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

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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


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 rates\(^9\) 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 pass-through entities and self employers.\textsuperscript{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.\textsuperscript{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 2000\textsuperscript{18} 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.\textsuperscript{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,\textsuperscript{20} to the mundane,\textsuperscript{21} and even arcane.\textsuperscript{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.\textsuperscript{23} Real estate businesses tend to be less suited to a C Corporation,\textsuperscript{24} somewhat less suited to an S Corporation,\textsuperscript{25} and more suited to an LLC.\textsuperscript{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.\textsuperscript{27} However, they

\textsuperscript{16.} See infra notes 137-49 and accompanying text.
\textsuperscript{17.} See infra note 283 and accompanying text.
\textsuperscript{18.} See infra note 289 and accompanying text.
\textsuperscript{20.} See infra notes 234-42.
\textsuperscript{21.} See infra notes 243-46 and accompanying text.
\textsuperscript{22.} See infra notes 247-72 and accompanying text.
\textsuperscript{23.} See infra notes 296-300 and accompanying text.
\textsuperscript{24.} See infra notes 206-11 and accompanying text.
\textsuperscript{25.} See infra notes 65 and accompanying text.
\textsuperscript{26.} See infra note 207 and accompanying text.
\textsuperscript{27.} See infra note 207 and accompanying text.
are well-represented in the ranks of S Corporations. The same pattern of concentration of real estate businesses and service businesses in all partnerships indicates that what Professor Hamill calls the "meteoric pace" 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.

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). 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.

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. Part V concludes that any hope for congressional enactment of the ideal tax treatment as to private C Corporations 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.
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,\textsuperscript{36} the potent political support for the private C Corporation in shelter\textsuperscript{37} and the powerful small business myth in the political rhetoric.\textsuperscript{38} The various shibboleths of conventional wisdom constitute conceptual stigmatisms clouding vision and precluding any effective appeal to Congress for reform. Past attempts, as in the 1984 Treasury Tax Reform Proposals,\textsuperscript{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.\textsuperscript{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 law\textsuperscript{41} or if it is

\textsuperscript{36} See infra notes 291-343 and accompanying text.

\textsuperscript{37} See infra notes 422-38, 445 and accompanying text.

\textsuperscript{38} See infra notes 446-56, 458-72, 475-92 and accompanying text.

\textsuperscript{39} See infra note 456 and accompanying text.

\textsuperscript{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 gain preference that was uniting the pressure groups in opposition lead 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 433-36 and accompanying text.

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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{44} In a redemption, liquidation, or sale of stock, the
"outside" taxes are usually assessed at the capital gains rate.\textsuperscript{45} This is the
classic double taxation scenario.\textsuperscript{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.\textsuperscript{47}

2. \textit{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.\textsuperscript{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.\textsuperscript{49} A partner's basis, or cost in her ownership interest in the

\begin{itemize}
\item J. Roger Mcentz, 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 regarded as a
corporation for federal income tax purposes, even if the enterprise may more closely resemble another
form of business organization).
\item \textsuperscript{42} See Treas. Reg. \S 301.7701-3 (as amended in 1999). An entity formally formed as a corpo-
ration 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 \S 1.05(1)(b) (6th ed. 1998). An S Corporation and its shareholders must properly elect
passthrough status under \S 1362. See id. at \S 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. \S 7704
(1994).
\item \textsuperscript{43} See BITTKER & EUSTICE, supra note 42, at \S 1.02, 2.10.
\item \textsuperscript{44} See TREA\nsURY REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS:
TAXING BUSINESS INCOME ONCE 2 (January 1992) [hereinafter TAXING BUSINESS INCOME ONCE].
\item \textsuperscript{45} See BITTKER & EUSTICE, supra note 42 at \S 1.02.
\item \textsuperscript{46} See id. \S 1.02, 1.03.
\item \textsuperscript{47} See infra notes 141-62, 172-98 and accompanying text.
\item \textsuperscript{48} See I.R.C. \S 701 (West Supp. 1999); Robert A. Schur, 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).
\item \textsuperscript{49} See I.R.C. \S 702, 704 (West Group 1999).
\end{itemize}
partner. 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. Partnership income is thus subject to only one level of Federal income tax.

