Service Corporation—Who Is Taxable on Its Income: Reconciling Assignment of Income Principles, Section 482, and Section 351*, 37 U. MIAMI L. REV. 657, 678-79 (1983) (harmonizing § 482 with *Fogelson* and illustrating the failures in the court's reasoning); Kerry M. Lavelle, Note, *Internal Revenue Code Section 482 Tax Implications for Closely-Held Domestic Business Associations*, 9 VA. TAX REV. 199, 209 (1989) (suggesting that Keller is a reasonable solution). The *Fogelson* court overlooked that being an employee of a corporation itself constitutes a trade or business. See *Primuth v. Commissioner*, 54 T.C. 374, 378 (1970) ("[I]t is possible for an employee to retain, at least temporarily, his status of carrying out his own trade or business, independent of receiving any compensation from a particular employer."). I thank Professor Gene Seago for calling Rev. Rul. 88-38 to my attention.

261. See *Foster v. Commissioner*, 80 T.C. 234, 236 n.146 (1983) (noting that characterization affects liability for FICA taxes).

262. Compare Treas. Reg. § 1.482-1(b) ("A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances . . ."), with *id.* § 1.162-7(b)(3) (defining reasonable compensation as "such amount as would ordinarily be paid for like services by like enterprises under like circumstances"). The "arm's-length" standard under the § 482 regulations is "equally applicable in ascertaining the 'ordinary and necessary' character of a

of course, is contained in President Clinton's still-born health bill: treat two percent or more S Corporation shareholders as partners for SECA purposes.²⁶³

There is a further choice of entity wrinkle in this context. Under a 1977 statutory amendment, the distributive share of a limited partner is excluded from net earnings from self-employment, except to the extent of a "guaranteed payment" under section 707(c) for services to or on behalf of the partnership.²⁶⁴ In 1997, the Service proposed conceptually sound regulations reminiscent of the passive activity loss regulations that would have barred this exception to any limited partner performing services in professional partnerships or participating in the partnership business for more than five hundred hours during the year.²⁶⁵ After a firestorm of pressure group complaints alleging a stealth tax increase²⁶⁶ by the

T.C. 836, 849 (1973). The Tax Court in *Bianchi v. Commissioner*, 66 T.C. 324, 332 (1976), ruled that "it is proper to make reference to prior self-employment earnings to decide whether current corporate compensation of an employee is reasonable." The new S Corporation made a "deferred compensation payment" covering a 7-day period far out of line with prior self-employment earnings to support a qualified plan contribution and create a passthrough loss, both of which the court disallowed as attributable to unreasonably high compensation. *See id.* at 333.

263. *See House Subcomm. on Health of the Comm. on Ways and Means, Report on H.R. 3600*, W.M.C.P. No. 103-25, at 302-03 (explaining the provision "(1) amend[ing] the definition of NESE to include the pro rata share of certain S corporation income of certain shareholders and (2) modify[ing] the rules applicable to limited partners in a partnership, for SECA tax and health insurance premium purposes"); *NYSBA Advocates Uniform Self-Employment Tax Treatment for Owners of Interests in Passthrough Entities*, TAX NOTES TODAY, Dec. 15, 1994, available in Westlaw at 94 TNT 245-43 (citing New York State Bar Association, Memorandum, *Uniform Self-Employment Tax Treatment of Owners of Interests in Pass-Through Entities*, Dec. 9, 1994, which advocates elimination of the distinctions between types of partnerships for SECA calculations); *see also* Thomas E. Fritz, *Flowthrough Entities And The Self-employment Tax: Is it Time For a Uniform Standard?*, 17 VA. TAX REV. 811, 856 (1998) (asserting that "the most noteworthy aspect of the various proposals introduced in the 103rd Congress is the fact that each measure would have extended application of the self-employment tax to two-percent shareholders of an S corporation").

264. *See* Pub. L. No. 95-216, § 313(b), 91 STAT. 1509, 1536; I.R.C. § 1402(a)(13) (1994). Congress intended to prevent passive limited partners from creating social security earnings from self-employment (especially when the earnings arose from securities income) in order to obtain social security benefits. *See* H.R. REP. NO. 95-702, pt. 1, at 40-41 (1977), *reprinted in* 1977 U.S.C.C.A.N. 4155, 4197 ("Under the bill, the distributive share of income or loss received by a limited partner from a trade or business of a limited partnership would be excluded from social security coverage. However, the exclusion from coverage would not extend to guaranteed payments (as described in section 707(c) of the Internal Revenue Code.)").

265. *See* Prop. Treas. Reg. 1.1402(a)-2(h), 62 FED. REG. 1702, 1704 (Jan. 13, 1997); *cf.* Temp. Treas. Reg. § 1.469-5T(a)(1) (1997). The conceptual soundness is limited, of course, to income from services.

266. *See* 143 CONG. REC. S8,472 (daily ed. Aug. 1, 1997) (remarks of Sen. Bond) (noting that millions of limited partners in limited partnerships and LLCs will be pleased by the proposed bill's "moratorium" on the IRS's proposed stealth tax); *id.* at H3,253 (daily ed. June 3, 1997) (remarks of Rep. Pappas) (referring to the 2.9% proposed tax on limited partnerships to pay for medicare as a "stealth tax"); Raby & Raby, *Avoiding SE and FICA Tax*, *supra* note 249 (describing reaction to the proposal as "intense"); *see also* 145 CONG. REC. S 2602-03 (daily ed. Mar. 11, 1999) (remarks of Sen. Bond) (stating that the stealth tax would negatively affect limited partners and members of LLCs); 144

Service, the Taxpayer Relief Act of 1997 postponed for one year issuance of any final regulation.²⁶⁷ Treasury, taking the hint, still had not promulgated such final regulations at the time of this writing.

What about LLCs? Limited partner usually means limited as to liability and since members of LLCs are so limited, aggressive practitioners have argued that active members in LLCs are not to be subject to these wage taxes,²⁶⁸ at least where a manager is appointed. Commentators have pointed out that since there is no definition establishing whether a member of an LLC is a limited or general partner, assuming that even a nonmanager member of an LLC with a management agreement is a limited partner for SECA purposes is risky and against the policy of SECA, which was aimed at passive investors attempting to obtain coverage, for social security purposes, from passive investments.²⁶⁹ Moreover, no active member of an LLP should be considered a limited partner for this purpose.²⁷⁰ I agree. Here, too, the sensible resolution is statutory.²⁷¹

CONG. REC. S928 (daily ed. Feb. 24, 1998) (remarks of Sen. Bond) (including sections of the Stealth Tax Prevention Act to provide a 60 day notice period to review any IRS raises in revenue). See generally David L. Green, *Bill Eases Small Business Burdens*, ST. LOUIS DISPATCH, June 6, 1997, at 19C, available in Westlaw, SLPD database (describing the "stealth Tax Prevention Act").

267. See Pub. L. No. 105-34, Sec. 935, 111 STAT. 788, 882 (placing a moratorium upon final regulations until July 1, 1998); Raby & Raby, *Avoiding SE and FICA Tax*, *supra* note 249. For a discussion of "limitation riders," which include such a moratorium, whereby Congress micro-manages tax policy, see John W. Lee et al., *Capitalizing and Depreciating Cyclical Aircraft Maintenance Costs: More-Trouble-Than-It's-Worth?*, 17 VA. TAX REV. 161, 169 & n.26 (1997).

268. See Stephen Lukinovich, *Limited Liability Companies, Partnerships Differ*, COURIER-JOURNAL (Louisville, Ky.), July 26, 1998, at 3E, available in LEXIS, News Library, MAJPAP File (noting that one of the advantages of an LLC is that "some members may be able to avoid self-employment tax" in a nonprofessional service business).

269. See, e.g., Carol Mayo Cochran, *Key LLC Issues and Answers*, THE TAX ADVISOR, July 1, 1996, available in 1996 WL 9338497 (asserting that guidance is needed for the application of the definition of "limited partner" in the context of LLCs); Carol R. Goforth, *Continuing Obstacles to Freedom of Choice for Management Structure in LLCs*, 1 J. SMALL & EMERGING BUS. L. 165, 197 (1997) (exploring the relationship between passive loss limitations, the choice of management structure in LLCs, and the definition of "limited partner"); Jennifer J. Johnson, *Limited Liability for Lawyers: General Partners Need Not Apply*, BUS. LAW., Nov. 1995 (discussing the implications of the self-employment tax for lawyers practicing in member-managed LLCs); Walter B. Moore et al., *Shaping Your Practice: Planning a Foundation to Give Your Business Structure and Form*, NAT'L PUB. ACC., Dec. 1995, at 18 (noting that under the current regulations problems arise in the context of passive investments "because all LLC members are literally limited partners"); see also *supra* note 264 and accompanying text.

270. See Raby & Raby, *Avoiding SE & FICA Tax*, *supra* note 249 (noting that the IRS considers the treatment of active members as limited partners "a perversion of the statutory scheme").

271. See Fritz, *supra* note 263, at 814 (noting that in recent years focus by Congress and the Clinton administration on the self-employment tax has rendered the unsettled and controversial area subject to substantial scrutiny, as well as to the real possibility of modification). At the 1999 Ernst & Young Conference, a participant stated that he recommended splitting services and investment activities into separate LLCs, with an S Corporation as a manager of each, to which the LLCs would pay a management fee. If all of the entities are owned by essentially the same interest(s), this seems to exalt

As between using a single member LLC and a sole shareholder S Corporation to attempt to avoid self-employment wage taxes, the LLC appears much weaker.²⁷² This, I suspect, explains some of the growth in S Corporations. In any event, for wage or self-employment taxes to be driving the choice of tax entity, particularly with a single principal where capital is not a material income producing factor, constitutes, in my eyes, a market failure.

E. Facts on the Ground as to Choice of Tax Entity

1. *Statistics of Income Data.*—The facts on the ground show that the number of active C Corporations increased by more than ten percent, from 2,063,124 in 1993²⁷³ to 2,321,048 in 1995.²⁷⁴ The bulk of that increase occurred, however, in 1994, with a net increase of only 2,434 C corporations in 1995.²⁷⁵ Nevertheless, the number of new C Corporations formed in 1995 was far greater than such net increase. For instance, 92,150 C Corporations elected S Corporation status for 1995.²⁷⁶ Accordingly, at least that many new C Corporations had to have been formed in 1993 in order for the 92,150 shrinkage in the 1994 base number of C Corporation returns to be offset. Undoubtedly, a number of other new C Corporations were also formed, which were offset by liquidations of and cessations of active business status by private C Corporations.

historically been risky in the wage tax arena. I find sound the advice that David N. Pope, CPA, one of the Conference directors who practices in Houston, Texas, gives clients, which is to follow the proposed regulations where they materially participate as to services income, etc.

272. A single member LLC is regarded under the classification regulations as a "tax nothing," *i.e.*, a sole proprietorship in this context. See David S. Miller, *The Tax Nothing*, TAX NOTES TODAY, Feb. 3, 1997, available in Westlaw at 97 TNT 22-69 ("[T]he tax nothing will most often be a single-member limited liability company that has not elected to be treated as an association for federal income tax purposes."). Dressing this up as a manager-directed LLC is quite aggressive. See Bernie Phillips, *Self-Employment Tax Treatment of LLC Members*, NAT'L PUB. ACC., Jan./Feb. 1999, at 6 (stating that, according to an IRS person who was responsible for the check-the-box regulations, "the single member LLC must be treated as a sole proprietor").

273. See *supra* note 130.

274. See STAT. OF INCOME DIVISION 1995, CORPORATION INCOME TAX RETURNS, 9, 481 (revised 1998). Internal Revenue Serv., Stat. of Income: Corp. Income Tax Returns 9, 481 (Pub. 1053 revised March 1998) [hereinafter 1995 STAT. OF INCOME DIVISION] (revealing that there were 4,474,167 active corporations, 2,153,119 S Corporations, and thus 2,321,048 C Corporations).

275. 2,321,048 C Corporations in 1995 - 2,318,614 C Corporations in 1994 (4,342,368 active Corporations in 1994 minus 2,023,754 S Corporations) = 2,434. See 1994 STAT. OF INCOME DIVISION, INTERNAL REVENUE SERV., STAT. OF INCOME: CORP. INCOME TAX RETURNS 9, 481 (Pub. 1053 revised March 1997). The large growth in C Corporations for 1994 might reflect the increase in top individual rates in 1993. See Pub. L. No. 103-66, §§ 13201(a), 13202, 107 STAT. 312, 457-58, 461.

276. See *supra* text accompanying note 223 (reporting that 29.3% of 270,000 new S Corporation elections for 1995 consisted of C to S conversions). For 1996, 28.4% of 268,000 new S Corporation elections were by C corporations, *i.e.*, 77,112 C to S conversions. See *supra* text accompanying note 223.

There were probably some S to C conversions in 1995, which would reduce the estimate of new C Corporation formations. I expect that private C Corporations fail more often than Subchapter S Corporations and surely LLCs, concentrated as they are in professional services and developed real estate as contrasted, for example, with restaurants.²⁷⁷ In any event, net C Corporation filings picked back up by 1997, as 2,699,000 C Corporation returns were filed in 1997, for a two-year increase of 16.28% from 1995.²⁷⁸ The drop in increase in net C Corporation returns for 1995²⁷⁹ might, as Professor Hamill and others predicted, reflect the new certainty as to partnership tax status for LLCs arising first from Revenue Procedure 95-10,²⁸⁰ which grants relatively easy classification of an LLC as a partnership, and then from Notice 95-14,²⁸¹ which announces that Treasury and the Service were considering discarding the entire entity classification regime and adopting a "check-the-box" elective classification as a partnership or association taxed as a corporation, which was widely publicized in the practitioner literature and tax conferences.²⁸² If so, the

277. There is no data for 1995 available as to the number of C Corporations liquidating or as to the number of S Corporations terminating their S elections and filing C Corporation returns.

278. See Zaffino, *supra* note 13, at 184 tbl. 1. 2,699,000 C Corporations in 1997 (5,149,000 total returns for corporations - 2,450,000 returns for S corporations) - 2,321,048 C Corporations in 1995, see *supra* note 274, = 377,952; $377,952 \div 2,321,048 = 16.28\%$. As of November 1, 1999, no SOI data was available as to C Corporation formations for 1996.

279. See *supra* note 275 and accompanying text.

280. See 1995-1 C.B. 501; see also Hamill, *supra* note 1, at 406-07 (describing how Revenue Procedure 95-10 has provided the tax world with certainty concerning the way in which LLC managers will be taxed); *supra* note 87 and accompanying text.

281. See 1995-1 C.B. 297. Check-the-box entity classification regulations were proposed in mid-1995, see Prop. Treas. Reg. § 301.7701-1, 61 FED. REG. 21989 (1996), and then finalized later the same year. See 61 FED. REG. 66584 (Dec. 18, 1996) (codified at 26 C.F.R. §§ 1.581, 301.7701, 602.101 (1999)). All persons filing under an LLC statute automatically receive partnership taxation. See Treas. Reg. § 301.7701-3 (1999); Hamill, *supra* note 30, at 1483 (discussing the impact of Notice 95-14).

282. See Sheldon I. Banoff, *Top Ten Reasons for Professionals to Consider Using LLCs*, 73 TAXES 515, 519 (1975) (noting that Revenue Procedure 95-10 clarifies the tax consequences of converting to an LLC); Donald J. Hess et al., *Limited Liability Companies and Real Estate: A California Perspective*, 47 U. S. CAL. ANN. INST. ON FED. TAX'N § 1705 (1995) (implying that California could have minimized the risks of uncertain tax characterization for LLCs by passing measures similar to Revenue Procedure 95-10); Richard M. Horwood & Jeffrey A. Hechtman, *The Internal Revenue Service's Perspective on LLCs: An Update*, 22 J. REAL EST. TAX'N 356, 358 (1995) (detailing the requirements that must be satisfied to be taxed as a partnership pursuant to Revenue Procedure 95-10); John G. Schmalz & Samuel P. Starr, *IRS Provides Welcome Certainty in the Classification of LLCs as Partnerships*, 82 J. TAX'N 260, 265 (1995) ("Rev. Proc. 95-10 provides welcome guidance that offers taxpayers and practitioners a high degree of certainty in their attempts to classify LLCs as partnerships."); W. Joey Styron, *Securing Partnership Tax Status for Limited Liability Companies*, 12 J. TAX'N INVEST. 306, 307 (1995) (stating that Revenue Procedure 95-10 is a general document that applies to all LLCs and sets out the requirements that must be met before the Service will rule on the corporate verse partnership tax status of an LLC); Patricia Pace Hamill, *A Case for Eliminating the Partnership Classification Regulations*, TAX NOTES TODAY, July 20, 1995, available in Westlaw at 1995 TNT 141-65 (concluding that "because limited partnerships and limited liability companies can

resurgence in net C Corporation returns by 1997 may reflect that the novelty of check-the-box is wearing off. In any event, through 1997 the number of new C Corporations and new S Corporations formed annually each appears to have equaled or exceeded the number of new LLCs formed that year.

SOI projects, for 1999-2005, smaller increases in the number of C Corporation filings as compared with the projected increases in S Corporation or in partnership filings.²⁸³ With complete parity of tax treatment of health and life insurance fringe benefits as between C Corporations, passthrough entities, and self-employed taxpayers over the next few years, the projected decrease in smallest asset and income C Corporation filings might reflect a decrease in the use of small asset and little or no taxable income C Corporations to provide preferentially taxed health and life insurance fringe benefits of private C Corporations as contrasted with passthroughs.²⁸⁴ To the extent this is so, new C Corporations may still be formed to obtain an inside tax shelter from graduated inside corporate rates for small income C Corporations.

SOI projects annual increases in somewhat larger asset or income C Corporations for 1999-2005,²⁸⁵ so that the use of the inside shelter from the lower flat thirty-four percent rate in the case of moderate income private C Corporations will probably continue to grow. In any event, to the extent that the widespread myth of double taxation of private C Corporations does have the effect of retarding their use as an inside tax shelter post-1997, we may have a rare instance in Taxland of two wrongs

currently comply with the regulations while substantively resembling corporations . . . , eliminating the classification regulations will save enormous transaction costs without adversely affecting the revenue base or increasing the types of businesses that can use these forms.”); Daniel Shefter, *Check The Box Partnership Classification: A Legitimate Exercise in Tax Simplification*, TAX NOTES TODAY, Apr. 13, 1995, available in Westlaw at 1995 TNT 72-44 (supporting the IRS’s proposed simplification of tax procedure because of its potential to reduce costs to the IRS and the taxpayer and remove some complexity from the entity taxation system); Sheryl Stratton, *IRS Proposes ‘Check The Box’ Partnership Classification Procedure*, TAX NOTES TODAY, Mar. 30, 1995, available in Westlaw at 1995 TNT 62-3 (summarizing the mechanics of the proposed “check-the-box” classification structure); Seth M. Zachary & Andrew M. Short, *Attorneys Say Check-the-Box Proposal Should Include Single Owner Organizations, Unincorporated Foreign Entities*, TAX NOTES TODAY, July 19, 1995, available in Westlaw at 1995 TNT 140-57 (supporting the proposed “check-the-box” classification structure and arguing for the extension of the benefits conferred by this structure to such groups as single-owner unincorporated organizations and foreign unincorporated business organizations). See generally Barbara C. Spudis, *LLCs and LLPs: Take the “L” Train*, 53 N.Y.U. INST. ON FED. TAX 9 (1995) (comparing the advantages and disadvantages of LLCs, LLPs, and S Corporations).

283. SOI projects a 1.38, 4.6, and 4.04 average annual percentage increase for 1999-2005 for Form 1120 C Corporations (greater than \$500,000 in income or assets), S Corporations (Form 1120S), and partnerships (Form 1065), respectively. See Zaffino, *supra* note 13, at 179. It also projects for this period an average annual percentage decrease in Form 1120-A small income (less than \$500,000 in income and assets) C Corporation returns. See *id.*

284. See *supra* note 138 and accompanying text.

285. See Zaffino, *supra* note 13, at 179.

((1) inside graduated and flat thirty-four percent rates for small and moderate income private C Corporations and (2) the myth of their double taxation) making a right (requiring passthrough or conduit entity taxation where management and ownership are not separated, *i.e.*, private and public corporation differentiation).

The number of S Corporations also increased around ten percent, from 1,901,505 in 1993 to 2,153,119 in 1995 and 2,304,416 in 1996.²⁸⁶ For 1997, there were 2,450,000 S Corporation returns.²⁸⁷ SOI projects S Corporation returns to increase an average of 4.16% annually from 1999-2005.²⁸⁸ SOI estimates that S Corporation filings will first exceed C Corporation filings in 2000.²⁸⁹

The number of partnerships of *all* types also increased around six percent, from 1,493,963 in 1993 to 1,580,900 in 1995.²⁹⁰ The number of partnerships further increased to 1,654,256 for 1996 and to 1,755,000 for 1997, with SOI projecting an average 4.04% annual increase for 1999-2005.²⁹¹ The increases in the number of partnerships commencing in 1994 reversed a pattern of declining numbers since 1989, which corresponded with the collapse of the commercial real estate market.²⁹² This recent pattern of growth in numbers of partnerships is largely attributable to LLCs, which grew from 17,335 in 1993 to 47,816 in 1994, and then from 118,559 in 1995 to 221,498 in 1996.²⁹³ Indeed, in 1996, in contrast to the just over 100,000 increase in LLCs, there was a 50,000 decline in the number of general partnerships and only a 16,000 increase

286. See 1995 STAT. OF CORPORATE INCOME, *supra* note 274; 1993 CORPORATE SERVICE BOOK, *supra* note 14, at 481; Wittman & Grant, *supra* note 19, at 41. See *supra* note 218 for the argument that greater numbers of new S elections in 1994, 1995, and 1996 than net growth probably indicates a large number of liquidations of S Corporations and possibly a large number of terminations of S elections each year.

287. See Zaffino, *supra* note 13, at 184 tbl.1.

288. See *id.* at 179 fig.A.

289. See *id.*

290. See Timothy D. Wheeler, *Partnership Returns, 1995*, 17 SOI BULLETIN 43 (1997).

291. See Zaffino, *supra* note 13, at 184 tbl.1, 179 fig. A; Alan Zempel, *Partnership Returns, 1996*, 18 SOI BULLETIN 45 (1998).