S corporations, like partnerships, are generally (but not always) treated as conduits, or passthroughs, for tax purposes. 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. 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.

51. See id. § 731(a)(1). Distributions of property are generally tax free, with carry-over basis adjustments. See id. § 732. Proportionate distributions of property or money may trigger recognition to the distributee and other partners. See id. § 751(b).
52. See Joint Comm. on Taxation, 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 taxfree 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 Meng) (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 89-93 (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. Law. 665, 692-99 (2007) (comments of Professor Glenn E. Coven on 3(d) Disruptive Taxation).
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


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


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).


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

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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); Rand, 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. Whitledge, Partnership or Subchapter S Corporation: Which Provides the Greater Tax Benefits?, 10 TAX LAW. 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[ed] 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.\textsuperscript{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.\textsuperscript{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".\textsuperscript{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.\textsuperscript{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.\textsuperscript{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 \textit{Taxation of Private Business Enterprises}.\textsuperscript{73}

\begin{itemize}
\item \textsuperscript{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).
\item \textsuperscript{69} See I.R.C. § 1211(b) (1994) (explaining that capital losses may only be used to offset $3,000 of ordinary gains).
\item \textsuperscript{70} See generally, Susan Kalinka, \textit{Death of a Member of an LLC}, \textit{57} I.A. 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).
\item \textsuperscript{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).
\item \textsuperscript{73} Yin & Shakow, \textit{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. \textit{See id.} at 12; \textit{see also} Lee, \textit{Entity Classification,} \textit{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. \textit{See Jerald David August, Benefits and Burdens of Subchapter S in a Check-the-Box World,} \textit{4 FLA. TAX REV.} 278, 272 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, except to the extent of unpaid stock subscriptions. In contrast, general partners are jointly and severally liable for partnership liabilities. 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. 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. 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. LLCs provide a limited liability shield much like private corporations while permitting, but not requiring, owners to actively manage the entity.

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 not (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”).
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 A.B.A. J. 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. 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. In short, the nontax advantages of private C Corporations and LLCs appear dubious at best.

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

“The report of my death was an exaggeration.” 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. L. 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, Wase & 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 Gruftz, supra note 60, 1998 SUPPLEMENT at 9; Richard A. Booth, Limited Liability Companies: Profits Seeking, Individual Liability, and the Idea of the Firm, 73 WASH. 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); Rand, 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.").


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. IRWIN RAY PITT, FAMOUS CITATIONS 578 (1998).
LLCs. 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, the LLC is the wave of the future for new small business ventures. 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.

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).


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. Kestinge 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

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.
only 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 passthrough 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

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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 Alt 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 simplicity—could never have arisen.\textsuperscript{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 1993\textsuperscript{113} corporate income tax distribution manifests a long-standing pattern of income concentration in large asset, mostly publicly traded corporations.\textsuperscript{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].


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%. 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, and there were only 295 S Corporation returns with more than $100 million in assets, with just 226 reporting a profit. Roughly two million S Corporations reported 11.1% of net income of all corporations in 1993. 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.”)

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.\footnote{120}

The pattern of concentration of corporate income in a handful of public corporations is long-standing,\footnote{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.\footnote{122} About 214,000 of the corporations had net income under $10,000; 43,000 corporations had net income above $10,000.\footnote{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.\footnote{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.\footnote{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.

\textit{Id; see also} David L. Brumbaugh, \textit{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.").

\footnote{120. See Joint Comm. on Taxation Staff, supra note 116 at tbs. 4-6 (comparing the 31.59% of partnerships with assets Jess 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).

\footnote{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.}

\footnote{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).