292. See Zaffino, *supra* note 13, at 184 tbl.1; James Bates, *California May Avoid Brunt of a Real Estate Market Slump*, L.A. TIMES, Dec. 3, 1989, available in 1989 WL 2214017 (describing the problems created for lenders and financial institutions as a result of the real estate crisis); Peter Cary & Stephen J. Hedges, *Can't Anybody Here Sell Some Property?*, U.S. NEWS & WORLD REPORT, Dec. 10, 1990, at 56 (discussing the Resolution Trust Corporation's problems in recovering for the S&L crisis, namely, the crash of the commercial real estate market); Ellen Freilich, *Shopping Center Values Face Decline*, CHI. TRIB., Dec. 16, 1990, available in 1990 WL 2899078 (describing the collapse of the retail real estate market in 1990); Kenneth R. Sheets & Robert F. Black, *A Roof But No Shelter*, U.S. NEWS & WORLD REPORT, Mar. 6, 1989, at 45; Steve Waldman et al., *The Big Bust*, NEWSWEEK, Oct. 1, 1990, at 48 (exploring the reasons for the omnipresent 1989 decline of the real estate market).

293. See Timothy D. Wheeler, *Partnership Returns, 1994*, 16 SOI BULLETIN (Number 2) 76, 82 (1996); Wheeler, *supra* note 290, at 52; Zempel, *supra* note 291, at 56.

in the number of limited partnerships.²⁹⁴ SOI projects that partnership returns in general will increase 4.04% annually for 1999-2005.²⁹⁵ The rate of growth of LLCs may be expected to be greater than this because the annual decrease in the number of general partnerships offsets some of the annual formation of LLCs.

Significantly, in 1996, over seventy percent of the LLCs were concentrated in "finance, insurance, and real estate" and services.²⁹⁶ Real estate businesses constituted almost 80% of the "finance, insurance, and real estate" SOI category and the industry group as a whole made up over 53.9% of all partnerships in 1996.²⁹⁷ Note that eighty percent of the income of services partnerships was attributable to the professions of law, health, and accounting.²⁹⁸ Such real estate and services market segments dominate all partnerships in roughly the same percentages as in LLCs.²⁹⁹ In short, the growth in LLCs as to market segments as of 1995-96 followed exactly the same pattern as all partnerships generally. Thus, the growth was probably tending to take more from other forms of partnerships, or what would have been other partnerships, rather than from C or S Corporations.³⁰⁰

294. See Zempel, *supra* note 291, at 50 fig. F (noting that the number of LLCs grew from 118,559 to 221,498, the number of general partnerships declined from 1,167,036 to 1,116,054, and the number of limited partnerships increased from 295,304 to 311,563).

295. See Zaffino, *supra* note 13, at 179 fig. A.

296. See Wheeler, *supra* note 290, at 45 (noting that in 1995, 2/3 of LLCs were found in these areas). A June 1999 study of registration records for 1,252 LLCs in 43 states found a large portion were professional service firms. In the sample, 26% consisted of engineering and management support companies; 19%, real estate businesses; 12%, construction; and 9%, investment companies. See Zempel, *supra* note 291, at 48 ("Over 70 percent of all limited liability companies were classified in the finance, insurance, and real estate and services industrial divisions."). See Conrad S. Ciccotello & C. Terry Grant, *LLCs and LLPs: Organizing to Deliver Professional Services*, BUS. HORIZONS, Mar. 1, 1999, available in 1999 WL 14051370. In a similar sample of 680 limited liability partnerships, 29.7% consisted of law firms; 28.5%, medical firms; 12.1%, accounting firms; and 9.7%, real estate services. See *id.*

297. See Zempel, *supra* note 291, at 50, fig. F (allowing the reader to calculate this figure by dividing the total number of businesses in these three categories by the number of those businesses which were real estate businesses). Using 1990 SOI data, the General Accounting Office reported that real estate accounts for 44% of "partnerships"; financial and insurance, 7%; services, 18%; retail trade, 10%; and agriculture, 8%. See General Accounting Office, *Tax Administration: IRS's Partnership Compliance Activities Could Be Improved*, tbl. I.2 (GAO/GGD-95-151 June 16, 1995), reprinted in 95 TAX NOTES TODAY 118-21, June 19, 1995, available in Westlaw at 95 TNT 118-21.

298. See Zempel, *supra* note 291, at 46 fig. B.

299. See Wheeler, *supra* note 293, at 76, 78 fig. D (reporting that for 1993, finance, insurance, and real estate accounted for 54.2% of all partnerships, while services accounted for 17.5%, and together they accounted for almost 75% of both net income and deficits of all partnerships). Eighty-four percent of the income of services partnerships was attributable to the professions of law, health, and accounting. See *id.*; Wheeler, *supra* note 290, at 44 fig. B (reporting essentially the same pattern for 1994); Zempel, *supra* note 291, at 46 fig. B (reporting essentially the same pattern for 1995).

300. See Spudis, *supra* note 282, § 9.03 at 9-11 (suggesting that when a state adopts an LLC statute the number of corporate organizations is not significantly reduced).

The above tendencies as to choice of tax entity are not absolute rules (except as to most tax sensible professional businesses, and even there a fair number may go the C Corporation route and then pay out all profits as compensation or fully deductible fringe benefits, which probably works, so long as capital is not an income producing factor³⁰¹). SOI data shows that for 1995, 10.8% of S Corporation net income consisted of "finance, insurance, and real estate" industrial groups,³⁰² which reported 61.9% of the *net* rental net income of S Corporations.³⁰³ Finance, insurance, and real estate returns made up 10.5% of all S Corporation returns.³⁰⁴ The significantly greater percentage of partnerships than of S Corporations in this industrial group is consistent with the bias in the S Corporation tax rules against including entity level debt in a shareholder's basis, which is a key element of partnership passthrough of real estate losses.³⁰⁵

It is not possible to determine from the published data what percentage of real estate businesses constitute C Corporations. The entire finance, insurance, and real estate industrial group for 1995 accounted for 15% of all active C and S Corporation returns³⁰⁶ and for 15.45% of all active C Corporation returns.³⁰⁷ Real estate businesses made up seventy percent of the returns for the entire finance, insurance, and real estate industrial groups for all corporations.³⁰⁸ Since the S Corporation SOI data do not break the finance, insurance, and real estate industrial group down into its components, it is not possible to determine how many real estate businesses file C Corporation as contrasted with S Corporation returns or the percentage real estate business returns constituting C Corporation and S Corporation returns. Nevertheless, given the fact that many of the

301. See Booth, *supra* note 83, at 563 (stating that small firms can easily avoid corporate tax by paying bonuses and fringe benefits). The Appendix combines professional and nonprofessional corporations as does IACA Annual Report of the Jurisdictions 1997, 1998, and 1999. See 1997 IACA ANN. REP. OF THE JURISDICTION: UPDATE; 1998 IACA ANN. REP. OF THE JURISDICTION: UPDATE; 1999 IACA ANN. REP. OF THE JURISDICTION: UPDATE.

302. See Wittman, *supra* note 141, at 49 fig. E.

303. See *id.* at 47.

304. See *id.* at 44 fig. A (reporting that finance, insurance, and real estate made up 326,149 out of 2,153,119 S Corporation returns in 1995).

305. See *supra* notes 62-65 and accompanying text; *infra* note 342 and accompanying text.

306. See 1995 STAT. OF INCOME DIVISION, *supra* note 274, at 9, 482 (consisting of 683,211 out of 4,474,167 returns).

307. See *id.* at 9, 182, 481, 491. From the number of finance, insurance, and real estate returns for all corporations, subtract the number of S Corporation finance, insurance, and real estate returns. 683,211 (returns for all corporations) - 326,149 (returns for S Corporations) = 357,062 (returns for C Corporations in the aforementioned businesses). The total of all C Corporation returns for 1995 was equal to 4,474,167 (total of corporate returns) - 2,153,119 (total of S corporation returns) = 2,321,048. The proportion of C Corporations in the finance, insurance, and real estate industries was thus 15.38% of the 2,321,048 total.

308. See *id.* at 182, 202 (calculating as follows: 481,450 C and S Corporation real estate returns

subgroups in this industrial group listed for all corporations are conducted only in C Corporation form (*e.g.*, banks, insurance companies, condominium and co-operative associations, regulated investment companies (mutual funds), real estate investment trusts (REITs)), most of which are not even eligible to elect under Subchapter S.³⁰⁹ I expect that the S Corporation's percentage of this entire industrial group that consists of real estate businesses is substantially greater than seventy percent. The countervailing tendencies toward selection of C Corporation status by real estate businesses is explained by large firms seeking public financing and in small income profitable firms with not more than \$100,000 a year income after compensation to principals. In any event, it is clear that real estate businesses make up a far smaller percentage of all corporations (about ten percent) than their percentage of all partnerships and of LLCs (forty percent or more).³¹⁰

2. *International Association of Corporation Administrators Annual Report of the Jurisdictions Data.*—The conclusion drawn from the SOI data as to partnerships and statistics of corporate income data—that the increase in LLCs are by-and-large not coming from a decrease in formation of corporations—is corroborated by the trends in the information contained in the 1997-1999 Annual Update Reports of the Jurisdictions of the International Association of Corporation Administrators (IACA), containing information for the years 1995-1998, which can be found in the Appendix.³¹¹

While the number of new reportings by LLCs has indeed increased greatly in most jurisdictions, the number of new reportings by corporations for 1997 stayed constant or increased slightly in most jurisdictions and declined, usually by less than one hundred, in thirty percent of the jurisdictions.³¹² For 1998, ten percent of the jurisdictions, including California and Texas, continued to show a slight increase in the number of new corporate filings, but most jurisdictions reported small percentage declines.³¹³ Nevertheless, for 1995 to 1998 in all jurisdictions except Connecticut (which phenomenon may be explained below), the number of new corporations reporting has exceeded the number of new LLCs

309. See I.R.C. § 1361(b)(2) (1994).

310. See 1995 STAT. OF INCOME DIVISION, *supra* note 274, at 9, 202. Real estate businesses account for 10.76% of all corporations (calculating as follows: 481,450 C and S Corporation real estate returns divided by 4,474,167 total C and S Corporation returns).

311. The numbers of new corporate reportings in this data are far greater than the increase in corporations in corresponding SOI data, probably because the former but not the latter data include corporate subsidiaries and inactive corporations, and the latter data reflect net increases after corporate liquidations and terminations and C to S conversions.

312. See *infra* Appendix.

313. See *infra* Appendix.

reporting.³¹⁴ Indeed, for 1997, the ratio of new corporation to new LLC reports in two jurisdictions was as high as 20:1 and 50:1; in two more jurisdictions the ratio of corporate to LLC formations was 8:1. The ratio was 5:1 in twenty percent of the jurisdictions; 3:1 in thirty percent; 2:1 in twenty percent; and in three jurisdictions, the ratio of LLC to corporate formations was approaching 1:1.³¹⁵

For 1998, the percentage of the jurisdictions in the 4:1 range, which included Texas and New York, declined to ten percent of the jurisdictions; the percentage of 3:1 range jurisdictions declined to twenty percent; and over fifteen percent were between 2:1 and 2.5:1, including California and New Jersey.³¹⁶ For 1998, in most jurisdictions with large numbers of new corporate filings (more than 30,000), the corporate to LLC new filings ratio was greater than 4:1 (Florida, Illinois, New York and Texas), or between 2:1 and 3:1 (California, New Jersey and Georgia); the exception to this pattern is Michigan, with a 1.5:1 ratio.³¹⁷

In some instances, the varying ratios may reflect different legal cultures, different choices among different market segments, or different local tax treatment. This especially appears to be the case where LLCs are subject to franchise taxes but (limited) partnerships are not, as in Texas and California³¹⁸ and, until recently, in Florida and Pennsylvania.³¹⁹ This franchise tax treatment resulted in a 50:1 and a 5:1 corporation to LLC filing ratio in Florida and Texas, respectively, for 1997.³²⁰ For 1998

314. See *infra* Appendix. In Connecticut there was roughly a three-to-two ratio of LLC to corporate formations for 1997; the ratio was more than two-to-one for 1998. See *infra* Appendix.

315. See *infra* Appendix. Ratios are probably more important than Professor Hamill's focus on the rate of increase because there is such a low base. See Hamill, *supra* note 1, at 405-06.

316. See *infra* Appendix.

317. See *infra* Appendix.

318. See CAL. REV. & TAX. CODE § 23151(a) (West 1998) (imposing a franchise tax on corporations doing business in the state); TEX. TAX CODE ANN. § 171.001(a) (West 1992) (imposing franchise taxes on corporations and LLCs doing business in Texas).

319. See *infra* note 320.

320. See *infra* Appendix. For instance, California's LLC regime originally contained two biases against full use, which reportedly caused the statute to be a "dud" at first: (1) professionals and anyone licensed by the state (67 categories) could not form an LLC (due to pressure from the California Trial Lawyers Association), see Jane Applegate, *Thanks to Exclusions, Liability Shield Plan Languishes*, SACRAMENTO BEE, Dec. 26, 1994, available in Westlaw, SCRMTO-BEE Database; Norman, *supra* note 244; and (2) in addition to an annual fee based on gross receipts, LLCs had to pay the minimum \$800 corporate franchise tax. See *id.* Subsequently, special taxes on limited partnerships, LLCs, and limited liability companies were repealed, but the franchise tax is still imposed on LLCs. See CAL. REV. & TAX. CODE §§ 23081, 23091-23096.5, 23097-23099.5, 23038(c) (West 1992 & Supp. 1999). Not surprisingly, in 1995, the ratio of California corporate filings to LLC filings was 6:1, but has dropped to 4:1 for 1996, 3:1 for 1997 and 2.5:1 for 1998. See *infra* Appendix. California now permits "professionals," but not other licensed services businesses, to organize limited liability partnerships. See CAL. CORP. CODE § 16951 (West 1992 & Supp. 1999) (recognizing only registered limited liability partnerships and foreign limited liability partnerships). Texas and Florida applied a

Florida's adverse LLC franchise tax rule was repealed for half the year and the ratio of new corporate to new LLC filings dropped to 27:1 for the whole year, while Pennsylvania, with the repeal of its adverse LLC franchise tax rule for the whole year, dropped from a 16:1 ratio to a 6:1.³²¹ In Texas, the adverse LLC franchise tax remained in place, and the 5:1 ratio remained the same as well.³²² Conversely, in Connecticut, where LLC to corporation formations were running 3:2 for 1997 and a little over 2:1 for 1998,³²³ the state taxation rules greatly favor members of LLCs over shareholders in S Corporations, since Connecticut imposes no individual income taxation (except on certain passive income of partnerships) while subjecting S Corporations, but not LLCs, to a franchise tax based on income.³²⁴ Thus, the extremes at both ends of the spectrum of corporate to LLC formation ratios for 1997, 3:2 LLCs to corporations (Connecticut) and 20:1 (Pennsylvania) and 50:1 (Florida) corporations to LLCs, appear to reflect peculiar state taxation of one form or another of these business tax entities.

I suspect that in many of the other jurisdictions, the varying ratios of filings may reflect the relative importance of the various market segments in the jurisdiction and perhaps the varying degrees of inertia among the small business practitioners and possibly clients. It may be that high corporation to LLC formation ratios correlate with the importance of

no income tax that would apply to partnerships. See TEX. TAX CODE ANN. § 171.001(a)-(b) (West 1992); FLA. STAT. ANN. §§ 608.471, 220.02 (West 1989 & 1993, respectively). Florida has repealed its franchise tax as to LLCs, effective July 1, 1998. See FLA. STAT. ANN. § 608.47 (1999 Supp.). Prior to the amendment, Florida's corporate filings compared to LLC filings were 50:1 for 1997 (115,835 to 2,357). See *id.* Comparison of 1997 filings to 1999 filings will be very interesting. For 1998, the Florida ratio fell to 27:1 (114,796 to 5,124). See *id.* Similarly, Pennsylvania originally taxed LLCs generally like corporations, except for LLCs by professionals, which were taxed like limited partnerships. See 15 PA. CONS. STAT. §§ 8925, 8997 (1995) (treating LLCs like corporations for tax purposes and taxing professional LLCs as limited partnerships), *repealed insofar as inconsistent with* § 35.1(b) of Act of May 7, 1997, P.L. 85, No. 7 (effective Jan. 1, 1998). Section 8925 was repealed effective January 1, 1998. See Act of May 7, 1997, P.L. 85, No. 7, § 35.1(b) (amending the Act of March 4, 1971 (P.L. 6, No. 2)). For 1998, new corporate filings dropped, and new LLC filings increased, by roughly the same number; the ratio of new corporate to LLC filings dropped from 20:1 to 7:1. See *infra* Appendix.

321. See *supra* note 320.

322. See *infra* Appendix.

323. See *infra* Appendix.

324. See CONN. GEN. STAT. §§ 12-214, 217(c)(1) (West Supp. 1999) (providing that an S Corporation also must bring back compensation paid to principals into pro rata shares subject to income-based franchise tax); John T. Del Negro, *Connecticut Taxation of Business Entities*, 64 CONN. BAR J. (Special Issue) SI-113, SI-115 (1990) (providing an overview of the business taxation system in Connecticut and explaining that S Corporations are subject to the corporate franchise tax while partnerships and other passthrough entities are not); William Hathaway, *Profit Protection: Limited Liability Entities Emerge as Popular Tax and Liability Shield*, HARTFORD COURANT, Apr. 28, 1997, available in 1997 WL 2997655 (asserting that the cost of setting up an LLC can be "recouped quickly in reduced state tax liabilities because LLCs do not pay a separate business tax").

manufacturing, which is more likely to be conducted in corporate form, as in New York (5:1), New Jersey (3.6:1) and Ohio (3:1) for 1997.³²⁵ Delaware's ratio of 2.5:1 corporations to LLCs for 1997 and 1.6 to 1 for 1998³²⁶ is less important than the high numbers of formations in both categories, which probably reflects that it is the jurisdiction of choice both as to corporations and LLCs for many out of state businesses.³²⁷

IV. Populist Perspective

A. *Overview of Populism*

Populism means many things to many people. It is too often categorized, even by admirers, as champion of the underdog against the big interests. Writers in legal periodicals often use the term as a caricature-shorthand for prejudice against big business in general, and in particular against big corporations,³²⁸ banks,³²⁹ insurance companies³³⁰ (and,

325. See *infra* Appendix.

326. See *infra* Appendix.

327. I am grateful to Peter Mahoney, CPA, Conference Co-Director for the 1999 Ernst & Young Conference, for telling me that he chose Delaware as the jurisdiction for the many LLCs (in effect joint ventures) formed between large income C Corporations, as to which he was consulted in his National Office practice.

328. "Among others, populists of the 1880s and 1890s and demagogues through the ages (Huey Long, for example) have rallied citizens to their cause by demonizing large corporations." Douglas M. Branson, Book Review, 48 CASE W. RES. L. REV. 459, 466 (1998); see also Michael H. Orbison, Note, *Vertical Restraints in the Brewing Industry: Is the Malt Beverage Interbrand Competition Act the Answer?*, 50 BROOK. L. REV. 143, 186-87 (1983) (speculating that brewers have not chosen to support the use of exclusive territories as a sound business practice because legislators are sensitive to a populist pressure against business interests). A contrary positive view of populism is that the people know best "and, as long as representatives are faithful to popular preferences, social welfare will be maximized." David A. Dana, *The Case for Unfunded Environmental Mandates*, 69 S. CAL. L. REV. 1, 11 (1995). Be that as it may, I find refreshing the following critique of too-ready criticism of populism as simply prejudice by political and academic elites. "Identifying the tradition of populism with passion and intolerance often implies a contrasting identification of elite discourse with reason and lack of prejudice, an identification that may be more imagined than deserved." J.M. Balkin, *Populism and Progressivism as Constitutional Categories*, 104 YALE L.J. 1935, 1951 n.42 (1995) (book review). Elitism versus populism in this context means "disagreement about the competence of people to handle their affairs" and transcends traditional debates between liberalism and conservatism. JEFFREY BELL, *POPULISM AND ELITISM: POLITICS IN THE AGE OF EQUALITY* 3, 5 (1992).

329. See Avery Wiener Katz, *An Economic Analysis of the Guaranty Contract*, 66 U. CHI. L. REV. 47, 104 (1999) (suggesting that the desire of populists to limit the economic power of banks contributed to the placement of restrictions on banks); John B. McCoy, *The Future of U.S. Banking: A Modest Legislative Agenda to Encourage Competitiveness*, 49 OHIO ST. L.J. 1189, 1191 (1989) (noting the presence of a "lingering populist distrust of banks that dates back to Revolutionary War times"); Roberta Romano, *The Political Dynamics of Derivative Securities Regulation*, 14 YALE J. ON REG. 279, 311 n.106 (1997) (describing bigoted populist agitation by farmers against Jews and Catholics due to antibanker sentiments).

330. See Barry E. Adler, *Politics and Virtual Owners of the Corporation*, 82 VA. L. REV. 1347 (1996) (book review) (noting that "the insurance industry [was] a favorite target of populist outrage over concentrated wealth"); Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act*

historically, railway companies³³¹), lawyers,³³² and the rich.³³³ At the worst it connotes the demagogue and the mob,³³⁴ usually with a Southern hill-country flavor.³³⁵ Populism's philosophical and even ethnic origins are, indeed, the egalitarian democracy of President Andrew Jackson³³⁶ who was of Scotch-Irish origin³³⁷ and who was a

(1993) (linking populism to the beginning of rate regulation of insurance companies by states); Mark J. Roe, *Foundations of Corporate Finance: The 1906 Pacification of the Insurance Industry*, 93 COLUM. L. REV. 639, 656 (1993) (identifying insurance companies as among the largest economic organizations to which populists were opposed).

331. See FRANK R. KEMERER, WILLIAM WAYNE JUSTICE: A JUDICIAL BIOGRAPHY 28 (1991) (noting that populist sentiment induced farmers to protest the exploitative practices of railroad companies).

332. See Gerald Caplan, *Criminal Justice in the Lower Courts: A Study in Continuity*, 89 MICH. L. REV. 1694, 1703 (1991) (recognizing that populists are "highly suspicious of lawyers"); Carrie Menkel-Meadow, *Culture Clash in the Quality of Life in the Law: Changes in the Economics, Diversification and Organization of Lawyering*, 44 CASE W. RES. L. REV. 621, 625 (1994) (analyzing the strong antilawyer sentiment which was a part of Jacksonian populism in the 1800s).