\footnote{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).

\footnote{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.

\footnote{125 See supra text accompanying notes 113, 115-16; infra note 290. at 18-21.}\n
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 percent 129 (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

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 x .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). 
Other particular circumstances of shareholders may militate towards selection of a small income private C Corporation over a pass-through entity. Early commentators pointed out that LLCs offered a tax advantage over S Corporations, which prohibit stock ownership by a nonresident alien. 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. 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.

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.

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).
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.
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 individuals\(^{141}\) (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. \(\text{§}\) 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. \(\text{§}\) 162(l)(1) (1994 &

\(^{140}\) 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, 33.3% 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)).\textsuperscript{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.\textsuperscript{143}

The Congressional Research Service (CRS) assumes that the benefits of this inside rate preference are concentrated at higher \textit{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.\textsuperscript{144}

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

\textsuperscript{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.

\textsuperscript{143} See I.R.C. § 11(b) (1994).

\textsuperscript{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].
[families 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 36, 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).

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.*

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.”

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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
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 printer 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

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151. Battersby, supra note 150, at 60.
153. See Federal Tax Policy for Economic Growth and Stability: Hearings Pursuant to Sec. 5(a) of Public Law 504, 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 Donald J. Coffman) (discussing various proposals to amend corporate partnership provisions of law).
financing) did drive the various Congressional corporate-shareholder integration debates.\textsuperscript{154}

[The 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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{158} Due to the inside

\textit{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. \textit{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, \textit{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. \textit{See Yin & Shkow, supra note 35.}

\textsuperscript{154} \textit{Lee, Entity Classification, supra note 35, at 66-67 and authorities collected therein.}

\textsuperscript{155} \textit{Id.} at 67-69 (footnotes omitted).

\textsuperscript{156} \textit{See I.R.C. § 1(a)(1) (West 1999).}

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

\textsuperscript{158} \textit{Id.} at 67-69 (footnotes omitted).
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 $25,000\textsuperscript{159}), 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.\textsuperscript{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%.\textsuperscript{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 \textit{before} phase-outs of exemptions, and reduction of itemized deductions, and imposition of wage taxes) hold forty-five percent of small private businesses.\textsuperscript{162}

4. \textit{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.”\textsuperscript{163} These

\textsuperscript{159} See I.R.C. \textsection 11(b)(1) (1994).

\textsuperscript{160} The inside corporate graduated income tax on $75,000 is $13,750, computed as follows: $50,000 \times 15\% = $7,500; $25,000 \times 25\% = $6,250; $7,500 + $6,250 = $13,750. See I.R.C. \textsection 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 \times 36\% = $27,000. See id. \textsection 1(a). The inside corporate graduated income tax on $50,000 is $7,500, computed as follows: $50,000 \times 15\% = $7,500. See I.R.C. \textsection 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 \times 36\% = $18,000. See id. \textsection 1(a).

\textsuperscript{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. \textsection 1(a) (1994).

\textsuperscript{162} See supra notes 141-43 and infra notes 145-46 and accompanying text.


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.

\textit{Id.} For an enlightening samolite of the literature see P. CARON ET AL., \textit{FEDERAL INCOME TAX
special tax provisions can take the form of exclusions, credits, deductions, preferential tax rates, or deferrals of tax liability. 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.

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). 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. 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


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. Hittinrath, Income Tax Hike Surs 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. 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 $25,000 with (2) the $30 billion in taxable income I estimate is attributable to the profitable small income C Corporations as a class for 1993 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 average 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. 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 Menta, 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 rate, while avoiding or reducing outside shareholder level
rarely distribute earnings (in excess of payment of compensation to principals) formally as dividends, but instead usually retain them for expansion. 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.