333. See Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283, 287 (1994) (mentioning "soak the rich" populism).

334. See Robert W. Gordon, *The Independence of Lawyers*, 68 B.U.L. REV. 1, 29 (1988) (advancing the point that lawyers often portray the law to their clients in a cynical fashion as "the legislation of populist demagogues"). "Until the appearance of Frederick Jackson Turner's essay on frontier democracy in 1893, the dominant historical interpretation of Jacksonian Democracy was 'as a destructive, degrading expression of the mob spirit in politics.'" Morton J. Horwitz, *Foreword: The Constitution of Change: Legal Fundamentalism Without Fundamentalism*, 107 HARV. L. REV. 32, 59-60 (1983) (quoting ALFRED A. CAVE, JACKSONIAN DEMOCRACY AND THE HISTORIANS 27 (1964)). It was Turner's essay, with its celebration of western democracy, that helped exemplify the populist era's positive attitude toward democracy. See *id.*

335. See Calvin Woodard, *Listening to the Mockingbird*, 45 ALA. L. REV. 563, 574 n.13 (1994) (describing Hugo Black as "a resolute hill country populist, stoutly refusing to join a big firm or to represent large corporations. He became a highly successful plaintiff's lawyer who delighted in taking on the 'Big Mules' of industrial Alabama.").

336. See Justice Robert L. Brown, *From Whence Cometh Our State Appellate Judges: Popular Election Versus the Missouri Plan*, 20 U. ARK. LITTLE ROCK L.J. 313, 314 (1998) (describing the radical movement toward the election of judges sparked by populism during Jackson's presidency); Barry Friedman, *The History of the Countermajoritarian Difficulty, Part One: The Road to Judicial Supremacy*, 73 N.Y.U. L. REV. 333, 382 n.189 (1998) ("Although Andrew Jackson often is seen as the figurehead for the aggressive form of populism that he championed, history suggests Jackson was as much a recipient of the democratic movement as he was its creator."); Matthew J. O'Hara, Note, *Restriction of Judicial Election Candidates' Free Speech Rights after Buckley: A Compelling Constitutional Limitation?*, 70 CHI.-KENT L. REV. 197, 207 (1994) ("In the 1830s President Andrew Jackson led a populist movement that promoted popular control over all elements of a democratic society.").

337. See DAVID H. FISCHER, ALBION'S SEED: FOUR BRITISH FOLKWAYS IN AMERICA 642-44 (1989) (reporting that Jackson came from an elite American Scotch-Irish family). See generally JAMES G. LAYBURN, THE SCOTCH IRISH: A SOCIAL HISTORY 185 (1962) (noting that Ulster Scots settled in the back country of Pennsylvania, Virginia, and the Piedmont Carolinas). The Scotch-Irish and their restless descendants moved on after their initial arrival, settling the next frontier (Tennessee and Kentucky) and then the next. Bill Gilbert, *Pioneers Made a Lasting Impression on Their Way West*, SMITHSONIAN, May 1994, at 40 (documenting the westward movement of Scotch-Irish settlers in 19th Century America); Billy Kennedy, *An Irishman's Diary*, THE IRISH TIMES, Sept. 7, 1998, at 17

frontiersman in hill-country Tennessee and a general of hill-country armies. Populism's more modern manifestation arose over a century ago as an agrarian movement³³⁸ among Texas hill-country farmers and ranchers who were also of Tennessee-Scotch-Irish (and some German) ancestry.³³⁹ While populism has, at times, displayed such demagoguery and prejudices, it also was the first American political party to propose a graduated income tax and direct election of Senators.³⁴⁰ I believe that its core message is good tax policy: equality of opportunity (horizontal equity) and distrust of aggregations of economic power³⁴¹ because of their political ability to obtain special privileges (violating vertical equity).³⁴² Taxation of private C Corporations has long been a populist concern, as is documented in Part IV below.

B. *Horizontal and Vertical Equity and Private C Inside Shelter*

For decades, national tax policy has encouraged profitable small businesses to select C Corporations as the tax entity of choice, due to the inside

338. The populist movement began in 1877 in Texas with the establishment of the Southern Farmers Alliance and culminated two years later when it endorsed the new People's Party. See KEMERER, *supra* note 331, at 27. The movement "died out as a political force . . . around the turn of the century when the Democratic Party co-opted their platform." See *id.*; see also T.R. FEHRENBACH, *LONE STAR: A HISTORY OF TEXAS AND THE TEXANS* 618-31 (1968). I find particularly apropos for this article the following observation: "The great public universities in this country must of necessity pursue multiple and partially conflicting missions. The University of Texas at Austin, as an elite public institution in a populist state, is as clear an example as can be imagined." Samuel Issacharoff, *Bakke in the Admissions Office and the Courts: Can Affirmative Action Be Defended?*, 59 OHIO ST. L.J. 669, 684 (1998).

339. See FEHRENBACH, *supra* note 338, at 286, 597 (noting that Texas north of Austin was settled predominantly from the upper South, *i.e.*, Tennessee, by "Anglo Celtic" frontier folk from mountains and forests); see also ROBERT A. CARO, *THE PATH TO POWER: THE YEARS OF LYNDON B. JOHNSON* 60 (1982) (hinting at the German heritage prevalent in central Texas).

340. See Lynn A. Baker, *Theoretical and Constitutional Issues: Comment: "They the People": A Comment on U.S. Term Limits, Inc. v. Thornton*, 38 ARIZ. L. REV. 859, 859 n.4 (1996) (describing the implementation by Progressives of causes first advocated by the Populists); Michael Kent Curtis, *Textualism and the Civil War Amendment: Two Textual Adventures: Thoughts on Reading Jeffery Rosen's Paper*, 66 GEO. WASH. L. REV. 1269, 1282 (1998) (arguing for inclusion of the Populists and Progressives in the pantheon of creators of the Constitution); Walter Dellinger, *The Legitimacy of Constitutional Changes: Rethinking the Amendment Process*, 97 HARV. L. REV. 386, 428 (1983) (recounting the role of the Populist Movement and others in the first three periods of Constitutional amendments).

341. See JULIAN E. ZELIZER, *TAXING AMERICA: WILBUR D. MILLS, CONGRESS, AND THE STATE, 1945-1975*, at 172 (1998) (indicating that populism "combined a belief in local participatory politics with an attack on concentrated power"); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 53 (1991) ("Populist sentiment against concentrations of economic power seems continuous . . ."); see also Hans A. Linde, *Introduction: Taking Oregon's Initiative Toward a New Century*, 34 WILLAMETTE L. REV. 391, 397 (1998) (tracing the evolution of populist support for direct lawmaking and its general distrust of representative government).

342. See *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 541, 548-49, 557, 565-69 (1933) (Brandeis, J., dissenting) ("Through size, corporations . . . have become an institution . . . which has brought

shelter of graduated corporate level rates on capital accumulations.³⁴³ The incentive existed even before the graduated corporate rates were introduced in 1935, because the flat inside corporate rate was so much lower than the top outside individual rate. "[I]n the year 1926 the number of copartnerships and corporations were about equal. The copartnerships have gradually gone down each year and the corporations have gone up, until in this year, the past year [1935], it has resulted in 205,000 copartnerships as against 500,000 and some corporations."³⁴⁴ By the mid-1930s, there were 450,000 active corporations (about fifty percent of which reported income, with many suffering losses from the Great Depression³⁴⁵), and there were 1.5 million proprietorships and partnerships (only 205,000 of which were partnerships). The corporations reported about \$140 billion in total gross receipts; the proprietorships and partnerships reported \$30 billion in total gross receipts.³⁴⁶ On the corporate side in the 1930s, ninety percent of the net corporate taxable income was reported by ten percent of the corporations (presumably the public and moderate income private corporations), fifty percent was reported by five hundred to six hundred corporations, and one third by sixty-seven giant corporations.³⁴⁷ The stock in these public corporations was disproportionately held by high income taxpayers. In 1936, Treasury estimated that seventy-one percent of all corporate stock was owned by individuals with more than \$25,000 in annual taxable income, with forty-five percent held by individuals with incomes in excess of \$100,000.³⁴⁸

343. See Kelvin H. Dickinson, *Partners in a Corporate Cloak: The Emergence and Legitimacy of the Incorporated Partnership*, 33 AM. U. L. REV. 559, 598 n.208 (1984) (describing tax benefits of the corporate form).

344. See 1936 Senate Hearings, *supra* note 122, at 20 (statement of Commissioner Helvering).

345. See Don Rosa & Dorothy Collins, *Statistics of Income Studies of Business Income and Taxes*, 8 SOI BULL. 81, 84 fig. D (1988) (reporting that many corporations reported no income during this period).

346. See 1936 Senate Hearings, *supra* note 122, at 20 (statement of Commissioner Helvering) (presenting the numbers of partnerships reporting net income within various income classifications); 1936 House Hearings, *supra* note 175, at 141, 427-28 (statement of Commissioner Helvering) (quoting these figures in response to questions concerning the amount of business done by copartnerships and corporations); *id.* at 890 (statement of Treasury General Counsel Oliphant) (noting that the gross sales or production of corporations was \$142 billion and the gross sales or production of individual enterprises and partnerships was \$30 billion).

347. See *supra* notes 122-24 and accompanying text; *infra* note 385 and accompanying text.

348. See 1936 Senate Hearings, *supra* note 122, at 21 (statement of Commissioner Helvering) (estimating the numbers of individuals who own stock based on the fact that "71 [percent of the increase in taxable income] would be received by individuals with net incomes of more than \$25,000 a year, and that about 45 percent [would be received] by individuals with net incomes in excess of \$100,000 a year"); *id.* at 29 (statement of George C. Haas, Director of Research and Statistics, Treasury Department) (noting that if withheld corporate earnings for the 1936 calendar year were distributed, about 45% of these would go to individuals subject to income taxes ranging from 58% to 75%); 1936 House Hearings, *supra* note 175, at 21 (statement of Commissioner Helvering) ("Our studies indicate that if corporations were to distribute to their shareholders all of their 1936 earnings.

The long-recognized phenomenon of the inside tax shelter of a private C corporation creates both horizontal and vertical inequities.³⁴⁹ Horizontal equity requires similar tax treatment of taxpayers in similar circumstances.³⁵⁰ This would mean that high income taxpayers conducting a business through a passthrough entity should bear much the same effective rate on that business income as similarly high income taxpayers conducting the same business through a private C Corporation.³⁵¹ Vertical equity requires that the burden of taxation fall upon taxpayers according to their ability to pay. This concept has been labelled progressivity or "fairness" in recent political discourse by the Democratic Party.³⁵² Currently, vertical equity is violated by high and highest

the taxable income of individuals would be increased by approximately 4 billion dollars. Of this large sum, more than 71 percent would be received by individuals with net incomes of more than \$25,000 a year, and about 45 percent would be received by individuals with net incomes in excess of \$100,000 a year."). The dollars are mid-1930s dollars probably corresponding to the top 5% and top .5% of individuals by income in present purchasing terms.

349. See Lee, *Entity Classification*, *supra* note 35, at 67-68; see also *Tax Reform, 1969: Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means (Part 4)*, 91st Cong., 1st Sess., 1592 (1969) (statement of Assistant Secretary of the Treasury for Tax Policy Stanley S. Surrey) ("Fairness it seems to me comes down to two things—one, that as between people who have different levels of income, one higher and one lower, the person with the higher income should pay a progressively greater tax [*i.e.*, vertical equity]; and, second, as between people who are at the same level of income and who are similarly situated, they should pay the same tax [*i.e.*, horizontal equity]."); Joint Committee on Taxation Staff, *Simplification I*, *supra* note 111, at 3, 14-6 (explaining that one of the factors contributing to tax complexity is the principle that "similarly situated individuals should bear similar tax burdens (horizontal equity) and that differences in ability to pay among individuals be taken into account where necessary and appropriate (vertical equity)").

350. See Allen Walburn, Comment, *Depreciation of Intangibles: An Area of the Tax Law in Need of Change*, 30 SAN DIEGO L. REV. 453, 454-55 (1993) (stating that the principle of horizontal equity means "that fairness dictates that similarly situated people should be taxed alike" because a "tax law that treats similarly situated taxpayers differently will probably be perceived as unfair and will likely lead to increased taxpayer noncompliance").

351. See Lee, *Entity Classification*, *supra* note 35, at 95, 101.

352. See Lee, *supra* note 141, at 40, 54-56 (characterizing the Clinton Administration's "fairness test" as being based on progressivity). I agree in the abstract that "the tax system should have little to do with the welfare system or safety net enacted during the New Deal." Steven A. Bank, *Origins of a Flat Tax*, 73 DENV. U. L. REV. 329, 401 (1996). However, when ideology or political necessity prevents Congress from enacting direct spending programs to keep the safety net from unraveling or to educate and train the poor so they need such a net less, I would use the tax system to provide meaningful tax expenditures for such purposes. I do not favor the current tendency to enact symbolic provisions for those purposes often targeted more at middle than lower income taxpayers, particularly when bi-partisan support is obtained by very expensive provisions primarily benefiting high income taxpayers, as was the case in 1997. See Jonathan Alter, *Hostage to the Winds*, NEWSWEEK, Aug. 11, 1997, at 29 (suggesting that "Clinton will be remembered as a president who saw widening gaps between rich and poor, and helped widen them further. If [Clinton] hadn't caved on capital gains cuts there would have been no deal," in which case the surging economy would have balanced the budget the next year instead of five years later); Clay Chandler, *Tax Cuts Across the Spectrum*, WASH. POST, Aug. 1, 1997, at A-14, available in 1997 WL 11976845 (positing that the deal rewards middle-income families with children under 17 or in higher education and households with substantial capital gains income); E.J. Dionne Jr., . . . *A Political Classic*, WASH. POST, Aug. 1, 1997, at A21, available in 1997 WL 11976841 (noting the inclination of the Democratic party to spend revenue surpluses on social

income tax bracket individual taxpayers conducting a business through a private C Corporation and thus garnering the same rate of Federal income taxation on capital accumulations as sole proprietors (who tend to be bottom income tax bracket) bear on their business income. Once, populists were concerned over violations of both horizontal and vertical equity as to partners and proprietors by use of a private C Corporation. Now their concern is likely to be only with the violation of vertical equity.

Interestingly, today the fault line between conservatives and liberals as to tax fairness is often over whether to favor horizontal or vertical equity.

During hearings in front of the Committee on Ways and Means a couple of years ago, I asked Jack Kemp, the gentleman from Texas, Mr. Dick Armey, and the gentleman from Missouri, Mr. Dick Gephardt what their definition [of fairness] was. Jack Kemp and the gentleman from Texas, Mr. Dick Armey, said, when everybody is treated the same. The definition of the gentleman from Missouri, Mr. Dick Gephardt was, based on your ability to pay.³⁵³

1. *In the Beginning Years: Focus on Horizontal Inequity.*—Over the years populist voices have railed against the inequitable subsidy of the private C Corporation inside graduated tax rates. My favorite story comes from the House Ways and Means Committee's hearings in 1936 on

programs); William G. Gale, *The Budget Deal: An Opportunity Lost . . .*, WASH. POST, Aug. 1, 1997, at A21, available in 1997 WL 11976839 (arguing that tax cuts for the wealthy, capital gains, and estate taxes will have the greatest impact in future years but are not taken into account under congressional budget calculation conventions); John B. Judis, *Rubin Sandwich*, NEW REPUBLIC, Aug. 25, 1997, at 11 (stating that the tax bill gives the top 20% over 75% of the tax benefits, with the major beneficiaries being individuals "who live in the affluent suburbs of Archer's Houston and Gingrich's Atlanta and who now vote Republican"); Robert Kuttner, *Clinton Has Stolen the GOP's Clothes; The President Has Abandoned Democratic Principles in the Pursuit of a Balanced Budget*, L.A. TIMES, Aug. 3, 1997, at M5, available in 1997 WL 2234853 (noting that although both Democrats and Republicans supported tax relief, Clinton, rather than the Republicans, made sacrifices to achieve a balanced budget); Wendell Primus, et al., *The Impact on Families in Different Income Categories of the Tax and Entitlement Changes Approved by House Committees*, TAX NOTES TODAY, June 25, 1997, available in Westlaw at 1997 TNT 122-20 (explaining that a disproportionate amount of the benefits from the House-committee-approved tax entitlement changes would help wealthier taxpayers); Leo Rennert, *Wealthiest Americans the Victors in New Tax Bill*, DENV. ROCKY MOUNTAIN NEWS, Aug. 3, 1997, at 12G, available in 1997 WL 6848725 (noting that the top 1% will receive more than 32% of the tax cuts, an average yearly tax cut of \$16,200, as contrasted with an average yearly tax cut of \$148 for median income families); Robert J. Samuelson, *Good Theater, Bad Policy*, WASH. POST, Aug. 6, 1997, at A-19, available in 1997 WL 12880043 (postulating that the budget windfall was devoted mostly to tax cuts and new spending exhibiting "enormous contempt for the public's intelligence and integrity"); Robert Scheer, *Congress Giveth and Congress Taketh Away; The Tax Changes Pit One Generation Against Another, and Only the Rich Come out Winners*, L.A. TIMES, Aug. 5, 1997, at B7, available in 1997 WL 2235406 (deriding the agreement for enabling the wealthy to benefit from the lower capital gains tax at the expense of lower-income families).

353. 143 CONG. REC. H10,035 (daily ed. Nov. 5, 1997) (remarks of Rep. Ensign).

President Franklin Delano Roosevelt's ill-fated undistributed profits tax, which would have reduced the inside corporate tax base by dividend payments.³⁵⁴ This was an integration provision intended to force out as dividends otherwise low-taxed (12.5% to 15%) corporate profits so they would go through the individual high "tax mill" (which again had been raised to seventy-five percent at the top).³⁵⁵ In 1936, the Supreme Court had overturned an agricultural consumption tax with revenue yields of almost fifty percent of the individual income tax revenue (or of the corporate sector revenue, since the two sector's revenue yields were then equal).³⁵⁶ President Franklin Roosevelt proposed to replace this revenue by enacting an undistributed profits tax.³⁵⁷ The proposed rate turned on the percentage of net income retained, but the base consisted of both the undistributed and distributed income, with no shareholder level credit upon any later actual distribution of income already taxed inside the corporation.³⁵⁸

Since most, but not all, publicly traded corporations then paid out, on the average, dividends equal to about seventy to seventy-five percent of

354. See *infra* note 357 and accompanying text.

355. See 1936 *House Hearings*, *supra* note 175, at 341 (statement of Rep. Hill); 1936 *Senate Hearings*, *supra* note 124, at 4 (statement of Treasury Secretary Henry Morgenthau, Jr.); *accord*, 1936 *Confidential Senate Hearings (Part 1)*, *supra* note 124, at 11 (statement of Commissioner Helvering). For inside corporate rates see *infra* note 414 and accompanying text. For outside individual rates see Pub. L. No. 74-407 § 101, 49 STAT. 1014, 1015 (1935).

356. See *United States v. Butler*, 297 U.S. 1 (1936) (declaring portions of the Agricultural Adjustment Act of 1935 unconstitutional as improper applications of Congress's taxing authority); see also Message from the President of the United States Transmitting Additional Information Concerning the Budget for the Fiscal Year 1937, H. DOC. NO. 418, 74th Cong., 2d Sess. (1936), reprinted in 1936 *House Hearings*, *supra* note 175, at 2; 1936 *House Hearings*, *supra* note 175, at 33 (statement of A.S. McLeod, Treasury Statistician) (estimating, for 1936, \$1,132,000,000 in corporate tax revenue and \$1,153,000,000 in individual income tax revenues); *id.* at 17 (statement of Commissioner Helvering) (suggesting that \$500 million annually was needed to take the place of such agricultural consumption taxes); 1936 *Senate Hearings*, *supra* note 122 at 2 (statement of Treasury Secretary Morgenthau) (reporting that \$517 million in revenue was lost with invalidation of Agricultural Adjustment Act or "Triple A").

357. Compare 1936 *House Hearings*, *supra* note 175, at 2-4 (letter by President Franklin D. Roosevelt) (recommending legislative actions to counteract the loss of revenue caused by the overturning of certain provisions of the Agricultural Adjustment Act of 1935), with *id.* at 33-34, 36 (statement of A.S. McLeod, Treasury statistician) (discussing revenue-raising estimates for various options under consideration by Congress); *accord* S. REP. NO. 74-2156, at 1-3 (1936) (reporting favorably on the revenue bill, with reference to the President's message to the House of Representatives).

358. See 1936 *House Hearings*, *supra* note 175, at 6, 9 (recommending that the Ways & Means Committee adopt corporate tax rate schedules with rates increasing along with the percent of undistributed income, but also recommending relief for corporations that have insufficient accumulated earnings to distribute dividends even though they have net income for the year); *id.* at 53 (defending the fairness of the president's proposed plan, and criticizing the committee's recommendations); *id.* at 278 (opposing the "burdensome double taxation" of the proposal that a shareholder receiving dividends would get no credit for taxes already paid on corporate earnings).

current earnings, and since the proposed undistributed profits tax would be triggered by accumulations above thirty percent of current income for larger corporations and forty percent for smaller corporations, the true target of that tax was high income private corporations that did not pay out much of their earnings.³⁵⁹ An example recognized in the 1920 discussion of a similar undistributed profits tax proposal seems to have been Henry Ford and the then private Ford Motor Company.³⁶⁰ Another instance (not then recognized) was the author of the Tarzan series who formed Edgar Rice Burroughs, Inc., in 1923, in part to lower personal income taxes, "which in recent years had taken a sizable bite out of his six figure earnings."³⁶¹

Not only was the far simpler approach of corporate-shareholder integration thought barred by *Eisner v. Macomber*,³⁶² but a hidden agenda for this "roundabout device,"³⁶³ was to force out dividends in order to

359. See 1936 House Hearings, *supra* note 175, at 49 (exchange between Reps. Hill and Cooper) (agreeing that corporations retain approximately 25% to 30% of earnings); 1936 Confidential Senate Hearings, *supra* note 124, at 108 (statement of A.S. McLeod, Treasury Statistician) ("[A] considerable part of that income comes from large income, closely held corporations.").