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. § 535(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 $30,000 in taxable income is $7,500 ($50,000 x 15%). Id. § 11(b)(1)(A). Thus, accumulated taxable income for such a C Corporation with $30,000 in taxable income would increase $42,500 ($30,000 - $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 x $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 & 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 JINT 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. WALTZ, 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")\(^\text{176}\), 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).\(^\text{177}\)

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 $25,000)\(^\text{178}\) 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.\(^\text{179}\) The leading Code Section in audit of all business taxpayers is section 162 and the related provisions of sections 263 or 274.\(^\text{180}\) 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).


\(^{177}\) See MLP Hearings, supra note 39, at 348 (statement of Lee).

\(^{178}\) See I.R.C. § 11(b) (West Supp. 1999).


deductibility of "reasonable" compensation. This has been the case for over two decades. The fact that taxpayers win most of the litigated reasonable cases, which Professor Hamill documents, overlooks the substantial transaction costs in audits, since litigation is only the tip of the audit iceberg. 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. This seems to be avoided at least half the time by holding the private corporation stock until death (thereby obtaining a stepped up basis in her estate's hands) or merging it tax-free into a public corporation 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 Really 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.


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. When the inside tax rate is 15% and the outside tax rate is 20% (the maximum individual capital gains rate), the after tax income is greater than it would be after direct taxation at 39.6%. 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%.

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. 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.

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, 1. 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.

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.
194. See I.R.C. § 55(b)(3)(D) (West 1999). I thank Professor Tumier 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" argument 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 entity (leading to surprises and perhaps recriminations upon exiting). A few significant contexts, such as business reasons, idiosyncratic investor preferences, or a near-term goal of going public, may induce selection of a C Corporation, even when initial losses are anticipated, foregoing the income tax savings of a pass-through 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. I assume that this entire group was around 33,490 C Corporations in 1993. This group reported for 1993 around 11.7% of C Corporation income.

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 debt 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 "publicly 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. 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.

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). 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.

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 65). 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. 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% x $571,922,088,000 = $66,914,884,300. $66,914,884,300 / 33,490 = $1,998,056.

203. See Hamill, supra note 1, at 422 n.145 (calculating that approximately 10% of medium asset corporations are publicly 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 206 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).


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(b)(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. Winnman, 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.\textsuperscript{213}

\section{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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).\textsuperscript{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.\textsuperscript{218}

\begin{footnotesize}
\begin{enumerate}
\item[213.] “Economic analysis of law traditionally posits a world in which decisions are based on rationality, not on emotion.” Melinda J. Branscomb, \textit{Labor, Loyalty, and the Corporate Campaign}, 73 \textit{B.U. L. REV.} 291, 339 n.339 (1993) (citing \textsc{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.
\item[214.] \textit{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, \textit{Entity Classification}, supra note 35, at 91 n.130.
\item[215.] \textit{See} Lee, \textit{Entity Classification}, supra note 35, at 91 n.130.
\item[217.] \textit{See} id.
\item[218.] \textit{See supra note 176 and accompanying text}
\end{enumerate}
\end{footnotesize}
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;\textsuperscript{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;\textsuperscript{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;\textsuperscript{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;\textsuperscript{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.\textsuperscript{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,\textsuperscript{224} probably reflecting the substantial failure rate in small businesses\textsuperscript{225} 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

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219. See Wittman & Grant, supra note 19, at 40.
220. See Wittman, supra note 141, at 43.
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 for the first time in 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 & Grant, supra note 141, at 44; Wittman & Grant, supra note 19, at 41.
225. The literature indicates a 30% 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. Zelizerman, 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.


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


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.”

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)) as nonlevel playing field barriers to raising capital not present in LLCs or other partnerships. The stock ownership patterns in S Corporations suggest that these restrictions have scant impact at the time of formation, although it was 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. Another thirty percent have only two shareholders. 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, although with check-the-box most now permit single member LLCs. Initially I surmised that lower LLC-to-corporation

232. Wittman, supra note 141, at 43.
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 BeIntroduced 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.
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, 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. 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 too complicated for many small business practitioners and taxpayers. 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

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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. Melkon, 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); Rand, 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"); Swidetzky, supra note 89, at 398 ("Another substantial advantage of the partnership over the S corporation is the availability of the 'section 754 election'.").