360. See Revenue Revision: Hearings Before the House Comm. on Ways and Means, 66th Cong. 15 (1920) (statement of Ways and Means Chair Fordney) [hereinafter 1920 House Hearings] (using an example of a man in Michigan who through his private C Corporation "added many million dollars' worth of additions to his plant, invested several million dollars, and, of course, employ[ed] a large number of men," but with an income of \$30,000,000 to \$50,000,000 a year "he did not pay taxes on an income of more than \$4,000,000"). Senator Hugo Black, D-Ala., specifically referred to Mr. Morgan [apparently of J.P. Morgan & Co.], who paid no income taxes although his corporations were very profitable and he was very wealthy. See 1936 Senate Hearings, *supra* note 122, at 21, 159 ("You have read where one man who [sic] everybody knew was very wealthy has paid no income tax at all, even though the corporations through which he did business . . . made profits, Mr. Morgan . . ."). Actually, as the widely publicized Pecora Hearings had just disclosed in 1934, partners in the "House of Morgan" partnership paid no income taxes in 1930 and 1931 due to the then capital loss rules (under which 12.5% of net capital losses offset ordinary income). See John Lee, *Partnership Profits Share for Services: An Aggregate Exegesis of Revenue Procedure 93-27 (Part 1)*, 62 TAX NOTES TODAY 1733, 1754 (1994), available in WL at 94 TNT 61-27.

361. JOHN TALIAFERRO, *TARZAN FOREVER: THE LIFE OF EDGAR RICE BURROUGHS, CREATOR OF TARZAN* 188 (1999).

362. 252 U.S. 189, 207-08 (1920) (emphasizing that a stock dividend is not taxable income in the constitutional sense because income "derived from capital" has to be "received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal. . . . Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise . . ."). It is commonly thought that the Supreme Court has since abandoned the constitutional realization requirement enunciated in *Eisner v. Macomber*. See Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 ILL. L. REV. NW. U. 779, 793, 781-94 (1941) ("*Eisner v. Macomber* was both the first and the last decision declaring an application of the income tax unconstitutional under the Sixteenth Amendment."). But cf. Henry Ordower, *Revisiting Realization: Accretion Taxation, the Constitution, Macomber, and Mark to Market*, 13 VA. TAX REV. 1 (1993) (re-examining the conclusions of Surrey and others about the realization doctrine).

363. 1936 House Hearings, *supra* note 175, at 193 (statement of Rep. Lewis) ("I do not know that it is fully understood by the public that this roundabout device of compelling the distribution of the real income of the corporation to its shareholders . . . is due to a decision of a divided court."); see also

break up large concentrations of capital.³⁶⁴ Integration in the form of a shareholder level tax on imputed corporate income and repeal of corporate level taxes would not have advanced this latter purpose as well as an undistributed profits tax giving an inside deduction for dividends paid.

Senator Tom Connally, D-Tex., and other members of the tax writing committees, fully understood at the time the inside shelter of corporations.³⁶⁵ Furthermore, Commissioner Helvering explained to them that high income shareholders could “reduce their taxes by taking part of their income in the form of so-called capital gains” after their corporations had retained income for a number of years, taxed inside at low rates and thus enhancing the value of the stock.³⁶⁶ The Commissioner viewed this as a violation of ability to pay. “It is inequitable and it is a source of great loss to the public revenues to permit the corporate form to be used by wealthy persons to avoid graduated

Internal Revenue: Hearings on H.R. 8245 Before the Senate Comm. on Finance, 67th Cong. 9-10, 15 (Confidential Comm. Print 1921) (statement of Dr. T.S. Adams, Tax Adviser, Treasury Department, and father of the Revenue Act of 1921, the first modern revenue act) [hereinafter *1921 Confidential Senate Hearings*] (expressing how it would arguably be unconstitutional to tax personal-service corporations as partnerships under *Eisner v. Macomber* because the government would be taxing shareholders on the undistributed profits of corporations). An undistributed profits tax passed the Senate in the Revenue Bill of 1924, H.R. 6715, 68th Cong. (1924), but was rejected by the Conference Committee and thus not enacted by Congress. See *1936 Senate Hearings*, *supra* note 122, at 13, 16 (statement of Commissioner Helvering). This provision was even more clearly intended as a means of circumventing *Eisner v. Macomber*, since it permitted shareholders of a corporation subject to the undistributed profits tax to elect to be taxed as partners, in which case the corporation was not subject to the corporate tax. See H.R. 6715, 68th Cong. § 228 (1924).

364. See *infra* note 375 and accompanying text.

365. See *1936 Senate Hearings*, *supra* note 122, at 27-28 (statement of Sen. Connally) (“[U]nder the existing law the operation is really favorable to corporate incomes as against individual incomes, against individuals who might be engaged in the same business.”). Commissioner Helvering had just stated that the increased revenues from the proposed undistributed profits tax would come not from the corporate level tax on undistributed profits, but instead from the increased individual level taxes on the dividends forced out.

[The increased revenue] comes primarily from stockholders already enjoying large incomes who would pay higher taxes on their incomes as these incomes are increased by additional dividend distributions. It would come in other words, primarily from those who are now able to avoid their just share of the burden of income taxation by holding income-producing property in the corporate form, and having their corporations retain very large proportions of these earnings subject only to the ordinary corporation income tax. It is inequitable and it is a source of great loss to the public revenues to avoid graduated individual income surtaxes.

Id. at 24 (statement of Commissioner Helvering).

366. See *id.* at 22-23 (“What this means in simple terms is the privilege of reinvesting earnings without the payment of surtaxes upon them, a privilege of very great monetary value . . .”). Individual capital gains were then taxed under a sliding scale dependent upon the holding period much lower than ordinary income tax rates with a maximum rate of 20.1% at the highest ordinary income tax bracket after a ten year holding period. See *Lee, Capital Gains Proposals*, *supra* note 35; *Lee*,

individual income surtaxes.³⁶⁷ Rather than selling the appreciated stock, the taxpayer could hold it until death so that a stepped up (to then fair market value) basis under the predecessor to section 1014 avoided the second level of taxation altogether. "Thus, no special compensation is received by the Federal Government for the loss in revenues suffered during the lifetime of the owner by reason of his use of the corporate form."³⁶⁸ Concrete examples in Executive Session also brought this inside sheltering home to populist Senators Connally and Robert La Follette, R-Wis.³⁶⁹

General Counsel Herman Oliphant stated well the underlying tax policy in the House Ways and Means Committee Hearings: "[B]usiness profits, by whomever derived and from whatever form of business derived, should all bear the same tax burden, just because it is right"³⁷⁰ Democratic members of the House Ways and Means Committee expressly articulated that an undistributed profits tax served to eliminate the then preference in the tax law for small income private corporations over partnerships and proprietorships with equal income.³⁷¹ House Ways and Means Chair Bob Doughton, a Democrat from Alleghany County in the Blue Ridge Mountains of northwest North Carolina, held long and grueling hearings in which virtually no one supported FDR's proposal.³⁷² He seems to have lost his temper when an opponent of the proposal evoked the image of a "small fellow" beginning to grow, and then getting a helper

367. 1936 *Senate Hearings*, *supra* note 122, at 24 (statement of Commissioner Helvering).

368. *Id.* at 20 (statement of Commissioner Helvering); *see also* 1921 *Confidential Senate Hearings*, *supra* note 363, at 307 (statement of Sen. Reed) (relating an anecdote of a publisher with a multimillion dollar building who would rather give it to posterity than sell with 80% of the profits going to the government).

369. *See* 1936 *Confidential Senate Hearings*, *supra* note 124, at 17-18 (statements of Sens. Connally and La Follette) (discussing the tax advantages enjoyed by a shareholder of Great Western Sugar Co., which had a total annual income of \$7 million but paid no dividends).

370. 1936 *House Hearings*, *supra* note 175, at 607 (statement of Herman Oliphant, General Counsel, Treasury Department).

371. *See id.* at 341 (statement of Rep. Hill) (emphasizing that the undistributed profits tax would "put all the money earned in enterprise through the tax mill on a comparable basis"); *id.* at 139, 470-71, 799-800 (statements of Rep. Doughton) (pointing out the importance of the undistributed profits tax to eliminate the preferential tax treatment of corporations). Opponents argued that very few partnerships earned as much as the larger corporations (except for professional or securities partnerships). *See* 1936 *Senate Hearings*, *supra* note 122, at 158 (statement of R.C. Fulbright, representing the Southern Pine Association). There were 833 partnership returns filed for 1935 showing net income of \$100,000 or more and 178,419 reporting less. *See id.* at 20 (statement of Commissioner Helvering).

372. There was actually controversy as to whether only two or only three witnesses supported the proposal. *Compare* 1936 *House Hearings*, *supra* note 175, at 800 (statement of Rep. Woodruff) (observing that only two witnesses favored the proposal, one a government employee and the other a Communist), *with* H.R. REP. NO. 2475 (1936) (relating that only three witnesses testified in support of the proposed system). For the actual testimony of the witnesses, *see* 1936 *House Hearings*, *supra* note 175 at 432, 597-99.

“and that is the way the life of industry continues.”³⁷³

THE CHAIRMAN. Of course, every man in business, every corporation, or every individual [sic] engaged in business, think they would grow more rapidly, and probably could, if they had no expenses; but the support of the Government is necessary and a proper expense of business, on those who make money. Now, they should be placed on the same level, should they not? The corporation[s], those engaging in business in a corporate form, have an advantage, over the individual, the partnership; a decided advantage. They have an advantage in many ways, but the special advantage they have is that they have a larger amount of capital with which to do business, and the larger the capital is, the stronger the organization they can perfect, and the more they can have of mass production; and they can organize a more extensive sales agency. They have an advantage in both production and in distribution that the man of small means does not have.

MR. WALTERS. That helps everybody.

THE CHAIRMAN. Why should we still give them another advantage in the matter of taxes? In that way, the big man can always keep the little fellow down and prevent his ever getting on his feet. . . . Should not all have an equal start? . . . You want to cripple him, start him out at a disadvantage, start him with the other fellow miles ahead of him, and then expect him to keep up in the race.³⁷⁴

Note the focus of Chairman Doughton on the advantage of big capital to the large corporation; a central idea was to force out current income, reducing concentrations of capital.³⁷⁵ While Treasury listed horizontal

373. 1936 House Hearings, *supra* note 175, at 343 (statement of G.L. Walters, representing the Illinois Manufacturers Association).

374. 1936 House Hearings, *supra* note 175, at 343-44; *see also* citations to passages in the Hearings in note 353 *supra*; Revenue Revision, 1938: Hearings Before the House Comm. on Ways and Means, 75th Cong. 420 (1938) [hereinafter 1938 House Hearings] (statement of Chairman Doughton) (suggesting that there is “no reason why [profitable corporations] should not pay taxes now”). The sophistication of Chairman Doughton’s sentiments may be seen by comparing Justice Brandeis’s contemporaneous dissenting opinion in *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 541, 548-49, 557, 565-69 (1933) (expressing his desire to preserve small, independently-owned businesses facing the threat of competition from large chain stores, and his associated concerns about inequities in wealth and opportunity). For Chairman Doughton’s sentiments on ability to pay, *see also* 1938 House Hearings, *supra*, at 420 (making light of the notion that a corporation’s years of past “sacrifice” to create a large investment, which is not generating tremendous profits, should be considered a reason for not taxing the profits of corporations).

375. *See* 1936 House Hearings, *supra* note 175, at 193 (statement of Rep. Hill) (“[T]his would rather encourage them to pay out their net earnings.”); *id.* at 193 (statement of Rep. Lewis) (referring to a “roundabout device of compelling the distribution of the real income of the corporation to its

equity between partnerships and sole proprietorships and corporations first on its list of policy reasons for the undistributed profits tax,³⁷⁶ its true first goal appears to have been vertical equity: running all corporate sector income through the individual (steeply progressive) "tax mill" one time.³⁷⁷

Members of Congress made similar observations as to a similar tax on undistributed profits proposed in 1920 by Secretary of the Treasury Houston to equalize tax treatment of corporations with partners-proprietors.³⁷⁸ The next year, the new Secretary of Treasury under the Republican Harding Administration, Andrew Mellon, while acknowledging "an inequality in cases of partnerships," opposed an undistributed profits tax because "it would have a bad effect on industry, and on the dividend policy of corporations."³⁷⁹ Populist Representative John Nance, "Cactus Jack" Garner (D-Tex.), surely was not surprised at this melon-headed

shareholders, so that the shareholders may be called upon to pay taxes upon their income"); *id.* at 321 (statement of Rep. Hill) ("[W]e cannot reach the net earnings of the corporation as earnings of the individual stockholders until the earnings are distributed as dividends."); *id.* at 341 (statement of Rep. Hill) (discussing the advantages of "amassing larger amounts of money for carrying on business"); *id.* at 581 (statement of Arthur H. Kent, Acting Chief Counsel, Bureau of Internal Revenue) (noting that one of the main criticisms of the revenue act is that "such a tax will prevent corporation management from accumulating reserves for a rainy day or for purposes of plant and business expansion"). A minority Republican member of the Committee noted the partisan nature of the Committee. *See id.* at 298 (statement of Rep. Treadway). Representative Daniel A. Reed, R-N.Y., "wondered" where the pressure in connection with the distribution of net profits was coming from and quoted a passage from Rexford G. Tugwell, *The Industrial Discipline and the Governmental Arts* (1933), advocating governmental forcing of "corporate surpluses into the open investment market." *See 1936 House Hearings, supra* note 175, at 42. Rexford G. Tugwell was one of the original Roosevelt "Brain Trusters" temporarily leaving academia to serve in Government (as the Undersecretary of Agriculture from 1934 to 1937). For a discussion of the influence of his and other Brain Trusters' works upon the evolution of business-government cooperation theories in the early 1930s, see WILLIAM E. LEUCHTENBURG, *FRANKLIN D. ROOSEVELT AND THE NEW DEAL* 34-35 (1963).

376. *See 1936 House Hearings, supra* note 175, at 19 (statement of Commissioner Helvering).

377. *See id.* at 793 (statement of Rep. Hill) ("This whole proposal is based upon the proposition that every dollar of earnings in the taxable brackets should go through the tax mill, whether it is earned by a corporation or by an individual, and it should be on a comparable basis as between the two."); *accord, id.* at 193 (statement of Rep. Lewis) (referring to a "roundabout device of compelling the distribution of the real income of the corporation to its shareholders, so that the shareholders may be called upon to pay taxes upon their income"); *id.* at 321 (statement of Rep. Hill) ("[W]hat we are seeking to do here is to subject all income, both of corporations and individuals, to practically the same basis for tax purposes."); *1936 Confidential Senate Hearings, supra* note 124, at 12-13 (statement of Commissioner Helvering) ("And the whole thing is based on the equity of all the money either being paid on a rate comparable to the rates paid by the taxpayers, going through the tax mill, either by the corporation or the shareholder, and that is where the equity of the bill comes through.").

378. *See 1920 House Hearings, supra* note 360, at 26 (statement of Chairman Fordney); *id.* at 22 (statement of T.S. Adams) ("If you desire to retain a progressive income tax, then you must impose an additional tax on corporations to compensate for the surtaxes as applied to individuals.").

379. *Hearings on Internal-Revenue Revision Before the House Comm. on Ways and Means Together with Certain Portions of the Proceedings of the Comm. in Executive Session, Indexed*, 67th Cong. 403 (1921) [hereinafter *1921 House Hearings*].

opposition to the undistributed profits tax by his and other populists' arch-nemesis for the next dozen years.³⁸⁰

Senate Finance Committee member Senator Hugo Black (D-Ala.), well known as a populist,³⁸¹ also raised the policy of tax equity between sole proprietorships and partnerships on the one hand and corporations on the other, noting that "the natural tendency . . . has been a very coercive influence in causing people to organize corporations."³⁸² Commissioner Helvering confirmed that there had been a substantial shift from the partnership form to the corporate form over the preceding decade (from a 1:1 ratio of partnerships to corporations in 1926 to two to five ratio in 1935).³⁸³ Some members of Congress, including Senator Tom Connally

380. See 61 CONG. REC. 8,073 (1921) (remarks of Rep. "Cactus Jack" Garner, ranking minority member of the House Ways and Means Committee, subsequent Speaker of the House, and Vice President during President Roosevelt's first two terms) (criticizing the Treasury Department's view of taxation designed "to relieve the heavy taxpayer from his taxes and continue the taxes upon the masses of the people"); 65 CONG. REC. 3,031-32 (1923) (remarks of Rep. Lankford) (expressing his opposition to the "real Mellon plan" with an extended ditty that begins "Tax the people, tax with care, tax to help the millionaire . . ."); H.R. REP. NO. 68-179, at 82, 77-82 (1924) (presenting the minority views of 11 Democratic members of the House Ways and Means Committee, who asserted that "[t]he proposed Mellon bill is drawn for the purpose of giving principle [*sic*] relief to the large taxpayer and our plan is based upon giving relief to all income taxpayers, but the larger percentage of relief to the small taxpayer"); John Lee, "Death And Taxes" and Hypocrisy, 60 TAX NOTES TODAY (1993), available in WL at 93 TNT 188-43 (concluding that "[i]n short, the 1920s (and the 1930s as well) saw consumption taxes on the masses and both nominally and decreasingly progressive income taxes on only the rich and well-to-do" because of the various revisions to the Revenue Act of 1921 effectuated by Mellon).

381. Senator, and later Justice, Hugo Black was a native of the Alabama hill country, often describing himself as "just a Clay County hillbilly." Woodard, *supra* note 335, at 573-74 n.13. He established a highly successful personal injury law practice in Birmingham, refusing to join a big law firm or to represent large corporations and instead delighting in taking on the "big Mules" of industrial Alabama. See *id.* Black next was a self-styled populist political candidate, who attacked banking and corporate interests, was committed to improving the lives of all of his working class constituents, and "instinctively shied away from manipulating the race issue" (two years before the 1925 Senate race he had joined the Ku Klux Klan, which almost kept him off the Court). Dan T. Carter, "Let Justice Be Done": Public Passion and Judicial Courage in Modern Alabama, 28 CUMB. L. REV. 553, 563 (1998); James F. Simon, *Judging the Justices*, 49 STAN. L. REV. 173, 174 (1996) (book review).

[N]o one—not even Roosevelt—gave much, if any, thought to how . . . [Hugo Black's] populist upbringing, uncommon drive and intellect, and experiences as a county prosecutor, police court judge, highly successful trial and appellate lawyer, and senator (who had from 1928-1936 been an active member of the Senate Judiciary Committee) would shape his performance on the Supreme Court.

Michael J. Gerhardt, *The Art of Judicial Biography*, 80 CORNELL L. REV. 1595, 1642 (1995) (book review). Immediately following his appointment to the Court, Justice Black "shocked the legal world by a series of unrestrained populist dissents." David P. Currie, *The Constitution in the Supreme Court: The Second World War, 1941-1946*, 37 CATH. U. L. REV. 1, 1-2 (1987).

382. 1936 Senate Hearings, *supra* note 122, at 20; see also 1936 Senate Hearings at 144 (statement of Sen. Black) ("Now, as a matter of fairness, no system should be permitted to stand . . . if it gives certain individuals an exceptional rate by reason of their investment in a corporation and a much higher rate on income from individual investment . . ."); *id.* at 128 (statement of Chairman Harrison) ("Does it not appear . . . that it is a fair thing from a governmental standpoint that a corporation should not be put in a more favorable position than an individual in paying taxes?").

383. See 1936 Senate Hearings, *supra* note 122, at 20.

(D-Tex.), acknowledged the response by saying that the business person could incorporate.³⁸⁴

The mood of Senate Finance Committee Chair Senator Pat Harrison (D-Miss.), was "to get the matter out of the way," and coming to realize the "90:10 phenomenon," (that ninety percent of corporations report less than ten percent of the corporate income), he suggested that the ninety percent earning less than \$15,000 not be subject to the undistributed profits tax.³⁸⁵ In the end, the Senate Finance Committee abandoned principle in favor of a compromise of retaining the inside corporate income tax (which, along with the much lesser capital stock and excess profits taxes, the House and Administration would have replaced with a heavy undistributed profits tax), and instead called for a two-tier undistributed profits tax with much lower rates than proposed and especially low rates on small income corporations.³⁸⁶ The Senate view prevailed in conference.

Ironically, even the greatly watered down undistributed profits tax did force out dividends in 1937, thus reducing the potential corporate level undistributed profits tax revenues, but many high income individuals avoided outside taxation on such dividends through personal holding companies and other "clever little schemes," in FDR's words.³⁸⁷ Some shareholders undoubtedly simply evaded the outside taxes by not reporting the dividends.³⁸⁸ In any event, implacable opposition of management, the

384. See 1936 Senate Hearings, *supra* note 122, at 132; cf. 1936 House Hearings, *supra* note 175, at 75 (statement of Melville F. Weston, representing Raymond-Whitcomb, Inc.) ("[A]ny individual who considers the corporate structure better adapted to their type of business, more suitable to level out the fluctuations of income, can incorporate."). Senator Connally's apparent preference, however, was that private corporations pay the same as individuals "instead of making them [*i.e.*, individuals] incorporate." 1936 Senate Hearings, *supra* note 122, at 258 (statement of Sen. Connally).

385. 1936 Confidential Senate Hearings, *supra* note 124, at 38, 42 (statement of Chairman Harrison).

386. Compare 1936 House Hearings, *supra* note 175, at 21 (statements of Commissioner Helvering) (testifying that the President's proposal was more fair than the tax law in force at the time, particularly to lower income shareholders), with S. REP. NO. 74-2156, at 4 (1936) (recognizing imperfections in existing tax law, but citing "fundamental defects" in the House Bill that would unduly penalize corporations).

387. Message from the President of the United States, *Tax Evasion and Evaders*, 75th Cong., 1st Sess. 6 (H. Doc. 260 1937) ("'Clever little schemes' are not admirable when they undermine the foundations of society."); see also 1936 Confidential Senate Hearings (Part 2), *supra* note 124, at 108 (statement of McLeod, Treasury Statistician) (stating that, under existing law, minority shareholders of large corporations were able to place their stock in the principal corporation in another corporation, such as a personal holding company, thereby escaping taxation).