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

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, SCRMTNO-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. Baptist & 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) and on partners and proprietors under the Self-Employment Contributions Act (SECA) 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. 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.” 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). 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).


S corporation are subject to FICA taxes on the wages paid to them."

(A field service advice holding that a Subchapter S Corporation shareholder's pro rata share may constitute earnings from self-employment unfortunately is erroneous. 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. 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." 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). Where the shareholder performed services,

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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. Show, The New Subchapter S Distribution Rules: A Half-Step Forward But...
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.\footnote{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.\footnote{258}

Section 482 cases dealing with sole proprietor service businesses
which incorporate (as a C Corporation) suggest that the Service can deter­
mine 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.\footnote{259} In such circumstances, under the majority

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Act of 1982 on constructive, unallocated dividends).}
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\footnote{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).}

\footnote{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.
("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.".).}

\footnote{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. \textit{Id.} at 1028-29. Congress' unhappiness with the "result" in Keller lead to Section 269A. \textit{See} H.R. CONF. REP. NO. 97-760, at 634 (1982), \textit{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.\textsuperscript{260} Such reallocation would impact FICA wage taxes.\textsuperscript{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.\textsuperscript{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.

\textsuperscript{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 Fogelsong 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 Fogelsong 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 Fogelsong 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 Fogelsong 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.

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

\textsuperscript{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

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 NBSE 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)(l3) (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.").


266. See 143 Cong. Rec. S,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) (warning that the stealth tax would negatively affect limited partners and members of LLCs).
Service, the Taxpayer Relief Act of 1997 postponed for one year issuance of any final regulation.\textsuperscript{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,\textsuperscript{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.\textsuperscript{269} Moreover, no active member of an LLP should be considered a limited partner for this purpose.\textsuperscript{270} I agree. Here, too, the sensible resolution is statutory.\textsuperscript{271}

\textsuperscript{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).

\textsuperscript{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).

\textsuperscript{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.

\textsuperscript{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").

\textsuperscript{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 1993 273 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.

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.


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. 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. The drop in increase in net C Corporation returns for 1995 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, which grants relatively easy classification of an LLC as a partnership, and then from Notice 95-14, 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. 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 + 2,321,048 = 16.28%. As of November 1, 1999, no SOl data was available as to C Corporation formations for 1996.

279. See supra note 275 and accompanying text.

280. See 1995-1 C.B. 301; 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.


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. Schmitz & 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 versus 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 (conclude 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.\textsuperscript{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.\textsuperscript{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\textsuperscript{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

\textsuperscript{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.

\textsuperscript{284} See supra note 138 and accompanying text.

\textsuperscript{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. For 1997, there were 2,450,000 S Corporation returns. SOI projects S Corporation returns to increase an average of 4.16% annually from 1999-2005. SOI estimates that S Corporation filings will first exceed C Corporation filings in 2000.

The number of partnerships of all types also increased around six percent, from 1,493,963 in 1993 to 1,580,900 in 1995. 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. 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. 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. 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; Witman & 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.

289. See id.


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 36.
in the number of limited partnerships. SOI projects that partnership returns in general will increase 4.04% annually for 1999-2005. 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. 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. Note that eighty percent of the income of services partnerships was attributable to the professions of law, health, and accounting. Such real estate and services market segments dominate all partnerships in roughly the same percentages as in LLCs. 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.

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. Cicotello & 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 factor\textsuperscript{301}). SOI data shows that for 1995, 10.8% of S Corporation net income consisted of “finance, insurance, and real estate” industrial groups,\textsuperscript{302} which reported 61.9% of the net rental net income of S Corporations.\textsuperscript{303} Finance, insurance, and real estate returns made up 10.5% of all S Corporation returns.\textsuperscript{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.\textsuperscript{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 returns\textsuperscript{306} and for 15.45% of all active C Corporation returns.\textsuperscript{307} Real estate businesses made up seventy percent of the returns for the entire finance, insurance, and real estate industrial groups for all corporations.\textsuperscript{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...


\textsuperscript{302} See Wittman, supra note 141, at 49 fig. E.

\textsuperscript{303} See id. at 47.

\textsuperscript{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).

\textsuperscript{305} See supra notes 62-65 and accompanying text; infra note 342 and accompanying text.

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

\textsuperscript{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.

\textsuperscript{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. 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).  

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.  

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. 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. 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

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. 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.

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. 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.

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 California and, until recently, in Florida and Pennsylvania. 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.

For 1998
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. In Texas, the adverse LLC franchise tax remained in place, and the 5:1 ratio remained the same as well. Conversely, in Connecticut, where LLC to corporation formations were running 3:2 for 1997 and a little over 2:1 for 1998, 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. 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 30:1 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 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.

See supra note 320.

See infra Appendix.

321. See infra Appendix.

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 pass-through 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 estate 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. Delaware’s ratio of 2.5:1 corporations to LLCs for 1997 and 1.6 to 1 for 1998 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.

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, banks, insurance companies (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, Notes, 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).
historically, railway companies\(^{331}\), 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 Jackson\(^{336}\) who was of Scotch-Irish origin\(^{337}\) and who was a
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 movement among Texas hill-country farmers and ranchers who were also of Tennessee-Scotch-Irish (and some German) ancestry. 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. I believe that its core message is good tax policy: equality of opportunity (horizontal equity) and distrust of aggregations of economic power because of their political ability to obtain special privileges (violating vertical equity). 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

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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. FEHRENBACK, 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 FEHRENBACK, 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).


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. 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." By the mid-1930s, there were 450,000 active corporations (about fifty percent of which reported income), with many suffering losses from the Great Depression, 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. 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. The stock in these public corporations was disproportionally 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.

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. Horizontal equity requires similar tax treatment of taxpayers in similar circumstances. 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. 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. 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 (citing 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.333

I. 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 $48 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).

President Franklin Delano Roosevelt's ill-fated undistributed profits tax, which would have reduced the inside corporate tax base by dividend payments.\textsuperscript{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).\textsuperscript{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).\textsuperscript{356} President Franklin Roosevelt proposed to replace this revenue by enacting an undistributed profits tax.\textsuperscript{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.\textsuperscript{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

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\item See infra note 357 and accompanying text.
\item 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 I), 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).
\item 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”).
\item 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).
\item 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).
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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. 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. 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.

Not only was the far simpler approach of corporate-shareholder integration thought barred by but a hidden agenda for this “roundabout device, 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.


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 lll. L. Rev. 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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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

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\textit{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 \textit{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 \textit{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).
\end{quote}

\textsuperscript{364}. See infra note 375 and accompanying text.

\textsuperscript{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 from 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.

\textit{Id.} at 24 (statement of Commissioner Helvering).

\textsuperscript{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 \textit{Lee, Capital Gains Proposals, supra note 35; Lee,}}
individual income surtaxes." 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." Concrete examples in Executive Session also brought this inside sheltering home to populist Senators Connally and Robert La Follette, R-Wis.

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 . . . ." 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. 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. 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 1936 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 472-507.
"and that is the way the life of industry continues."\textsuperscript{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.\textsuperscript{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.\textsuperscript{375} While Treasury listed horizontal

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

\textsuperscript{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).

\textsuperscript{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, its true first goal appears to have been vertical equity: running all corporate sector income through the individual (steeply progressive) "tax mill" one time.