388. See 1920 House Hearings, *supra* note 360, at 60 (statement of Rep. Green) (suggesting that greater dividends paid as a result of then proposed undistributed profits corporate tax might not be reported by shareholders notwithstanding Form 1099 reporting, which in fact was not effective for another six decades or so until computerized matching); cf. 1936 House Hearings, *supra* note 175, at 47 (statement of Rep. Woodruff) (predicting correctly that little revenue would be raised by the proposed tax bill). In Executive Session in 1936, A. S. McLeod, Treasury Statistician, initially claimed that Treasury had a record of how much cash dividends were paid to individual shareholders, who actually received them, and the income bracket in which they fell, but actually it did not have such a

revenue shortfall, and the second crash of Wall Street and return of the Great Depression led to the gutting of the already weak undistributed profits tax in 1938 and to its repeal in the Internal Revenue Code of 1939.³⁸⁹ All that remained of the undistributed profits tax was the model for a preferential rate or credit for small income corporations, which became the federal corporate income tax small net income base subject ultimately to a preferential rate of only fifteen percent.³⁹⁰

2. *In the Middle Years: Focus on Inside "Ultimate" Tax Shelter.*—Four decades later, when public³⁹¹ and private C Corporations rejected President Jimmy Carter's well-intentioned calls for corporate-shareholder integration, Secretary of the Treasury Mike Blumenthal passionately testified against tax shelters before a Senate Finance Committee, describing private C Corporations as

a device already advertised widely as the 'ultimate tax shelter', thus a] graduated corporate rate structure raises troubling questions of tax equity. . . . [I]ndividual owners of closely-held corporations . . . are generally in higher income tax brackets than the owners of publicly-held companies. . . . To many owners of closely held corporations, the corporate tax income tax—far from being an additional burden—is actually a relief from taxes which they would otherwise pay if all of the income of their corporation were attributed directly to them.³⁹²

Hearings, *supra* note 124, at 97, 134. Furthermore, repeated probing by Senator Harry Flood Byrd (D-Va.), who was strongly opposed to the proposed undistributed profits tax as to specific large corporations, made it painfully clear that Treasury had not done its homework and often could not tell who received dividends or how much except as to particularly large shareholders in very large corporations. See *id.* at 8-9, 21-22, 35 (statements of Deputy Commissioner Charles T. Russell).

389. Pub. L. No. 75-377, 50 STAT. 813; Pub. L. 75-554, 52 STAT. 447 (1939) (reprinting testimony of numerous business owners as to the undistributed income tax's extremely detrimental effect on profitability). The indices to the 1938 House and Senate hearings reveal that the undistributed profits tax was the most frequent topic of witnesses. For examples linking the tax with lessened revenues and the second stock market crash in 1937, see *Hearings on H.R. 9682, Revenue Act of 1938, Before the Senate Finance Comm.*, 75th Cong., 3rd Sess. 22, 26, 105, 127, 135, 180, 228, 233, 565, 593, 651 (1938); *Hearings Before the House Ways and Means Comm. on Revenue Revision, 1938*, 75th Cong., 3rd Sess. 298-99, 484-85 (1938) and also *Report of a Subcomm. of the House Ways and Means Comm. on a Proposed Revision of the Revenue Laws*, 75th Cong., 3rd Sess. 2-5 (1938).

390. See Pub. L. No. 74-740, § 14(a)(1), 49 STAT. 1648, 1656; *1936 Senate Hearings*, *supra* note 122, at 36-37 (statement of George C. Haas, Director of Research and Statistics, Treasury Department); *infra* notes 415-67 and accompanying text.

391. *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the House Comm. on Ways and Means*, 95th Cong., 2d Sess. 94, 95, 102, 468-88 (1978) [hereinafter *1978 House Hearings*] (statement of W. Michael Blumenthal, Treasury Secretary) (defending the President's proposal which retained the double taxation of corporate dividends, in favor of reducing corporate tax rates); *id.* at 6144-51 (statement of Professor Michael J. Graetz) (analyzing the opposition by corporations to the President's integration proposal).

392. *Id.* at 94-95 (statement of W. Michael Blumenthal); see also TAX EXPENDITURES

Why else do you think that adequately tax advised private C Corporations were then, and are still, formed?³⁹³ Why else did Congress fashion the tax law this way?³⁹⁴

3. *In the Present Years: Focus on Vertical Inequity.*—Citizens for Tax Justice well illustrates the vertical inequity today, from a populist perspective, of the corporate graduated rates inside tax shelter in Hidden Entitlements.

Although the special lower corporate tax rates are purportedly designed to help the little guy, they are of no benefit at all to the vast majority of business owners who make less than about \$60,000. Since married business owners stay in the 15 percent personal income tax bracket until about that level, they get no tax advantage from incorporating and paying the lower corporate rate rather than not incorporating and simply paying taxes on their profits as individuals.

. . .

shelter, benefitting high-income owners of small corporations); STAFF OF SENATE FINANCE COMM., 98TH CONG., PRELIMINARY REPORT ON THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS 88 (Comm. Print 1983) (stating that "present law often leaves taxpayers better off, on balance, than they would be if no corporate level tax were imposed").

393. See Lee, *supra* note 147 (observing how, when compared to the income tax rates applicable to alternative business forms, the "ridiculously low graduated bottom corporate [tax] rate" prompts many entrepreneurs to incorporate their businesses rather than operate them as sole proprietors or partnerships); 1936 *Senate Hearings*, *supra* note 122, at 160 (statement of Sen. Black) (noting, incredulously, that "it is true the corporation has been used as a device to keep from paying as much tax as they would have to pay doing business as a partnership or individual"); *Proposed Revenue Act of 1921: Hearings Before the Senate Finance Comm.*, 67th Cong. 453 (1921) [hereinafter *1921 Senate Hearings*] (statement of Robert M. Miller, formerly Solicitor of Internal Revenue) (warning that with outside individual rates proposed to remain as high as 40%, "it is clear that some balancing tax must be put on corporations, so as to avoid forcing all businesses to incorporate"). The outside individual rate initially was reduced from 72% to only 50%, no balancing tax was imposed, and such a general shift did occur. See *supra* note 382 and accompanying text.

394. Cf. Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 327 (1995) (noting that federal corporate tax structure was created in response to what managers want). Professors Arlen and Weiss also fall into the double taxation of private C Corporations briar patch. See *id.* at 346-47. I have long suspected that the corporate tax and capital gains tax structure were deliberately designed by Secretary Mellon in 1921 to preserve the appearance of progressive individual rates while making a "faree" of them. Cf. WALTMAN, *supra* note 174, at 98-99 (suggesting that the Revenue Act of 1921 represented the "beginnings of the use of symbolism in the [tax] rates"); 65 CONG. REC. 2085 (1924) (remarks of Rep. Mills). Representative Mills railed against high ordinary rates when high income taxpayers could invest in tax exempt income bonds (because the capital could better be invested in corporate America than in things like schools and roads). On the other hand, he favored preferential treatment of capital gains (which did make a farce of progressivity). Mills had practiced tax law in New York and later was to be the last Secretary of the Treasury under President Hoover. See Lee, *supra* note 380. He admitted in a congressional grilling at the beginning of the Great Depression that the individual federal income tax of the day was a class tax and the masses were subject to the heavier excise-consumption taxes. See *id.*; see also *infra* note 504.

But the lower corporate rates on smaller businesses do benefit well-off business owners, who routinely split their incomes between the personal and corporate rate schedules to minimize their tax rates. For example, a business owner with \$200,000 in total income can save \$9,200 in taxes compared to what he'd owe under the regular personal income tax by paying himself a salary of \$125,000 and keeping the remaining \$75,000 in his corporation. A business owner making \$500,000 can cut his taxes by \$16,400 by arranging to have 20 percent of his income taxed at the reduced corporate rates.³⁹⁵

Citizens for Tax Justice's clever exposure of the low effective rates of the corporate giants in the early 1980s provided the political and rhetorical fuel for the Tax Reform Act of 1986.³⁹⁶ The 1986 Act was President Ronald Reagan's now largely eroded great compromise of lower rates, which were to be paid for by broadening the base, but which were actually paid for, in large parte, by increasing the deficit.³⁹⁷ Senator Bill Bradley (D-N.J.), the conceptual father of that compromise, opposed President Bill Clinton's 1993 rate hike on high income individuals³⁹⁸ which, as he predicted, ultimately led to the 1997 restoration of a capital gains rate cut.³⁹⁹ The capital gains rate cut primarily benefited high income individuals.⁴⁰⁰ Bradley implicitly laid the blame for pulling the string that began the unraveling of the compromise at the feet of President George Bush who had "pushed, pushed, pushed, pushed, pushed" for a special capital gains cut without an ordinary rate increase from 1988 to 1992.⁴⁰¹

Citizens for Tax Justice asserts that most non-farm sole proprietors are taxed at the fifteen percent individual bracket.⁴⁰² Thus, it correctly points out that there is no major tax incentive for them to incorporate to use the graduated inside corporate rates also starting at fifteen percent on

395. Robert S. McIntyre, Director of Citizens for Tax Justice, *The Hidden Entitlements*, TAX NOTES TODAY, April 24, 1995, available in Westlaw at 95 TNT 79-82.

396. See JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM 11-13 (1987).

397. See Lee, *Entity Classification*, *supra* note 35, at 134-37 (noting that the projected increase in corporate sector revenues designed to pay for the individual rate cuts was never realized).

398. See 139 CONG. REC. 13,781 (1993).

399. See Martin J. McMahon, Jr., *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, FLA. TAX REV. 1, 29-30 (1998) (discussing changes in the capital gains tax rate throughout the 1990s and suggesting that, for high-income tax payers, the 1993 capital gains tax increase was probably "just a temporary blip that was fixed by a sympathetic Congress shortly there-after").

400. See Lee, *supra* note 141, at 40-42 (noting the distributional effects of a similar proposal). As I predicted therein, *id.* at 64, the resurrection of a substantial individual capital gains preference reduced the top individual effective rate from 31.4% for 1996 to 29.5% for 1997. See CRS Report on *Individual Tax Returns for 1995-1997*, TAX NOTES TODAY, Jan. 27, 2000, available in Westlaw at 2000 TNT 18-22.

401. See 139 CONG. REC. 13,781 (1993).

402. See McIntyre, *supra* note 395.

accumulations of net income.⁴⁰³ As many as two-thirds of self-employed individuals filing Schedule C are reporting "second jobs, that individuals perform to make ends meet,"⁴⁰⁴ in addition to being wage income taxpayers. The Service itself considers the pool of self-employed taxpayers to number around six to eight million.⁴⁰⁵ For 1995, 16,423,900 sole proprietorship returns were filed, reporting \$166.8 billion.⁴⁰⁶ Even if *all* of that net income were attributed to the say 8 million full-time sole proprietors, it would only average \$20,850 per proprietorship, which is below the breakpoint for the twenty-eight percent bracket for a joint return.⁴⁰⁷ With personal and dependency exemptions and the standard deduction, the average proprietor's taxable income would be considerably below the twenty-eight percent bracket.

Since LLCs are mostly used by real estate businesses and the professions, horizontal inequity arising from other high income individuals conducting other businesses in C Corporations is not likely to engender the same populist concerns that it did in the 1920s and 1930s.⁴⁰⁸ The vertical inequity arising from high income entrepreneurs splitting their income with their C Corporations (subject to a fifteen percent rate without wage taxes), as contrasted with sole proprietors who are subject to the same fifteen percent income tax rate (plus wage taxes) and thus use the private C Corporation as the "ultimate tax shelter," does continue to raise populist ire, as it did in President Carter's Treasury in the 1970s. The story of the 1960s and 1980s is told below.

V. Political Perspective

A. *Origins of the Inside Graduated Corporate Tax Rates*

Conventional wisdom traces the origin of the present graduated inside corporate tax rates on small income to the Revenue Act of 1935.⁴⁰⁹

403. *See id.*

404. *See Oversight on Impact of Complexity in the Tax Code on Individual Taxpayers and Small Business: Hearing Before House Ways & Means Subcomm.*, 105th Cong., 2d Sess. 7-8 (1998) (statement of Steve Bafundo, C.P.A., in a three-partner, four-staff-member Connecticut firm serving over 200 small businesses and nonprofit organizations). Service data indicates that only 50% of sole proprietors report more than 50% of their income from self-employment. *See* GENERAL ACCOUNTING OFFICE, GAO/GGD-99-76, TAXPAYERS FACE MANY LAYERS OF REQUIREMENTS 4 n.5 (1999).

405. The Service considers the pool of self-employed taxpayers to number around 6.6 million. *See* GENERAL ACCOUNTING OFFICE, GAO/GGD-94-175, TAX ADMINISTRATION: IRS CAN BETTER PURSUE NONCOMPLIANT SOLE PROPRIETORS 1 (1994); *see also* THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 21 (1992) (reporting that more than one-half of all American businesses have only one employee, a self-employed owner).

406. *See* Therese Cruciano, *Sole Proprietorship Returns, 1995*, 17 SOI BULL. 8, 9 fig. B (1997).

407. *See* I.R.C. § 1(a) (1994) (setting \$36,900 as the breakpoint above which income is taxed at 28%).

408. *See supra* notes 365-83 and accompanying text.

409. Rev. Act of 1935, ch. 829, 49 Stat. 1014 (1935); *see also* 131 CONG. REC. 8375 (1985)

Although technically true, the Revenue Act of 1921, by coupling a flat rate with a tax credit of \$2000 for small corporate incomes (\$25,000 or less) when the inside corporate rate was 12.5%, effectively imposed a graduated rate.⁴¹⁰ Large, public corporations had, on the average, a lower return on capital (in part due to larger amount of capital being invested or acquired in acquisitions and greater amounts and percentages of retained earnings, added to the capital base) and hence a lower effective rate.⁴¹¹ The existing flat 12.5% corporate income tax applied to a base *net of excess profits* with a \$2000 credit.⁴¹² This had the practical result of graduated rates. Republican Treasury Secretary Mellon opposed the 1921 Act exemption, which was justified as providing parity taxation of partners and sole proprietors, who had a similar exemption under the individual income tax.⁴¹³ In 1932, the by-then \$3,000 small corporate income

410. Pub. L. No. 67-98, §§ 230(b), 236(b), 42 STAT. 227, 257 (1921). The tax rate under the original corporate tax was 1% of net income in excess of a \$5,000 exemption. *See* Payne-Aldrich Tariff Act, ch. 6, 36 STAT. 11, 112 (1909). *See generally* Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 94-133 (1990) (giving the history of the Corporate Excise Tax of 1909). Dr. T.S. Adams, later the father of the Revenue Act of 1921, favored, in Hearings at the end of the Wilson Administration, replacing the then major source of corporate revenues, the excess-profits tax—which favored large established firms with a 20% undistributed profits tax—in order to promote tax equity between corporations and partnerships-proprietorships subject to individual surtax rates. *See 1920 House Hearings, supra* note 360, at 17-18 (statement of Dr. T. S. Adams, Tax Adviser to the Treasury Department) (“It is highly desirable that the taxation of individuals, partnerships, personal service corporations, and ordinary corporations be placed on the same basis.”). The simpler mandatory passthrough treatment was thought precluded by the Supreme Court’s decision in *Eisner*. *See supra* notes 362-64 and accompanying text. The Republican Chair of the House Ways and Means Committee, while concerned about the disparate tax treatment of partnerships and corporations, strongly opposed any tax on undistributed corporate profits as a tax on prudence. *1920 House Hearings, supra* note 360, at 24-25 (statement of Chairman Fordney) (noting that the proposed undistributed profits tax would apply to profits retained “to add to the plant and provide far greater production”). The revenue raising equivalent on the table was a flat 15% on corporate income. *See 1921 House Hearings, supra* note 379, at 397 (statement of Secretary Mellon); *id.* at 405 (statement of T.S. Adams).

411. *See 1936 House Hearings, supra* note 175, at 287 (statement of Rep. Hill) (recognizing that the government loses significant tax revenue by imposing only a “comparatively moderate rate of tax” on corporations and allowing corporations to “withhold the distribution of dividends” and, therefore, avoid the higher personal income rates); Thomas Earl Geu, *Professor T.S. Adams (1873-1933) on Federal Taxation: Deja Vu All Over Again*, 10 AKRON TAX J. 29, 33 (1993) (noting that even eminent tax professor and influential tax policymaker T.S. Adams “perceived a breakpoint in the application of the excess profits tax between large and small corporations”).

412. *See* Pub. L. No. 67-98, § 236(b), 42 STAT. 227, 257 (1921). In 1921, Secretary of the Treasury Andrew Mellon, under the new Republican Harding Administration, also favored repeal of the excess profits tax and replacement with an equivalent tax. *See 1921 House Hearings, supra* note 379, at 398-99; *1921 Senate Hearings, supra* note 393, at 10-11 (letter from Secretary Mellon).

413. *See 1921 House Hearings, supra* note 379, at 397-400 (Chair Fordney) (noting that partnerships currently pay less in taxes than comparable corporations). Ironically, it was later thought that the corporate income tax was enacted to create parity with partnerships, which were taxed like individuals. *See 1936 Senate Hearings, supra* note 122, at 20-21 (colloquy between Sen. Gerry and Commissioner Helvering).

exemption was repealed for obvious revenue reasons,⁴¹⁴ but in 1935, the Democratic Roosevelt Administration, as part of a broad package of revisions, advocated replacing the then existing flat 12.5% corporate income tax with a graduated 10% to 15% inside income tax rate, ostensibly to tax vast concentrations of capital heavier than small businesses.⁴¹⁵ Cynics (or perhaps realists) might note that the proposal cut inside corporate income tax rates for the ninety percent of corporations with small (or no) annual income.⁴¹⁶ Republican opposition to decoupling might have been based upon the assumption that, with the masses of corporations separated from the six hundred or so high income corporations earning the bulk of the income, raising the rates on the big fellows (or Rockefellers), while leaving the little fellows alone, would be easier politically. And so it was. The final legislation contained much less graduation (12.5% to 15%), with no cut at the bottom, but by decoupling of the rates on small and large income corporations, Congress raised the rates on the large income corporations only.⁴¹⁷

B. 1954 Code

The 1954 ALI Draft Income Tax, generally the model for the 1954 Code, proposed in part a "two corporation" approach to Subchapter C. Under this approach, sales of private held businesses were to be treated the same regardless of whether conducted in proprietorship, partnership, or privately corporate form. However, the rate structure as to operations of private corporations would not be disturbed, as this was a political-policy issue.⁴¹⁸ Thus, the 1954 Code initially imposed a "normal" corporate tax

414. See Rev. Act of 1932, ch. 209, 47 Stat. 169, 177 (1932). Corporate revenues had fallen off considerably due to the commencement of the Depression—52% of corporations reported a deficit. See H.R. REP. NO. 72-708, at 4 (1932). The House bill proposed to reduce the \$3,000 exemption for corporations with \$25,000 or less in net income to \$1,000 for corporations with \$10,000 or less in net income; the Senate repealed the exemption in its entirety because "every corporation having net income . . . is in a position to contribute to the revenue needs of the government." S. REP. NO. 72-665, at 9 (1932).

415. *Proposed Taxation of Individual and Corporate Incomes, Inheritances and Gifts: Hearings Before the House Comm. on Ways and Means*, 74th Cong., 1st Sess. 3-4 (1935) (June 19, 1935, message from President Franklin D. Roosevelt to the Congress) (proposing that it seems "only equitable" to introduce graduated corporate tax rates, so that "vast concentrations of capital . . . carry burdens commensurate with their powers and their advantages").

416. See *supra* notes 122-24, 385 and accompanying text.

417. See Rev. Act of 1935, ch. 829, 49 Stat. 1015 (1935).

418. See 2 AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX STATUTE, FEBRUARY 1954 DRAFT 212 (1954); see also Edwin S. Cohen et al., *A Proposed Revision of the Federal Income Tax Treatment of the Sale of a Business Enterprise—American Law Institute Draft*, 54 COLUM. L. REV. 157, 161-71 (1954). This refusal to examine political issues was criticized. See William L. Cary, *Reflections Upon the American Law Institute Tax Project and the Internal Revenue Code: A Plea for a Moratorium and Reappraisal*, 60 COLUM. L. REV. 259, 269 (1960) (stating that the ALI's failure to consider political issues while working on their Institute Tax Project led to only "piecemeal" adoption of the ALI

of thirty percent and a “surtax” of twenty-two percent on taxable income in excess of \$25,000.⁴¹⁹ The rationale for the lower tax on the first \$25,000 of corporate income was to aid in capital accumulation,⁴²⁰ since commercial financing is seldom available to private firms.⁴²¹ The congressional policy of assisting small business can be traced back to the Industrial Revolution after the Civil War, “in which big business flourished and small business was threatened.” The policy “crystallized when the depression of the 1930’s and 1940’s focused attention on the nation’s economy and in the 1940’s when the economic mobilization for World War II began. . . . Congressional interest and concern was institutionalized in 1950 when the Senate and House of Representatives both established small business committees.”⁴²²

In 1963, President John F. Kennedy proposed tax cuts based upon deficit financing,⁴²³ including reductions in individual income tax rates and “[r]eversal of the corporate normal and surtax rates, so that the tax rate applicable to the first \$25,000 of corporate income would drop from 30 to 22 percent, so as to give encouragement to small business.”⁴²⁴ President Kennedy reasoned as follows:

Small businessmen with net income of less than \$25,000, who constitute over 450,000 of the Nation’s 585,000 corporations, will, under this program, receive greater reductions in their corporate taxes than their larger competitors. Under my program, beginning this year, the first \$25,000 of corporate taxable income will be subject to a tax rate of 22 percent rather than 30 percent, a reduction of almost 27 percent. This change is important to those small corporations which have less ready access to the capital markets, must depend more heavily for capital on internally generated funds, and are generally at a financial and competitive disadvantage.

419. See I.R.C. § 11(b), (c) (1954) (current version at I.R.C. § 11(b)-(c) (1999)).

420. See *Federal Tax Policy for Economic Growth and Stability: Hearings Before the Subcomm. on Tax Policy of the Joint Comm. on the Economic Report*, 84th Cong., 1st Sess. 566 (1956) (statement of John Lindner) (asserting that applying the same tax rate to both small and large businesses will more severely affect the small business because of reduced “opportunity to grow from retained earnings”); *General Revenue Revision, Hearings Before the House Comm. on Ways and Means*, 85th Cong., 2d Sess. 47-48, 55-56, 62, 72-73, 82 (1958) (statements of Rep. Sheehan; Rep. Hill; Rep. Seely-Brown, Jr.; and Spenser Smith, Ph.D.); cf. S. REP. NO. 85-1237, at 8-9 (1958) (recognizing financing problems and the heavier burden of a flat rate on small corporations, the Senate Subcommittee proposed a graduated reinvestment allowance for retained earnings).