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. 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." 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. Tredway). 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 in 1935). 383
Some members of Congress, including Senator Tom Connally

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 describ-
ing 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);

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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{387} Some shareholders undoubtedly simply evaded the outside taxes by not reporting the dividends.\textsuperscript{388} In any event, implacable opposition of management, the

\textsuperscript{384} See \textit{1936 Senate Hearings}, supra note 122, at 132; cf. \textit{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." \textit{1936 Senate Hearings}, supra note 122, at 258 (statement of Sen. Connally).

\textsuperscript{385} \textit{1936 Confidential Senate Hearings}, supra note 124, at 38, 42 (statement of Chairman Harrison).

\textsuperscript{386} Compare \textit{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).

\textsuperscript{387} Message from the President of the United States, \textit{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 \textit{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).

\textsuperscript{388} See \textit{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. \textit{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. 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.

2. In the Middle Years: Focus on Inside "Ultimate" Tax Shelter.— Four decades later, when public 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. . . . [Individual 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.

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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 lessered 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 6144-51.
Why else do you think that adequately tax advised private C Corporations were then, and are still, formed? Why else did Congress fashion the tax law this way?

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.

...
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 part, 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 individuals 398 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 cuts 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

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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).
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 thereafter").
400. See Lee, supra note 141, at 40-42 (noting the distributional effects of a similar proposal).
402. See McIntyre. * supra* note 395.
accumulations of net income.\textsuperscript{403} As many as two-thirds of self-employed individuals filing Schedule C are reporting “second jobs, that individuals perform to make ends meet,”\textsuperscript{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.\textsuperscript{405} For 1995, 16,423,900 sole proprietorship returns were filed, reporting $166.8 billion.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{409}
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.\footnote{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.\footnote{411} The existing flat 12.5% corporate income tax applied to a base net of excess profits with a $2000 credit.\footnote{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.\footnote{413} In 1932, the by-then $3,000 small corporate income

\footnote{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. \textit{See} Payne-Aldrich Tariff Act, ch. 6, 36 STAT. 11, 112 (1909). \textit{See generally} Marjorie E. Kornhauser, \textit{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. \textit{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 \textit{Eisner}. \textit{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. \textit{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. \textit{See} 1921 House Hearings, supra note 379, at 397 (statement of Secretary Mellon); \textit{id.} at 405 (statement of T.S. Adams).

411. \textit{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, \textit{Professor T.S. Adams (1873-1933) on Federal Taxation: Deja Vu All Over Again\textit{,} 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. \textit{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. \textit{See} 1921 House Hearings, supra note 379, at 398-99; 1921 Senate Hearings, supra note 393, at 10-11 (letter from Secretary Mellon).

413. \textit{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. \textit{See} 1936 Senate Hearings, supra note 122, at 20-21 (colloquy between Sen. Gerry and Commissioner Helvering).
exemption was repealed for obvious revenue reasons, 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. 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. 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.

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. 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.


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.

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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).
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 1964 428 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

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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.
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").
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 gain preference, but the pressure groups uniting in opposition guarded instead
Republicans and Southern Democrats passed, in the first wave of the “tax revolt,”\textsuperscript{433} upper income-skewed tax cuts, over the objections of ineffectual House Ways and Means Chair Al Ullman (D-Or.).\textsuperscript{434} On the ruins of Carter’s tax proposals, including corporate shareholder integration,\textsuperscript{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.\textsuperscript{436} One of the structural signatures of President Ronald Reagan’s tax cut in the Economic Recovery Tax Act of 1981\textsuperscript{437} (ERTA)—deficit financing (also found in JFK’s 1963 tax proposals, which Republicans had then opposed\textsuperscript{438})—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),\textsuperscript{439} after being told by the

\textsuperscript{433} See Robert G. Kaiser & Mary Russell, \textit{A Middle-Class Congress—Have Over Have-Not}s, \textit{WASH. POST}, Oct. 15, 1978, at A1 (“The 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., \textit{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, \textit{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.

\textsuperscript{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, \textit{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, \textit{Ullman Shakes “Loser” Tag in Give-and-Take with Long}, \textit{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”).