421. See Lee, *supra* note 141, at 10 (noting that 1995 capital gain proponents “contended that borrowing from financial institutions tends to be unavailable”).

422. 1990 Commissioner’s Advisory Group Report of Compliance Subgroup on Compliance and Small Business, 90 TAX NOTES TODAY, Dec. 19, 1990, available in WL 90 TNT 257-21; see also ZELIZER, *supra* note 341, at 97 (mentioning the efforts of the Cabinet Committee on Small Business to design tax reforms for small businesses).

423. See 1963 House Hearings, *supra* note 121, at 7.

Unincorporated businesses, of course, will benefit from the reduction in individual income taxes.⁴²⁵

Significantly, JFK's 1963 proposals broke down, by individual income tax classes, the distributional effects of the proposed tax cuts, but for the corporate rate cuts provided only the percentage decrease in rates.⁴²⁶ The notion that each class of taxpayers is entitled to a share of tax cuts was to be of great importance in ensuing decades.⁴²⁷ The Revenue Act of 1964⁴²⁸ did lower the normal tax rate from thirty percent to twenty-two percent, thus reducing the inside rate on the first \$25,000 of corporate income while generally lowering the individual rates as well.⁴²⁹

The next increase in the subsidy of the graduated inside brackets occurred against the backdrop of inflation-driven individual rate "bracket creep," which allowed Congress to use budget "surpluses" created from static revenue estimates, while inflation resulted in wage increases pushing individual taxpayers into higher brackets, to fund tax cuts by adjusting the break points for the brackets and while allowing even more tax expenditures.⁴³⁰ Consequently, in 1975, Congress further lowered the rate on the first \$25,000 of corporate income from twenty-two percent to twenty percent and created an additional graduated inside corporate rate by reducing the rate on the second \$25,000 from forty-eight percent to twenty-two percent.⁴³¹

President Jimmy Carter campaigned in 1976 on reforming the income tax; a campaign sound-bite was that the Federal tax system is "a disgrace to the human race."⁴³² In 1978, the Conservative Coalition of

425. *Id.* at 9.

426. *See id.* at 68, 70 (statement of Secretary of the Treasury C. Douglas Dillon). "For political and ideological reasons" the Kennedy tax package, however, was not intended to change the distributional impact of the individual income tax overall. ZELIZER, *supra* note 341, at 192.

427. *See infra* notes 448-49, 467-68 and accompanying text.

428. Revenue Act of 1964, Pub. L. No. 88-272, § 1, 78 Stat. 19 (1964).

429. *See id.* §§ 11, 111, 78 Stat. at 19-23.

430. *See Lee, Entity Classification, supra* note 35, at 128-29 (describing "a period in which inflation-driven individual bracket creep permitted Congress to enact current spending programs, depending on the revenue windfall of expected future bracket creep to produce a balanced budget").

431. *See* Pub. L. No. 94-12, § 303(a), 89 Stat. 26, 44 (1975). *See generally* 132 CONG. REC. 4,324 (1986) (remarks of Sen. Bumpers) (surveying the evolution of tax rate reductions for small businesses from 1975 to 1986). Significantly, Senator Bumpers was an early mentor of President Bill Clinton, who adopted in the Revenue Act of 1993 many of Bumper's ideas, particularly the § 1202-targeted small C Corporation capital gains cut. *See generally* Lee, *Capital Gains Proposals, supra* note 35.

432. "It is time for a complete overhaul of our tax system. I still tell you: It is a disgrace to the human race. All my life I have heard promises of tax reform, but it never quite happens. With your help, we are finally going to make it happen! And you can depend on it!" *See* President Jimmy Carter, Text of Carter's Speech Accepting the Nomination (July 15, 1976), in FACTS ON FILE WORLD NEWS DIGEST, July 17, 1976, available in LEXIS, News Library, Allnews File. Carter also proposed eliminating the capital gains preference, but the pressure groups uniting in opposition garnered instead

Republicans and Southern Democrats passed, in the first wave of the "tax revolt,"⁴³³ upper income-skewed tax cuts, over the objections of ineffectual House Ways and Means Chair Al Ullman (D-Or.).⁴³⁴ On the ruins of Carter's tax proposals, including corporate shareholder integration,⁴³⁵ Congress reduced the inside corporate rates by five percent across the board, resulting in a seventeen percent rate on the first \$25,000 and twenty percent on the next \$25,000.⁴³⁶

One of the structural signatures of President Ronald Reagan's tax cut in the Economic Recovery Tax Act of 1981⁴³⁷ (ERTA)—deficit financing (also found in JFK's 1963 tax proposals, which Republicans had then opposed⁴³⁸)—came to give the term a new meaning. In 1981, House Ways and Means Chair Dan Rostenkowski (D-Ill.) attempted (unsuccessfully) to out-bid Republicans for the swing votes of Southern Democrats by granting tax preferences (including the Reagan-sponsored rate cuts and investment incentives),⁴³⁹ after being told by the

an increase in the capital gains preference in the Revenue Act of 1978. See Lee, *Capital Gains Proposals*, *supra* note 35.

433. See Robert G. Kaiser & Mary Russell, *A Middle-Class Congress—Haves Over Have-Nots*, WASH. POST, Oct. 15, 1978, at A1 ("[T]he concerns of the middle class and American business clearly displaced the agenda of social and economic issues that has dominated congressional politics since the inauguration of the New Deal 45 years ago. . . . Majorities in both House and Senate were searching feverishly for legislative Acts that could cater to a 'tax revolt' that many members believed was sweeping the country."); see also E.J. DIONNE, JR., WHY AMERICANS HATE POLITICS 246 (1991) (describing the middle-class tax revolt embodied in California's Proposition 13). For discussion of the political science notion of a "Conservative Coalition" of Republicans and Southern Democrats arising on particular issues as a voting majority block allied against all other Democrats see Lee, *Capital Gains Proposals*, *supra* note 35. With Republicans by and large replacing Southern Democrats in Congress in the 1990s, the Conservative Coalition has largely been supplanted by a Southern-dominated Republican majority. See Lee, *supra* note 141, at 27-28.

434. In 1974, Representative Al Ullman replaced Representative Wilbur Mills as Chair of a House Ways and Means Committee with a changed complexion: its membership had been increased by almost 50% and over half of the members were new to the Committee. See Stanley S. Surrey, *Reflections on the Tax Reform Act of 1976*, 25 CLEV. ST. L. REV. 303, 304 (1976). Ullman was perceived as a "decent man," but a weak Chair. See Peter Milius, *Ullman Shakes "Loser" Tag in Give-and-Take with Long*, WASH. POST, Sept. 13, 1976, at C7 (explaining that critics of Ullman complained that he might be "too decent to do the scheming and head-knocking necessary to produce legislation from Ways and Means").

435. See 34 CONG. Q. ALMANAC 219 (1978) ("Almost all of his proposed 'reforms,' except for a few tokens, had been scrapped, and the cuts were skewed much more towards the upper end of the income scale than he had recommended.").

436. See Revenue Act of 1978, Pub. L. 95-600, § 301, 92 Stat. 2763, 2820 (1978).

437. Pub. L. No. 97-34, 97 Stat. 172 (codified as amended in scattered sections of 26 U.S.C.).

438. See DIONNE, *supra* note 433, at 251.

439. See Melissa Brown, *Democratic Strategy Backfires—GOP Wins in the House*, TAX NOTES, Aug. 3, 1981. Forty-eight Democrats defected to Reagan in adopting the Republican Substitute for the House Ways and Means bill. See *Congress Enacts President Reagan's Tax Policy*, 37 CONG. Q. ALMANAC 91, 100 (1981); 126 CONG. REC. 18,261 (1980) (extension of remarks by Rep. Gephardt) ("Senate Democrats, many of whom also must face the voters in the fall, caved in quickly to the

Administration that an unblocked economy would pay for the tax cuts through efficiency gains, an idea termed supply side economics.⁴⁴⁰ Congress took a "Riverboat Gamble" and cut the tax rates while fashioning, in effect, a consumption tax for capital-intensive industries.⁴⁴¹ The other major signature of the 1963 Kennedy tax proposals—enactment by projected benefits to income groups—was written in reverse by the 1981 Reagan tax cuts. Ostensibly pro rata as to the individual rate cuts, ERTA actually provided very disproportionate benefits to high income individuals.⁴⁴² Higher income individuals and large corporations benefitted

in that a slim majority of Southern Democrats remained in the Democratic fold. Republicans supported the alternative 190 to 1, while Southern Democrats opposed it 43 to 36 and Northern Democrats 151 to 12. See 37 CONG. Q. ALMANAC 58-H (1981).

440. See *Tax Aspects of the President's Economic Program: Hearings Before the House Comm. on Ways and Means*, 97th Cong., 1st Sess. 14, 17, 54, 57, 61, 70, 396-400 (1981) [hereinafter *1981 House Hearings*] (statements of Secretary of the Treasury Don Regan, OBM Director David Stockman, and Arthur Laffer) (asserting that the proposed tax reductions would lead to increased savings, investment, and tax revenues). Secretary Regan, in explaining how the Office of the Secretary of the Treasury arrived at their economic forecasts, confessed that "[w]hat we did in fact was to create our own scenario." *Id.* at 42. In addition, OBM Director Stockman admitted that supply side economics was merely a cover for the trickle-down theory. See William Greider, *The Education of David Stockman*, ATLANTIC MONTHLY, Dec. 1981, at 27, 47 (quoting a concession by Stockman that "[i]t's kind of hard to sell 'trickle down,' so the supply-side formula was the only way to get a tax policy that was really 'trickle down.'").

441. The Conservative Coalition prevailed in the vote on the House bill: Republicans and Southern Democrats supported the bill 190 to 1 and 69 to 9, respectively, while Northern Democrats opposed it 97 to 64. See 127 CONG. REC. 18,262-63 (1981) (rollcall vote); 37 CONG. Q. ALMANAC 58-H (1981). In the Republican-controlled Senate, the Finance Committee bill, which was much closer to Reagan's proposals, overwhelmingly passed 89 to 11 with majorities of Republicans and Northern and Southern Democrats. See 127 CONG. REC. 17,983 (1981) (rollcall vote); 37 CONG. Q. ALMANAC 41-S (1981). The backdoor consumption tax arose from the combination of accelerated capital recovery and the investment tax credit, intended to be equivalent on a present value basis to a current deduction for the cost of equipment. See Lee, *Capital Gains Proposals*, *supra* note 31 (noting that the "backdoor consumption tax" deduction for real estate depreciation led many high-income investors to use various tax shelters). Congress lost the gamble. See STAFF OF HOUSE COMM. ON WAYS AND MEANS, 101ST CONG. 2D. SESS., BACKGROUND MATERIALS ON FEDERAL BUDGET AND TAX POLICY FOR FISCAL YEAR 1991 AND BEYOND 75 (Comm. Print 1990) (criticizing the Reagan Administration's tax proposals, noting that as a result, "the personal savings rate actually fell," and moreover, "even if these new proposals did increase private savings somewhat, national saving would not rise unless the higher saving by individuals exceeded the government's loss in tax revenues, and that is not likely."); *Supply-Side Theory Revisited: Hearing Before the Joint Economic Comm.*, 99th Cong., 1st Sess. 2-3 (1985) (statement of Barry Bosworth, Senior Fellow, the Brookings Institute) (concluding from the "failure of the private savings rate in the United States to increase," the "tremendous decline in the national savings rate," and the fact that "the richest country in the world has now become a net debtor nation," that "in terms of its primary goal of stimulating private capital formation in the United States[, the 1981 Tax Act] has been a failure.").

442. The Reagan proposals refused to follow the 1969-1976 approach of tax cuts slanted towards the middle- and lower-income taxpayers to increase consumer spending as an economic stimulus, and instead followed supply-side economic theories of tax cuts aimed more at upper income individuals and corporations to encourage productive investments. See *1981 House Hearings*, *supra* note 440, at 13 (statement of Secretary of the Treasury Regan) (distinguishing the proposed tax cuts from prior tax

disproportionally this time, giving investment, perhaps greed, and certainly envy, new meanings in the Roaring 1980s and in the early 1990s aftermath of that speculative boom.

In ERTA, Congress, through a Senate floor amendment introduced by Senator Weicker (R-Conn.) and passed ninety-two to zero, reduced the tax rate on the first \$25,000 from seventeen percent to fifteen percent and the tax rate on the next \$25,000 from twenty percent to eighteen percent.⁴⁴³ The 1981 Senate floor debate on the Weicker amendment, much more extensive than the usual floor discussion of a provision contained in a committee bill, details the arguments for preferential tax rate treatment of small income C Corporations. Supporters of the Weicker amendment, including Senator Edward Kennedy (D-Mass.), relied on standard rationales⁴⁴⁴ (or better rhetoric) for preferential treatment of small business and in particular small C Corporations: (1) small business is the most efficient source of new jobs, innovation, and productivity;⁴⁴⁵ (2) private C Corporations have a need for capital which they can not meet by borrowing or issuing equity and that they therefore must rely on retained earnings;⁴⁴⁶ and (3) small business bears a disproportionate cost of government regulation.⁴⁴⁷ Apparently, the most convincing reasons to Congress in fact were (4) an appeal for equity in the "tax distribution system,"⁴⁴⁸ in that in the Economic Recovery Tax Act of 1981, large

not the customary one of providing consumption-oriented redistribution of income[, but] to provide incentives to individuals and businesses in the private sector to work, save, and invest and thus to increase productivity and employment . . .").

443. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 231(a)(1), 95 Stat. 172, 249 (1981); 127 CONG. REC. 16,251-52, 16,254 (1981) (Weicker amendment and roll call vote).

444. For a list of standard rationales, see Ronald F. Wilson, *Federal Tax Policy: The Political Influence of American Small Business*, 37 S. TEX. L. REV. 15, 29-33 (1996). See also Joshua E. Husbands, Comment: *The Elusive Meaning of "Small Business,"* 2 J. SMALL & EMERGING BUS. L. 355, 361-62 (1998) (recounting generally accepted concerns regarding small business taxation); Note, *supra* note 88, at 558 (suggesting that "small businesses provide the bulk of job creation and economic growth in our economy"). Boolean searches of the *Congressional Record* in recent years for (1) small business w/10 engine; (2) small business w/10 rais! capital; and (3) small business w/25 entrepreneurial spirit, as well as the 1981 and 1985-86 Congressional consideration of graduated corporate tax rates discussed below, confirm that the factors identified by these commentators are those most recurring in that medium of political discourse.

445. See 127 CONG. REC. 16,247 (1981) (statement of Sen. Kennedy) (arguing that small business has been "the greatest source of innovation, the greatest source of jobs, the greatest source of research and development, and the greatest source of productivity in our society"); *id.* at 16,252 (statement of Sen. Weicker) (observing that small companies "can be a major source of U.S. output, jobs, and innovation"); *id.* (statement of Sen. Nunn) (noting that small business "accounts for nearly half of the gross national product, 87 percent of all new employment, and half of the major industrial innovations" in the country).

446. See *id.* at 16,252 (remarks of Sen. Weicker) (observing that small corporations "must rely almost exclusively on internally generated capital from retained earnings, since they dare not borrow at today's interest rates and, of course, cannot sell equity shares").

447. See *id.* at 16,246 (remarks of Sen. Riegle).

448. This phrase, used in the 1986 tax reform debate by Senator Edward Kennedy (D-Mass.), 132

income C Corporations were getting a tax cut through a very generous capital recovery system and sole proprietors and individual partners were getting substantial tax rate cuts, so it was only fair that small income C Corporations, which tended not to be capital intensive, get a rate cut as well;⁴⁴⁹ and (5) small business, in a unified voice, had specifically asked for cuts in the small income graduated inside tax rates.⁴⁵⁰ The remaining standard rationales were brought out in the 1985-1986 Congressional consideration of the Tax Reform Act of 1986.

C. 1986 Code: *The Hidden Hand (Fist) Is Revealed*

In the Summer of 1984, Congress imposed a new technique of phasing out the benefits of graduated brackets to higher income C Corporations by imposing a five percent surtax beginning at \$1 million of income⁴⁵¹ "designed to ensure that a greater amount of the benefits of the lower rate enacted in 1981 would accrue to small businesses."⁴⁵² In sharp contrast to this congressional small income C Corporation bent, later in November, 1984, the Treasury Department Report to the President, *Tax Reform for Fairness, Simplicity, and Economic Growth*, proposed to tax all C Corporations at a flat rate on taxable income, reasoning that

the current progressive rate structure for corporate income serves no affirmative purpose and encourages the use of corporations to gain the advantage of low marginal tax rates. The progressive rate structure for individuals is premised on the ability-to-pay concept, which in turn reflects an assumption that additional amounts of income are increasingly available for discretionary, nonessential consumption. These concepts have no relevance to corporate

of the benefits of a tax cut. Senator Kennedy, in the 1981 debate, pointed out that he and others had urged that "at least 15 percent of any business tax [cut] should be especially designed for small business." 127 CONG. REC. 16,247 (1981) (remarks of Sen. Kennedy). See also *infra* notes 446, 465.

449. See 127 CONG. REC. 16,252 (1981) (remarks of Sen. Weicker) ("We have a 25-percent tax cut for individuals, and a vastly improved accelerated depreciation program for capital intensive firms. But we need to improve incentives for small business capital investment."); *id.* at 16,245, 16,247 (remarks of Sen. Riegle) ("It is very troubling that many American businesses will not benefit from this tax cut on an equitable basis because the proposed corporate tax cut relies almost solely on accelerated depreciation."). Proprietors and partners are taxed as individuals and get help under the individual rate cuts.

450. See *id.* at 16,252 (remarks of Sen. Weicker) (noting very strong, widespread support from the National Federation of Independent Business, the National Small Business Association, Small Business United, for lower graduated tax rates, and also noting that "small business corporate tax rate reduction was the number one recommendation of the White House Conference on Small Business convened in 1980").

451. See Pub. L. No. 98-369, 66(a), 98 Stat. 494, 585 (1984).

452. 131 CONG. REC. 8,376 (1985) (remarks of Sen. Weicker). See also STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 197 (Comm. Print 1984) (explaining that the phasing out of graduated rates for large corporations prevents them from taking advantage of a provision designed for

income, all of which is either distributed or used to produce additional income. Moreover, under current law a small corporation can escape high marginal tax rates on corporate income by electing pass-through treatment as an S corporation.

. . . . The current low rates of tax for certain amounts of corporate income permit the use of corporations as tax shelters for individuals. . . . Where the corporate rate is significantly below the individual's marginal rate, the deferral advantage can more than offset the extra burden of the corporate tax.⁴⁵³

Of course, Treasury was correct as a matter of tax policy. Use of a private C Corporation as an inside tax shelter is inconsistent with vertical equity or ability to pay.⁴⁵⁴ Tax politics, however, easily trumped tax policy.

A small business pressure group (National Federation of Independent Business) was among the first in new Treasury Secretary James Baker's door, "disturbed by the elimination of lower tax rates for small businesses."⁴⁵⁵ The Senate Committee on Small Business held field hearings in January, February, and March 1985 on the "Impact of Tax Reform and Simplification Proposals on Small Business"⁴⁵⁶ which revealed "that one of the most important concerns that small businesses have is whether the current graduated corporate tax rate will be retained"⁴⁵⁷ In April, 1985, Representative Charles B. Rangel (D-N.Y.) and Senator Max Baucus (D-Mont.), with bi-partisan support, introduced a joint resolution relating to graduated corporate tax rates⁴⁵⁸ which, together with the accompanying political discourse, repeated the themes of the 1981 debate and aired the remaining standard small business rationales. The resolution harkened back to the 1935 decoupling of small and large corporation inside income tax rates and President Roosevelt's rationale of the equity of adjusting the corporate tax rates "in accordance with economic capacity, advantage, and fact."⁴⁵⁹ The Joint Resolution repeated the statistics as to small business's contribution to the gross national product

453. 2 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT, GENERAL EXPLANATION OF THE TREASURY DEPARTMENT PROPOSALS 128-29 (November 1984) [hereinafter Treasury I].

454. See Yin, *supra* note 35, at 138-39.

455. BIRNBAUM & MURRAY, *supra* note 396, at 80.

456. *Impact of Tax Reform and Simplification Proposals on Small Business: Hearings Before the Senate Comm. on Small Business*, 99th Cong., 1st Sess. (1985) [hereinafter *1985 Small Business Hearings*].

457. See 131 CONG. REC. 8,376 (1985) (remarks of Sen. Weicker, Chair of the Senate Committee on Small Business); STAFF OF SENATE COMM. ON SMALL BUSINESS, 99TH CONG. REPORT SUMMARIZING THE COMMITTEE'S FIELD HEARINGS HELD IN 1985 ON THE IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS 18 (Comm. Print 1985).

458. See 131 CONG. REC. 8,375 (1985) (remarks of Sen. Baucus); *id.* at 8,535 (1985) (remarks of Rep. Rangel).

459. 131 CONG. REC. 8,376 (remarks of Sen. Baucus); see also President Franklin D. Roosevelt's

and new employment and proclaimed that "this entrepreneurial spirit needs to be encouraged, not stifled by Federal tax policies which run counter to the interests of the Nation's small businesses. . . . [B]ecause of economies of scale, small businesses compete at an economic disadvantage with larger businesses and therefore bear higher capital and operating costs" ⁴⁶⁰ Senator Max Baucus' accompanying statement responded to the Treasury's rationale for elimination of the graduated inside brackets:

First, the corporate income tax itself is partly based on the notion that corporations are independent entities that obtain valuable privileges from the Government and may, in return for these privileges, be subject to tax. It follows, as President Roosevelt said in his 1935 message to Congress, that "the advantages and the protections conferred upon corporations by Government increase in value as the size of the corporation increases," and that a graduated corporate tax rate takes this into account.

Second, many small businesses have difficulty obtaining loans for operating and expansion capital and must use retained earnings instead. As the 1980 White House Small Business Commission noted—while advocating a corporate rate structure that would be even more graduated than the current one:

[a] more graduated corporate tax would help expand the retained earnings available to a small company for reinvestment, and retained earnings are the soundest and most reliable source of business capital.