\textsuperscript{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.”).


\textsuperscript{438} See Dionne, supra note 433, at 251.

Administration that an unblocked economy would pay for the tax cuts through efficiency gains, an idea termed supply side economics.\textsuperscript{440} Congress took a "Riverboat Gamble" and cut the tax rates while fashioning, in effect, a consumption tax for capital-intensive industries.\textsuperscript{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.\textsuperscript{442} Higher income individuals and large corporations benefitted
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 ERFA, 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. 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 rationales (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; (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; and (3) small business bears a disproportionate cost of government regulation. Apparently, the most convincing reasons to Congress in fact were (4) an appeal for equity in the “tax distribution system,” in that in the Economic Recovery Tax Act of 1981, large...
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;\textsuperscript{449} and (5) small business, in a unified voice, had specifically asked for cuts in the small income graduated inside tax rates.\textsuperscript{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 income\textsuperscript{451} "designed to ensure that a greater amount of the benefits of the lower rate enacted in 1981 would accrue to small businesses."\textsuperscript{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

\textsuperscript{449} 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").

\textsuperscript{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").


\textsuperscript{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 phasout 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 rates 458 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

455. BIRNBAUM & MURRAY, supra note 396, at 80.
459. 131 CONG. REC. 8,376 (1985) (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 . . . ."

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 straightforward 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. 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 inheres 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."  

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. This was similar to an earlier proposal by Representative Charles B. Rangel (D-N.Y.). 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."

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.

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

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.C.A.N. 2313-1, 2313-712.
473. See TAX EXPENDITURES COMPENDIUM, supra note 144, at 255 (citing mixed evidence); BRUMBAUGH, supra note 119 (delegating to taxing 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 ("The 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.
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.\footnote{474}

In addition, there is clearly a fair amount of cloaking taking place.\footnote{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).\footnote{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:\footnote{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."\footnote{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.\footnote{479} Moreover, the graduated brackets only apply to a

\footnote{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).

\footnote{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.

\footnote{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.


\footnote{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. Martin) (referring to mom-and-pop sole proprietors as "true small businesses").

\footnote{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 closing doors and a smaller number actually failing). Professor Douglas Holtz-Eakin has stated:

\begin{quote} Even 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. \end{quote}

\textit{Hearing Before Senate Finance Comm. on S. 105, S. 161, S. 628, S. 632, S. 867, and H.R. 1215}
fraction of the small business universe. 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. The difficulty in obtaining capital is the only real difficulty small private C Corporations (and private S Corporations and proprietors as well) face.

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.’” 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.” Professor Kornhauser tells us that “[b]ecause rhetoric must persuade, politicians use rhetoric that reflects people’s beliefs.” The rhetoric of “entrepreneurial spirit” must,
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).
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. 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.

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. Yet Congress increased the inside graduated rate subsidy times after such notice. Apparently Congress is willing to let small business people buy their admission tickets to the tax shelter and take their chances.

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). 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, 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.
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 infra supra note 141: at 30 (comparing opening up S 1244 rather than increasing the
carryover to S Corporation years after a C to S conversion. 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. 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. 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. 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 terminology) was thought precluded by Eisner v. Macomber.

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 terminology$^{504}$). He seemingly wanted to undercut progressivity$^{505}$ 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 through . . . .$^{508}$

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

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$^{504}$ 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. In both of these early debates proponents focused more on horizontal than vertical equity.

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. Both focused more on ability to pay than horizontal inequity, in contrast to earlier decades. Both resulted instead in Congress increasing the subsidy by reducing the inside rates on small income C Corporations further. 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. 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.’”

Populist Democratic rhetoric was revived in response to the “failed” Reagan-Bush trickle down tax policies of disproportionally 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. 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 tight[ening] 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. 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

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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.
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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 pass-through 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.
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<sup>533</sup> Includes LLCs, LPs, and LLPs.
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