. . .

Finally, our graduated corporate rates are partly based on the fact that we want to give small corporations a break. An economist might argue that it's unfair and inefficient to tax a corner grocery at a lower rate than Safeway or A&P. But we've long believed that small businesses provide special benefits to our society and deserve reasonable incentives that help them thrive. A system of graduated corporate tax rates is a straight-forward way to provide such incentives. Some might call graduated corporate rates a "tax loophole." But even if that's true, it's one I'm not going to apologize for. ⁴⁶¹

460. 131 CONG. REC. 8,375 (1985).

461. 131 CONG. REC. 8,376 (1985) (remarks of Sen. Baucus). For early statements of this taxation in exchange for privileges notion see 1920 *House Hearings*, *supra* note 360, at 55 (statement of R.G. Elliott, Chair Tax Committee, National Assoc. of Credit Men, Chicago) ("[I]n most States, I believe, corporations are subjected to taxation, which does not apply to individuals or partnerships, and presumably that tax is levied because the State has granted them certain privileges [such as restricted shareholder liability]."); *Flint v. Stone Tracy Co.*, 220 U.S. 107, 162 (1911) ("[T]he [1909 excise] tax is laid upon the privileges which exist in conducting business with the advantages which inhere in the corporate capacity of those taxed, and which are not enjoyed by private firms or individuals."). For the real story on the creation of the corporate income tax, describing it as an early

These Hearings and the Joint Resolution were intended to send “a clear and convincing signal to the administration [which was in the process of rewriting the earlier proposals], and anyone interested in tax reform, that retention of the current graduated corporate tax rates is indispensable”⁴⁶² The signal was heard and heeded. The May, 1985, *President’s Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (Treasury II Report)⁴⁶³ proposed using the existing bottom graduated tax rates with a new top rate of thirty-three percent. This would result in a tax of fifteen percent on taxable income up to \$25,000, eighteen percent on taxable income between \$25,000 and \$50,000, twenty-five percent on taxable income between \$50,000 and \$75,000, and thirty-three percent on the excess, with a five percent surtax from \$140,000 to \$360,000, recapturing the lower graduated rates so that corporations with taxable income of \$360,000 or more would pay a flat thirty-three percent inside corporate tax rate.⁴⁶⁴ The Treasury II report simply stated that the “graduated rate structure for corporations would be maintained, in order not to increase the burden on small corporations.”⁴⁶⁵ Otherwise, it continued, complete elimination of the graduated rates would nullify the positive effects for small corporations of the proposed reduction in the maximum corporate marginal rate.⁴⁶⁶

Even after Treasury II’s about face as to repealing the inside graduated corporate income tax rates, some supporters of small C Corporations attempted to obtain *further* graduated rate reductions for small C Corporations, arguing for a more equitable distribution of rate cuts.⁴⁶⁷ Senator Dale Bumpers (D-Ark.) found it “hard to understand why every individual and corporate taxpayer will receive a reduction in rate except small businesses with less than \$25,000 in income.”⁴⁶⁸ Another Southern

government attempt at securities and corporate regulation, see Kornhauser, *supra* note 410. Moreover, for a discussion of the absence of these “privileges” in the typical private corporation, see Lee, *Entity Classification*, *supra* note 35, at 87 n.120.

462. 131 CONG. REC. 8,377 (remarks of Sen. Weicker) (1985); see also 1985 *Small Business Hearings*, *supra* note 456, at 5 (prepared statement of Sen. Sasser) (“The comments and remarks heard by the Small Business Committee will lay a firm foundation from which we can speak out in behalf of small business in upcoming debates on tax reform.”).

463. THE PRESIDENT’S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 117, 119 (May 1985) [hereinafter TREASURY II].

464. *Id.*

465. *Id.* at 117.

466. *Id.* at 119.

467. See 131 CONG. REC. 11,840 (1985) (remarks of Sen. Sasser); *id.* at 24,791 (1985) (remarks of Senator Sasser) (proposing a rate reduction for small businesses based on the view that under the Treasury II proposal, “small businesses will face a broadened tax base and tax rates that are the same as, or higher than those to which they are subject under current law” (quoting a letter from the National Federation of Independent Business and other small business associations to Secretary of Treasury James Baker)).

Democrat Senator urged his "colleagues to join . . . in promoting the concerns of small business in the tax reform debate and thereby reaffirm our national commitment to the entrepreneurial spirit and the spirit of free enterprise which form the very backbone of our economic system."⁴⁶⁹

In the end, the Tax Reform Act of 1986 not only retained the 1954 Code's lowest inside corporate tax rate of fifteen percent but *doubled* the favored tax base from \$25,000 of annual income to \$50,000.⁴⁷⁰ This was similar to an earlier proposal by Representative Charles B. Rangel (D-N.Y.).⁴⁷¹ The House Ways and Means Committee Report explained that: "The present law graduated rates for lower income corporations are intended to encourage growth in small business by easing the tax burden on such businesses."⁴⁷²

D. *Beyond Political Rhetoric*

CRS and commentators conclude that some, if not most, of the usual rationales for granting subsidies (such as graduated rates) to small business corporations are myths or rhetoric.⁴⁷³

Americans love small business. Despite the notoriously high rate of early failure, every year hundreds of thousands of undaunted

469. 131 CONG. REC. 24,792 (1985) (remarks of Sen. Sasser).

470. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 601(a), 100 Stat. 2085, 2249 (codified as amended at I.R.C. § 11(b)).

471. See 131 CONG. REC. 2,319-20 (1985) (proposing a 15% rate on the first \$50,000 of taxable income, 25% on taxable income between \$50,000 and \$100,000, and 33% thereafter with a surcharge from \$100,000 to \$200,000 in order to phase out this relief).

472. See H.R. REP. NO. 99-426, at 232 (1985) (detailing Congress's attempts to concentrate benefits by phasing out benefits with taxable income in excess of \$365,000); see also S. REP. NO. 99-313, at 220 (1986) (lowering the beginning of the phase out of graduated rates from \$1 million in income to \$100,000). In 1987 Congress barred the graduated inside rates to service corporations: "The personal service income of corporations owned by its [sic] employees is taxed to the employee-owners at the individual graduated rates as it is paid out as salary. The committee believes that it is inappropriate to allow the retained earnings to be taxed at the lower corporate graduated rates." H.R. REP. NO. 100-391, pt. 2, at 1097 (1987), reprinted in 1987 U.S.C.A.N. 2313-1, 2313-712.

473. See TAX EXPENDITURES COMPENDIUM, *supra* note 144, at 255 (citing mixed evidence); BRUMBAUGH, *supra* note 119 (debunking tax strategies favoring small business and the rationales often given in support of them); see also Gravelle, *Small Business Tax Subsidy Proposals*, *supra* note 146 (outlining the major criticisms of "the justifications advanced for favoring small business"); Marc Levinson & John M. Barry, *Small Business: Myth and Reality*, DUN'S BUSINESS MONTH, Sept. 1985, at 30, 31 ("[T]he mythology of small business has outdistanced the reality."); Robert J. Samuelson, *The Great Pretender*, WASH. POST, Aug. 11, 1993, at A19, available in 1993 WL 2104779 (providing statistics which illustrate that the impact that small businesses have on job creation is "somewhat exaggerated"). But see James E. Ellis & Christina Del Valle, *Tall Order for Small Businesses*, BUS. WEEK, Apr. 19, 1993, at 114 (noting that small businesses [employing 500 or fewer] accounted for 3.2 million new jobs between 1988 and 1990, while big business had a net loss of 500,000 jobs). Nearly all the new small-business jobs are generated by the smallest of the small; from 1988 to 1990, all of the job creation came at companies with fewer than 20 employees which added more than 4 million jobs. See *id.* Companies with 20 to 499 employees lost 849,000 jobs. See *id.*

Americans launch small businesses. The folklore of the independent entrepreneur being the backbone of American self-reliance and work ethic is a more persuasive argument for favorable tax incentives than any reality-based economic consideration.⁴⁷⁴

In addition, there is clearly a fair amount of cloaking taking place.⁴⁷⁵ The Congressional reliance on data as to small business jobs, invariably refers to all small business: sole proprietors, S Corporations, and partnerships as well as private C Corporations (with both small and moderate income).⁴⁷⁶ In the 1981 floor debate, Senator Durenberger (R-Minn.) pointed out that small C Corporations were far outnumbered by small businesses (the sole proprietors), who were in greater need:⁴⁷⁷ "The concern here is for who gets what benefits we can provide and how much help we are going to provide, and how much equity we are going to do for those who really need it in this country."⁴⁷⁸

The claims for jobs, innovation, and often regulatory difficulty are overstated as to small business in general, due to the high failure rate of small businesses.⁴⁷⁹ Moreover, the graduated brackets only apply to a

474. Wilson, *supra* note 444, at 64 (footnotes omitted). Cf. Blatt, *supra* note 186, at 316-17, 320-24, 339-48 (discussing the role of the "family business symbol" in legislative support for the issue of an estate tax freeze).

475. By "cloaking" I mean arguing for a tax preference on the basis of benefitting a popular interest group while really intending, or at least knowing, that the major benefits will go to another interest group. See Lee, *supra* note 141, at 86, 18 n.57, 26 n.101.

476. At the time, private C Corporations constituted 20% of all small business entities, but reported 65% of all small business net income. See *Small Business Staff Report*, *supra* note 457, at 16. Since that time, the portion reported by S Corporations has increased significantly and partnerships have gone from a net loss (reflecting the shelter years) to substantial positive income. See Amy Hamilton, *Partnership Profits in 1995 Largest in History*, *IRS Data Show*, TAX NOTES TODAY, Jan. 6, 1998, available in Westlaw at 1998 TNT 3-3 (reporting that an increase in partnership profits to \$106.8 billion for 1995 compared with 1994 was the largest in history, continuing the trend of large percentage increases in overall net income first observed in 1991); *supra* note 18 and accompanying text. Thus C Corporations' share of total small business income has fallen sharply.

477. See 127 CONG. REC. 16,246-47 (1981).

478. *Id.* at 16,247. Senator Durenberger was arguing against Senator Riegle's proposal to cut the graduated rates up to \$200,000, which was defeated in a roll call by a vote of 51 to 41. See *id.* at 16,248. Senator Durenberger voted in favor of Senator Weicker's proposed cuts on the first \$50,000. See *id.* at 16,254; see also 142 CONG. REC. H9859 (daily ed. Aug. 2, 1996) (remarks of Rep. Martini) (referring to mom-and-pop sole proprietors as "true small businesses").

479. See *Husbands*, *supra* note 444, at 363 (noting that net new small business jobs are much lower than claimed due to the huge numbers of small businesses annually their closing doors and a smaller number actually failing). Professor Douglas Holtz-Eakin has stated:

[E]ven when small firms create a lot of jobs, they destroy nearly as many as these small businesses fail. Because the failure rate among small businesses is so high, many of the jobs they create today will not survive over a year or so. In the same way, there appears to be little support in the numbers for a disproportionate role played by small firms in product innovation. It is true that there are numerous examples of valuable innovations from small firms. It is equally true that large firms innovate at roughly the same rate.

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fraction of the small business universe.⁴⁸⁰ Furthermore, the appeal to equity in the "tax distribution system" overlooked the fact that the high income owners of most private C Corporations are splitting their income between the private C Corporation and their individual returns and so were already obtaining (in 1981 and 1986) the benefits of the individual rate reductions.⁴⁸¹ The difficulty in obtaining capital is the only real difficulty small private C Corporations (and private S Corporations and proprietors as well) face.⁴⁸²

Beyond the accuracy of the stated rationales for preferences for small business, including graduated rates, are two political factors that are probably determinative. The first is the mystique of the entrepreneur as the backbone of the American economy. "Socially and psychologically, Americans (including politicians) are fascinated with the mystique of the small, independent business entrepreneur. Historians have noted that a 'small-business ideology has been present throughout American history' and politicians recently have proposed small business incentive packages in the name of America's 'entrepreneurial spirit.'"⁴⁸³ This mystique appears closely related to Americans' positive feelings about money in the form of earned income, identified by Professor Marjorie E. Kornhauser as "moral economic individualism."⁴⁸⁴ Professor Kornhauser tells us that "[b]ecause rhetoric must persuade, politicians use rhetoric that reflects people's beliefs."⁴⁸⁵ The rhetoric of "entrepreneurial spirit" must,

identifies the basis for the claim that small business is "America's 'job generator'" by citing several studies that reported higher net gains of jobs in small business than in large business in the early 1990s. Wilson, *supra* note 445, at 29. However, he later refutes the widely held view that small business is the nation's primary job generator and innovator as being based on economic myths. *See id.* at 59-63 (pointing out various flaws in economic studies supporting the "job generator" and "innovator" claims of small business groups).

480. The inside graduated corporate income tax rates apply to around 750,000 mostly private, small income C Corporations. *See supra* note 130 and accompanying text. In contrast, there are approximately 2,000,000 S Corporations, 1,500,000 partnerships, and 6,000,000 full-time proprietorships. *See supra* notes 132, 304-305, and 308-309 and accompanying text.

481. *See supra* notes 147-55, 167-68 and accompanying text.

482. *See Lee, supra* note 141, at 10-13. I recall that when I had first discovered the literature in the hearings as to the inside shelter over a dozen years ago and mentioned it to Tax Court Judge Lapsley Hamblen at a Virginia Tax Conference meeting, he immediately rejoined that they needed it to accumulate capital, which I later found confirmed in the legislative history and political discourse. Retired Chief Judge Hamblen always went to the nub of the issue. I have benefitted more than I can ever express from his example, friendship, and mentoring.

483. Wilson, *supra* note 444, at 31 (footnotes omitted).

484. *See* Marjorie E. Kornhauser, *The Morality of Money: American Attitudes Toward Wealth and the Income Tax*, 70 IND. L.J. 119, 123-28 (1994).

485. *Id.* at 131. Professor William Blatt goes the next step and advocates that cultural archetypes or symbols used in "public discourse" (news stories and legislative hearings) are evidence of social preferences, which in a democracy should be translated into tax policy. *See Blatt, supra* note 186, at 292-93, 327-28, 330. Personally, I find it difficult to distinguish using symbols, such as small business prevalent in the society, which are based on false claims, to justify legislation violating

indeed, have been a major factor underlying the 1981 ninety-two to zero Senate vote across party and ideological lines.⁴⁸⁶ If anything, business people tend to be more of a Republican constituency than a Democratic one,⁴⁸⁷ although small business has long been favored by Southern and, now, New Democrats as well.⁴⁸⁸ The second, and probably determinative, political factor, is that small business people tend to be local "opinion leaders" who influence local voting patterns and make political contributions.⁴⁸⁹ These are the people members of Congress of both parties talk to about taxes in their visits home.⁴⁹⁰

This history suggests some tax policy agenda for the future as to calls for integration of private C Corporate-shareholder taxation. The first is to be aware of the facts on the ground and political history of business tax entities. Otherwise, well-intentioned reformers may unite small business groups in opposition, who will then prevail with a greater preference *ex post* legislation than *ex ante*, as in 1978 and 1986. Clearly, an appeal to Congress to end the (rare) double taxation of unsophisticated small private

vertical equity, from symbols prevalent in a society, likewise based on false claims, used to support, for instance, racial segregation.

486. See *supra* note 443 and accompanying text.

487. One of the core Republican groups in the L.A. Times-Gallup Poll terminology of voting groups is "enterprisers" (high-income professionals, business people). See Lee, *supra* note 380. Over a decade ago the L.A. Times-Gallup Poll dissected the voting electorate into 11 factions, including "enterprisers" who were affluent, highly educated, 99% white, 60% male, mostly married, and concentrated in the suburbs, with strongly probusiness, antigovernment, and antiwelfare spending attitudes. See George Skelton, *In-Depth Study Sees 'Very Close' Vote; Parties Nearly Even in 1988 Presidential Race*, L.A. TIMES, Oct. 1, 1987, available in 1987 WL 2266825; David S. Broder, *The Campaign of 1988, GOP Seen Forming a Winning Coalition; Democratic Constituencies May Be on Collision Course, Poll Finds*, WASH. POST, Feb. 5, 1988, available in 1988 WL 2074282. In the late 1980s, enterprisers made up 16% of all likely voters, and together with "moralists" (roughly equivalent to the Christian Right), composed the core of the Republican coalition. See Broder, *supra*; Skelton, *supra*. For discussion of the alignment of the Christian Right with the Republican Party, see Laurie Goodstein, *Mixing God and Politics Brings Out the Naysayers: Ties to GOP Worry Some Evangelicals*, WASH. POST, Mar. 27, 1995, available in 1995 WL 2085446; Paul Starobin, *Oh, Woe Is Us! Well, Maybe Not*, NAT'L J., Jan. 16, 1999, at 94 (noting that the Christian Right is arguably the most powerful faction in the Republican party).

488. See Lee, *supra* note 141, at 27-28, 29-30 n.111 (stating that Southern Democrats supported capital gains preferences for small business owners and reporting statements made by Democratic Representatives expressing support for small business).

489. See Dennis Chong, *Values Versus Interests in the Explanation of Social Conflict*, 144 U. PA. L. REV. 2079, 2108-09 (1996); Susan B. Garland, *Small Business Rocks the Vote*, BUS. WEEK, June 3, 1996, at 14 (providing examples of the political influence wielded by small business leaders); Bradley A. Smith, *Money Talks: Speech, Corruption, Equality, and Campaign Finance*, 86 GEO. L.J. 45, 91 (1997) (noting that for small business owners, "money contributions are the primary source of political participation beyond voting"); Wilson, *supra* note 444, at 32-35 (discussing the significant political impact made by small business).

490. See, e.g., 1978 House Hearings, *supra* note 391, at 1253-54 (statement of Rep. Jenkins) (sympathizing with the tax and regulatory burdens faced by small business owners); *id.* at 2802-03 (statement of Rep. Jenkins) (explaining that small business owners in his district "showed great interest

C Corporations is a nonstarter, even if only to test whether the private C Corporation or LLC provides the better nontax attributes.⁴⁹¹ In fact, lobbyists for small private C Corporations fight fiercely and effectively for the preservation and expansion of the inside shelter from lower graduated rates applicable to small income private C Corporations, which are much lower than the outside, more progressive individual tax rates that their owners would be subject to on additional marginal income.⁴⁹²

Nor do I expect that arguing that the transaction and exit costs of private C Corporations, as contrasted with LLCs, may be so great as to outweigh the inside shelter, would persuade Congress. Although inside deductibility of (reasonable) compensation by the private C Corporation is currently the single biggest business expense tax audit issue for such corporations, according to the General Accounting Office, the tax writing committees were also informed that this was the case two decades ago by the Joint Committee on Taxation, also based on a General Accounting Office study.⁴⁹³ Yet Congress increased the inside graduated rate subsidy *three* times after such notice.⁴⁹⁴ Apparently Congress is willing to let small business people buy their admission tickets to the tax shelter and take their chances.⁴⁹⁵

Congress might be persuaded that the fact that sixty-one percent of C Corporations report no income, with a substantial percentage incurring "trapped" operating losses, presents the true hardship. One indication that private C Corporations do view this as a hardship is that a third of C to S conversions incur losses in the first S Corporation year (and over two-thirds of those first year loss new S Corporations go on to incur a loss the next year as well).⁴⁹⁶ A possible (and ideal) Congressional response to a full and accurate factual presentation of taxation of small business could be mandatory passthrough of income and losses of private C Corporations to prevent trapped losses. A more likely Congressional remedy, given its small business private C Corporation bias, might be increasing the ordinary deduction under section 1244 for losses on small business stock,⁴⁹⁷ or perhaps allowing small income C Corporation net operating losses to

491. See *supra* note 98 and accompanying text.

492. See *supra* note 455 and accompanying text.

493. See *supra* note 182 and accompanying text.

494. See *supra* notes 436, 443, and 470 (describing rate increases in the subsidy in 1978, 1981, and 1986 respectively).

495. The taxpayer's preference for the risks and chances associated with the purchase of that ticket may, however, reflect misinformation or a lack of information. Cf. Robin West, *Authority, Autonomy, and Choice: The Role of Consent in the Moral and Political Visions of Franz Kafka and Richard Posner*, 99 HARV. L. REV. 384, 411 (1985) (pointing out that consent to risk in general may be grounded in misinformation or ignorance, and that this is ultimately detrimental to the "risk-buyer"). Or, even if taxpayers are fully informed, they may not be adverse to playing the audit lottery.

496. See *supra* note 217 and accompanying text.

497. See *Id.* *supra* note 141, at 20 (suggesting opening up § 1244 rather than increasing the

carryover to S Corporation years after a C to S conversion.⁴⁹⁸ Perhaps it might be best to leave bad enough alone, since these existing rules increasing transaction and exit costs could be viewed as adding back a little of the progressivity eroded by use of the inside shelter. Changing them while leaving the inside shelter in place would only further erode progressivity.

VI. Conclusion

Ironically, the question of equal tax treatment of small business and the role of the inside corporate tax shelter was more clearly perceived three and four score years ago than today. Treasury, members of Congress, and witnesses in tax hearings all recognized that lower inside corporate rates in comparison to progressive outside individual rates lead to businesses choosing the C corporation form and resultant horizontal and vertical disparity with partnerships and proprietorships.⁴⁹⁹ Professor Edwin Seligman pointed out to the Senate Finance Committee in 1921 that Congress had gone off on the “wrong tangent” by taxing corporations separately from other businesses.⁵⁰⁰ The tax writing committees were warned by Treasury and academic and business witnesses that taxing partners and proprietors at steeply progressive individual rates while taxing corporations at a lower inside rate would “force” all larger businesses into corporate form.⁵⁰¹ Unfortunately for those seeking to put corporations on a tax parity with partners and proprietors in 1920-21 and 1936, the ideal true passthrough integration (passthrough and modified shareholder allocation methods in current terminology⁵⁰²) was thought precluded by *Eisner v. Macomber*.⁵⁰³

498. A C Corporation net operating loss does *not* carryover to an S Corporation tax year, except to offset a realized built-in-gain. See I.R.C. §§ 1371(b)(1), 1374(b)(2) (1994); *St. Charles Investment Co. v. Commissioner*, 110 T.C. 46, 49 (1998) (explaining that § 1371(b)(1) precludes an S Corporation from carrying forward any suspended passive activity losses (PALs) incurred during its prior status as a C Corporation); *Rosenberg v. Commissioner*, 96 T.C. 451, 454 (1991) (stating that § 1371(b)(1) expressly forbids the carryforward of a net operating loss incurred by a C Corporation to a later S Corporation year, and that the § 1371(a)(1) exception that allows application of Subchapter C where not inconsistent does not allow an S Corporation to use the tax benefit doctrine to override § 1371(b)(1)). See generally Kaye A. Thomas, *Built-in Gains Tax Under the Final Regulations*, TAX NOTES TODAY, Nov. 7, 1995, available in Westlaw at 1995 TNT 218-94 (offering a comprehensive look at the application of § 1374 regulations to built-in-gain).

499. See *supra* notes 365, 371 and accompanying text.

500. 1921 Senate Hearings, *supra* note 393, at 476.

501. 1920 House Hearings, *supra* note 360, at 24 (statement of Dr. Adams) (asserting that tax laws should not force corporations to take a form of organization not suited to their business, and citing Secretary of the Treasury Houston's 1920 Annual Report for the proposition that such a tax structure would give a “heavy premium” to the corporate form of business).

502. See TAXING BUSINESS INCOME ONCE, *supra* note 44, at 27. In contrast to a pure conduit or passthrough model, Treasury's shareholder allocation prototype does not pass through losses. See

Secretary Mellon nevertheless opposed an undistributed profits tax (dividend deduction method in current terminology⁵⁰⁴). He seemingly wanted to undercut progressivity⁵⁰⁵ through corporate inside shelter and outside capital gains preference, which were intentionally the same 12.5% rate.⁵⁰⁶ Thus, the status quo of much higher outside than inside rates continued. And so it happened that business entities went from a 1:1 ratio of corporations to partnerships in 1924 to 2:1 a decade later.⁵⁰⁷ At the same time, the combination of capital gains preference, inside corporate tax shelter, and stepped up basis at death made progressivity a farce. As Texas populist Representative "Cactus Jack" Garner put it so well in the context of another Mellon-backed revenue act provision undercutting progressivity:

Why, it happened just as it always will as long as the Treasury Department has the viewpoint of taxation that it now has. That will happen as long as you have a House or a Senate that obeys the mandates of the Treasury Department. It is the viewpoint of those who desire to relieve the heavy taxpayer from his taxes and continue the taxes upon the masses of the people, as they have done in this bill. You will find it all the way through⁵⁰⁸

By 1936, all of the larger businesses had become C Corporations and disparity was once again recognized by hill country populists such as Senator Hugo Black (D-Ala.) and Ways and Means Chair Bob Doughton (D-N.C.), who supported the undistributed profits tax which Republicans and business strongly opposed this time.⁵⁰⁹ Even more unfortunately, the ensuing enactment of the short-lived undistributed profits tax resulted in one of the worst of all possible tax worlds as to corporate-shareholder taxation.⁵¹⁰ Corporations distributed profits in 1937, avoiding the inside

504. See TAXING BUSINESS INCOME ONCE, *supra* note 44, at 107.

505. See Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 SO. CAL. L. REV. 397, 438 (1987) ("While rhetoric and attention focused on nominal tax rates, real or effective rates could be lowered more quietly by creating preferential capital gains rates . . ."). Mellon also persuaded Congress to cut the outside ordinary income rates. The Revenue Act of 1921 reduced the maximum rate from 73% to 58%. See Pub. L. No. 67-98, §§ 210, 211, 42 Stat. 227, 233, 237. Mellon directed further reductions in the Revenue Act of 1924, and the Revenue Act of 1926 reduced the top rate to 25%. See Pub. L. No. 69-20 §§ 210, 211, 44 Stat. 9, 21-23.

506. See 1921 *Confidential Senate Hearings*, *supra* note 363, at 37 (statement of Dr. Adams).

507. See *supra* note 344 and accompanying text.

508. 61 CONG. REC. 8,073 (1921). This view is roughly accurate if it is understood that the taxes on the masses at this time were regressive excise taxes and not the "class" income taxes. See Lee, *supra* note 380; Carolyn C. Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 BUFF. L. REV. 685 (1988) (chronicling the expansion of taxation during World War II).

509. See *supra* note 372 and accompanying text.

510. See RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 209 (1954) (listing the objections to the tax raised by the Ways and Means Subcommittee in 1937, including issues of unfairness,

undistributed profits tax (as intended), but the high income shareholders evaded outside taxation on the dividends as well.⁵¹¹ In both of these early debates proponents focused more on horizontal than vertical equity.⁵¹²

The next two considerations of corporate-shareholder taxation integration were by Treasury in 1978, criticizing the private C Corporation as the “quintessential tax shelter,” and in 1984, specifically proposing elimination of inside graduated small income private C Corporations rates.⁵¹³ Both focused more on ability to pay than horizontal inequity, in contrast to earlier decades.⁵¹⁴ Both resulted instead in Congress increasing the subsidy by reducing the inside rates on small income C Corporations further.⁵¹⁵ In contrast, starting with President John F. Kennedy in the 1960s and reappearing in a bi-partisan fashion in the early 1980s with Representative Rangel and Senators Kennedy, Bumpers and Weicker, the political rhetoric shifted from disparity of taxation between forms of business entities to jobs and entrepreneurial spirit.⁵¹⁶ No longer did populists rail in Congress against the tax advantages of the [private and public] corporation over the partnerships and proprietors: “Gone from the public rhetoric were terms such as ‘redistribution of wealth,’ ‘social class,’ and ‘economic justice.’ The new language of tax reform played down the discussion of income redistribution and social justice while focusing on economic ‘efficiency’ and ‘growth.’”⁵¹⁷

Populist Democratic rhetoric was revived in response to the “failed” Reagan-Bush trickle down tax policies of disproportionately lowering the top individual effective tax rates while the top captured most of the economic gains, just as had happened under similar Mellon era tax policies.⁵¹⁸ The

restrictiveness, and undue burden). Another worst of all tax worlds would result from an outside individual flat tax on wage income coupled only with an inside consumption tax as to corporate income, a bad idea in the air. See *Samuels Says Flat Tax Would Help Rich, Hurt Middle Class*, TAX NOTES TODAY, Sept. 25, 1995, available in Westlaw 95 TNT 187-3.

511. See *supra* notes 387-88 and accompanying text.

512. See *supra* note 370 and accompanying text.

513. See *supra* notes 392, 453 and accompanying text.

514. Contrast the authorities cited in *supra* note 370 with those cited in *supra* notes 392 and 453 for further discussion.

515. See *supra* notes 436, 471 and accompanying text.

516. See *supra* notes 425, 444-49, 458-61, and 467-69 and accompanying text.

517. ZELIZER, *supra* note 341, at 166. This change was probably related to the shift from the tax policy of redistribution of income to horizontal equity and lowering the top rates epitomized in the tax policies of House Ways and Means Chair Wilbur Mills, D-Ark, 1957-75. See *id.* at 141 (noting economist Dan Throop Smith’s remarks to the effect that reform no longer meant redistribution of wealth, but instead the reduction of “excessive rates of individual income tax and tighten[ing] the definition of taxable income to . . . assure more equal treatment of taxpayers.”).

518. See Lee, *supra* note 380 (noting that during the boom year of 1925, almost 50% of taxable income consisted of long-term capital gains, and that the top 10,000 individuals in income captured over 90% of the capital gains preference).

Democrats, and in particular "New Democrat" Arkansas Governor Bill Clinton, successfully revived the income redistribution rhetoric in the late 1980s and early 1990s.⁵¹⁹ This resurrection was directed, however, only at individual ordinary income and capital gains rates and did not address the inside tax shelter of C Corporations.

The LLC literature focusing solely on the burden of double taxation appears unaware of the violation of vertical and horizontal equity by the inside shelter of private C Corporations and of the considerable modern political support for the tax subsidy of graduated inside rates to small income private C Corporations. Proceeding from a fundamental flaw, a myopic focus on purported double taxation of private C Corporations, the common assumption has been that taxpayers seeking to avoid private C Corporation double taxation, while obtaining limitation of liability, would rush to the new passthrough entity.

Conventional wisdom arguments of double taxation as to private C Corporations are erroneous. As of 1993, sixty-one percent of C Corporations reported no income or losses and thirty-seven percent, or around 750,000 small income (mostly private) C Corporations, reported less than the phase out of the graduated corporate tax exemption total (\$335,000), amounting to over five percent of C Corporation income, but with average income of less than \$40,000, thus subject, on the average, to

519. See *id.* at 1397-98 (noting that the "ultimate triumph of this rhetoric was the successful 1992 Clinton presidential campaign"); Lee, *supra* note 141, at 40-43, 53-56 (reviewing the Clinton Administration's rhetoric regarding the true beneficiaries of the capital gains preference and the stagnation and drop of income in the lower 80% of families). This then resulted in the 1993 individual rate increase at the top without any substantial new capital gains preference. See Lee, *supra* note 380. After the Democrats lost control of Congress in 1994, the Clinton Administration and Democrats in Congress used class warfare or fairness rhetoric to thwart Republican tax policies. See Leon Panetta, White House News Briefing, Mar. 21, 1995, available in 1995 WL 117855 (statement of White House Chief of Staff Leon Panetta) ("Cuts in education programs, the school lunch and breakfast programs, cuts in women's, infants', and children's feeding programs—are the examples of how the Republicans are paying for, again, a tax program that largely favors the wealthy"); Robert Pear, *As Welfare Compromise Emerges, Clinton Aide Says Veto Is Certain*, N.Y. TIMES, Nov. 15, 1995, at A1, available in 1995 WL 9675280 (reporting that the administration objects that "Republicans are paying for tax cuts for rich by taking money from child nutrition, child care and child protection programs"). Then, in the 1996 presidential campaign, possibly in response to the fact that 1994 voting by suburban women—a critical swing vote—had dropped off, Clinton dropped the divisive fairness rhetoric and emphasized working together. See John F. Harris & Eric Pianin, *Bipartisanship Reigns at Budget Signing: Clinton, Gingrich Extol Benefits of Split Government at Ceremony*, WASH. POST, Aug. 6, 1997, at A-1, available in 1995 WL 9675280 (describing an atmosphere of bipartisan excitement at the signing of the budget which led Clinton and Gingrich to praise each other for working together to end the budget feud). The logic of this strategy resulted in the 1997 balanced budget agreement and a tax bill with cheap sound bite provisions for Democratic constituencies and, for the Republicans, a massive new capital gains preference and estate tax cuts mostly benefitting high income individuals. See *supra* note 352.

a fifteen percent rate.⁵²⁰ The overwhelmingly high income individual owners of such small income private C Corporations are mostly taxed from thirty-six to forty-five percent on any marginal income, such as the income they have split with their small or moderate income C Corporations.⁵²¹ A second, outside tax on that corporate income is largely avoided by (1) holding the private C Corporation stock (or merging with a public firm and holding that stock) until death, ideally without paying formal dividends; or by (2) selling it at a long-deferred capital gain, taxed at eighteen to twenty percent.⁵²² This gives rise to at least a \$3 billion a year or more tax subsidy. There also may be a similar subsidy for around 33,500 moderate income mostly private C Corporations reporting an average income of about \$2,000,000 a year, taxed at thirty-four percent.⁵²³ Thus, the true tax policy issue for private C Corporations is not double taxation, but whether the Treasury will get one tax, one time. It has not been able to do so for the past eight decades. Nevertheless, the widespread but erroneous claims of the clear tax advantage of LLCs over C Corporations may have some dampening effect after 1998 on choice of a private C Corporation as the tax entity for small businesses.

The LLC literature also assumes that, due to the various ownership, capital structure and allocation of income and loss restrictions applicable to S Corporations but not partnerships or LLCs, LLCs will supplant S Corporations as well.⁵²⁴ That clearly is not happening. The growth rate of S Corporations exceeds the rate for all partnerships and comes from a larger base. For 1997, there were 1,755,000 partnership returns, as contrasted with 2,450,000 S Corporation returns. SOI projects the average annual growth rate for 1999–2005 as 4.04 and 4.16% for partnerships and S Corporations, respectively.⁵²⁵

The story of the S Corporation's continued popularity, contrary to Conventional Wisdom, apparently rests on (1) over fifty percent of S Corporations in general (and probably much higher in newly formed S Corporations) having only one shareholder, so that the S Corporation

520. See *supra* notes 130, 132 and accompanying text.

521. See *supra* notes 141–48 and accompanying text.

522. See *supra* notes 186–89 and accompanying text. With the flat tax aspects of the 20% individual capital gains rate cap under § 1(h), installment reporting under § 453 does not offer any rate lowering potential to sellers, but may be demanded as a form of seller financing in a buyer's market. See Lee A. Sheppard, *News Analysis—Installment Method Repealed for Whom?*, TAX NOTES TODAY, Jan. 3, 2000, available in Westlaw, 2000 TNT 1-2 (“Large, strategic buyers pay cash, and often are willing to buy equity. But when the buyer is another closely held business that does not have a lot of cash or borrowing ability and wants assurances that it is not buying a pig in a poke, seller financing—the vernacular for installment sales—is the norm.”).

523. See *supra* notes 201–02 and accompanying text.

524. See *supra* note 89 and accompanying text.

525. See *supra* notes 286–88, 295 and accompanying text.

capital, ownership, and income allocation restrictions are academic; (2) substantial inertia toward the familiar and usually cheaper (as to formation costs) S Corporation, motivating both tax advisers and their small business clients; and (3) many, virtually all in my anecdotal experience, tax advisers believing, probably mistakenly, that an S Corporation may be used to reduce wage taxes in a services business by splitting profits between a "reasonable" salary, subject to such taxes, and S Corporation "dividends," which are not so subject.⁵²⁶ Also, in recent years, a quarter to a third of new S elections are made by private C Corporations (*i.e.*, C to S conversions), with almost a third of those conversions apparently being made by loss C Corporations.⁵²⁷

While formations of LLCs are increasing greatly, the types of businesses choosing that form appear largely to be the ones that historically chose the partnership form—real estate businesses and professionals.⁵²⁸ Thus, LLCs do not appear to be the wave of the future, supplanting both C and S Corporations. To the extent that LLCs will partially supplant private C Corporations in 1999-2005, it may be for the wrong reason (the myth of double taxation). This is not a bad result, since all businesses where the owners are not separated from management (roughly the public-private ownership dividing line) should be taxed the same as passthrough entities, that is, at individual rates.⁵²⁹ Similarly, while contrary to conventional wisdom, LLCs are not supplanting S Corporations, due to restrictions on capital and allocations (since such restrictions are largely irrelevant to the single owner entity). To the extent that LLCs are chosen more by professionals and real estate businesses, and S Corporations are chosen more by other service businesses and retail businesses, taxpayers are rationally self-selecting along complex or simple business lines—not a bad result. A thesis of *Taxation of Private Business Enterprises* is that the full complexities of aggregate Subchapter K are too much for small business practitioners and businesses to handle.⁵³⁰ To the extent, however, that the small and moderate income firms are still choosing private C Corporations, both horizontal and vertical equity are being violated—a very bad result.

A fundamental question is: Why did the conventional wisdom so err? A possible answer is lack of practical experience in advising small businesses. Yet the use of the small income private C Corporation as the ultimate tax shelter was discussed in the practitioner and some academic

526. See *supra* notes 254-62 and accompanying text.

527. See *supra* text accompanying notes 217-23.

528. See *supra* notes 296-99 and accompanying text.

529. See Lee, *Entity Classification*, *supra* note 35, at 83-93, 119.

530. See *supra* note 241-42 and accompanying text.

literature and in myriad congressional hearings and staff reports.⁵³¹ (The continued use of S Corporations for new businesses, as contrasted with C to S conversion, was much less widely discussed.⁵³²) I suspect that a root cause was the adoption of a theoretical hook for an article first, and then seeking to support it without thoroughly considering the actual application of the Internal Revenue Code in taxland.

531. *See supra* notes 147-55 and accompanying text.

532. *See supra* notes 219-32 and accompanying text.

VII. Appendix

Each IACA Annual Report covers two years. Often the common year for two years Reports contains conflicting data as to a particular jurisdiction. Furthermore, many of the jurisdictions responded to the author's February 1998 written request for data as to new entity filings for 1995-97 and often provided data somewhat at variance with the corresponding IACA Annual Report of the Jurisdictions data. Nevertheless, I believe that the above table accurately shows the trends of new reportings.

Where entry is followed by an asterisk (*), no data was contained in IACA Annual Report, and data reported in Questionnaires on file with the *Texas Law Review* were used instead. In case of *N/A, data was supplied in the IACA Annual Report but inconsistencies between the IACA Annual Report, the Annual Report and the questionnaires were so great that the data was treated as not available.

**Data Derived From: International Association of Corporation Administrators Annual Report of the Jurisdictions
1997-1999
(LEXIS®-NEXIS® and LEXIS® Document Services Compiler)**

State	Domestic and Foreign For-Profit Corporations				Domestic and Foreign LLCs			
	1995	1996	1997	1998	1995	1996	1997	1998
Alabama	8,611	9,976	10,176	9,344	1,800	2,548	3,430	4,624
Alaska	1,752	1,718	1,767	N/A	163	335	534	N/A
Arizona	13,978	15,402	15,362	14,237	5,189	6,601	8,199	10,267
Arkansas	N/A	8,445	8,344	7,925	N/A	1,420	1,717	2,047
California	48,309	51,841	55,757	57,815	8,373	12,151	17,979	23,190
Colorado	18,371	20,213	18,778	17,398	6,562	8,094	9,184	11,307
Connecticut	*8,770	8,747	8,600	5,225	*7,095	9,730	12,296	13,456
Delaware	48,168	51,600	53,030	48,885	6,933	10,888	20,731	30,793
District of Columbia	N/A	2,813	3,158	N/A	N/A	1,245	1,245	N/A
Florida	103,746	110,827	115,835	114,796	1,399	1,892	2,357	5,124

2000]

Business Tax Entities

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State	Domestic and Foreign For-Profit Corporations				Domestic and Foreign LLCs			
	1995	1996	1997	1998	1995	1996	1997	1998
Georgia	30,147	30,683	33,425	32,143	2,417	4,374	6,693	9,239
Hawaii	N/A	4,592	4,092	3,651	N/A	N/A	768	1,454
Idaho	3,830	3,886	3,954	3,883	1,107	1,449	1,899	2,323
Illinois	38,051	40,003	39,949	39,420	2,646	3,654	4,940	7,271
Indiana	14,089	14,247	15,928	15,224	2,465	3,152	4,022	5,115
Iowa	6,082	6,569	6,913	5,891	1,325	1,641	2,189	2,507
Kansas	*6,305	7,985	9,791	N/A	*1,658	1,867	2,397	N/A
Kentucky	9,438	10,809	10,810	9,870	1,505	2,190	2,647	3,955
Louisiana	13,122	13,804	13,766	11,845	2,872	3,908	5,750	7,554
Maine	3,780	4,018	4,039	3,869	293	434	708	1,054
Maryland	N/A	22,624	22,287	21,737	N/A	4,092	5,950	6,884
Massachusetts	16,378	15,872	16,012	15,251	N/A	2,193	3,363	4,973

State	Domestic and Foreign For-Profit Corporations				Domestic and Foreign LLCs			
	1995	1996	1997	1998	1995	1996	1997	1998
Michigan	N/A	28,670	28,213	25,449	8,868	7,955	11,053	17,589
Minnesota	13,943	14,620	14,803	14,607	1,403	1,987	2,549	3,844
Mississippi	6,460	7,065	7,589	6,814	859 ⁵³³	1,188	1,876	1,463
Missouri	12,188	13,100	14,821	17,163	2,991	4,078	6,887	7,043
Montana	8,798	3,417	4,475	4,616	500 ⁵³⁴	523	N/A	1,498
Nebraska	4,412	4,630	4,915	N/A	610	742	1,113	N/A
Nevada	20,790	N/A	N/A	N/A	1,956	N/A	N/A	N/A
New Hampshire	4,199	4,451	4,249	3,807	660	861	1,495	2,525
New Jersey	42,221	38,261	36,710	34,732	6,374 ⁵³⁵	8,442	10,700	13,609

533. Includes LLCs, LPs, and LLPs.

534. Apparently combines LLCs and LPs.

535. Includes LLCs, LLPs, and LPs.

State	Domestic and Foreign For-Profit Corporations				Domestic and Foreign LLCs			
	1995	1996	1997	1998	1995	1996	1997	1998
New Mexico	*4,568	*4,527	*4,353	N/A	*1,148	*1,485	*1,881	N/A
New York	77,533	79,725	80,529	78,912	8,431	11,170	14,454	18,101
North Carolina	*19,427	21,354	22,823	22,131	*3,267	4,494	6,001	8,162
North Dakota	2,254	2,273	2,508	2,253	269	304	370	477
Ohio	24,057	23,831	23,897	N/A	4,653	6,790	8,733	N/A
Oklahoma	9,332	9,972	10,140		2,356	2,904	3,721	N/A
Oregon	*N/A	*N/A	*N/A	*N/A	*N/A	*N/A	*N/A	*N/A
Pennsylvania	22,896	23,366	24,705	22,869	491	723	1,498	3,519
Rhode Island	3,690	3,626	3,626	3,472	510	785	1,018	1,448
South Carolina	9,977	10,592	15,485	16,149	1,270	2,143	3,645	4,826
South Dakota	2,414	2,670	2,600	2,685	399	478	550	600
Tennessee	10,546	10,798	10,139	9,203	3,340	4,855	6,456	7,702

State	Domestic and Foreign For-Profit Corporations				Domestic and Foreign LLCs			
	1995	1996	1997	1998	1995	1996	1997	1998
Texas	45,024	44,191	45,656	47,026	5,446	6,628	8,664	11,935
Utah	N/A	8,046	8,710	8,497	N/A	6,067	6,574	7,191
Vermont	N/A	2,498	2,388	2,107	N/A	179	524	676
Virginia	23,035	22,712	23,063	22,555	4,215	5,398	8,206	9,974
Washington	17,235	16,467	15,852	16,192	2,889	4,243	6,279	9,134
West Virginia	N/A	N/A	4,350	5,700	N/A	N/A	400	660
Wisconsin	10,297	10,119	9,762	8,920	3,473	4,124	6,149	8,136
Wyoming	3,207	3,478	3,607	3,194	1,301	1,407	1,841	1,879