Choice of Small Business Tax Entity

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CHOICE OF SMALL BUSINESS TAX ENTITY: FACTS AND FICTIONS
by John W. Lee

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This article summarizes parts of Lee’s forthcoming article “A Populist Political Perspective of the Business Tax Entities Universe: Hey the Stars Might Lie But the Numbers Never Do,” 78 Texas L. Rev. 885 (2000). Conventional wisdom, says Lee, holds that the LLC, due to its limited liability and hassle-free single level of taxation, will supplant C and S corporations as the choice of entity for new businesses. In fact, in most jurisdictions corporate formations outnumber LLC formations 2:1 or more, and IRS Statistics of Income (SOI) projects that the S corporation will be the fastest growing tax entity for 2000 to 2005. Lee believes that an underlying reason is that double taxation of private C corporations is a myth. Thirty-seven percent of C corporations (more than 750,000 in 1993) accounting for about 5 percent of C corporation income are small-income corporations, annually reporting on the average just $40,000, taxable at 15 percent. In sharp contrast, 80 percent of the owners of these small-income, mostly private C corporations are taxable at 31 percent or higher; 45 percent, at 39.6 percent before exemption and deduction phaseouts and wage taxes. And there is little or no second tax. Dividends are rarely paid by private C corporations. Moreover, about half of this private C stock is held until death and any sales are usually long deferred and taxed at capital gains rates (20 percent or less). Thus, inside sheltering results in a $3 billion/year tax expenditure according to the Joint Committee on Taxation, violating ability-to-pay principles just as Congress intended.

Similarly, 33,500 mostly private, moderate-income C corporations accounting for 11 percent of C corporation income, annually report average income of $2 million taxed at 34 percent while their owners are taxable at the highest rates, as high as 45 percent after phaseouts and Medicare taxes if this income were passed through to them. This probably results in at least as great a tax subsidy to the moderate-income as to the small-income C corporations. Also, in 1993 61 percent of C corporations reported no income or incurred a loss. Many of these “dry” C corporations used to deduct health insurance costs for owner-employees. As such costs gradually become fully deductible by the self-employed and 2 percent or more S corporation shareholders, such use ought to decline and, in fact, SOI projects slight declines from 2000 to 2005 in the number of smallest C corporation returns and slight increases in the number of larger C corporation returns.

The story as to S corporations’ flourishing is more complicated. Lee writes that the reasons vary from the practical (over 50 percent have only one shareholder, so the capital- and income-shifting advantages of LLCs are moot), to the mundane (taxpayers and advisers are more familiar with S corporations than LLCs), and to the arcane (perceived wage tax advantages to S corporations paying dividends rather than salaries to shareholder-employees). Finally, more than half of the undisputed growth in LLCs (including LLPs) is revealed by SOI to be in the real estate and professional services market segments, which are the dominant market segments for partnerships. In fact, much of the LLC growth is at the expense of general and limited partnerships.

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The limited liability company literature by and large myopically focuses on the “burden” of double taxation, not perceiving the considerable political support for the tax “boon” of graduated inside rates to small-income private C corporations and the resultant violation of vertical and horizontal equity. The common view resulting from that fundamental conceptual astigmatism has been that entrepreneurs seeking to avoid private C corporate double taxation while obtaining limitation of liability will rush to the new LLC passsthrough entity. 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, and the unavailability of inside basis adjustments on transfer of an ownership interest in the entity as well as other discontinuities in passthrough taxation, LLCs will supplant S corporations as well. Factually, however, new firms continued to be formed in most jurisdictions in corporation-to-LLC ratios of 2:1 to 3:1. What is wrong with this picture?

I. Facts on the Ground

The 1997-99 Annual Update Reports of the Jurisdictions of the International Association of Corporation Administrators (IACA) for 1995-1998, show that while the number of new reportings by LLCs has 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 100, in 30 percent of the jurisdictions. For 1998, 10 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 (undifferentiated between C and S corporations) reporting has exceeded the number of new LLCs reporting for each year.1 For 1997, the ratio of new corporation to new LLC reports in two jurisdictions was as high as 20 to 1 and 50 to 1; in two more jurisdictions the ratio of corporate to LLC formations was 8 to 1; in 20 percent of the jurisdictions 5 to 1; in 30 percent 3 to 1; in 20 percent 2 to 1; and in three jurisdictions, the ratio of LLC to corporate formations was approaching 1 to 1.

For 1998, the percentage of the jurisdictions in the 4:1 or greater range, which included Texas and New York, declined to 10 percent of the jurisdictions; the percentage of 3:1 range jurisdictions declined to 20 percent; and over 15 percent ranged from 2:1 to 2.5:1, including California and New Jersey. In the rest, save Connecticut, corporate formations still exceeded LLC formations. For 1998, in most jurisdictions with large numbers (more than 30,000) of new corporate filings, 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 state tax treatment. The latter especially appears to be the case where LLCs are subject to franchise taxes but (limited) partnerships are not, as in Texas and California,2 and until recently in Florida and Pennsylvania, resulting in a 50:1 and a 5:1 corporation-to-LLC filing ratio in Florida and Texas, respectively, for 1997.3 Florida’s adverse LLC franchise tax rule was repealed for half of 1998 and the ratio of new corporate to new LLC filings dropped to 27:1 for the whole year, while Pennsylvania, with the

1 In Connecticut there was roughly a 3:2 ratio of LLC to corporate formations for 1997; more than 2:1 for 1998.


3For instance, California’s LLC regime originally contained two biases against full use that reportedly caused the statute to be a “dud” at first: (1) professionals and anyone licensed by the state (67 categories) could not form an LLC (due to pressure from the California Trial Lawyers Association); Jane Applegate, “Thanks to Exclusions, Liability Shield Plan Languishes,” Sacramento Bee, Dec. 26, 1994, F-2; Jan Norman, “No Stampede — Yet — for Limited Liability,” Sacramento Bee, May 29, 1995, B-1; and (2) in addition to an annual fee based on gross receipts, LLCs had to pay the minimum $800 corporate franchise tax. Norman, supra. Subsequently, special taxes on limited partnerships and limited liability companies were repealed but the franchise tax is still imposed on LLCs. See Cal. Revenue & Tax’n Code Ann. sections 23081, 23091-23096.5, 23097-23099.5, 23038(c) (1992) (1999 Supp.). Not surprisingly, in 1995, the ratio of California corporate filings to LLC filings was 6:1, dropped to 4:1 for 1996 and 3:1 for 1997 and 2:5:1 for 1998. Id. California now permits “professionals,” but not other licensed services businesses, to organize limited liability partnerships. Cal. Corp. Code section 16951 (1992 & 1999 Supp.) (recognizing only registered limited liability partnerships and foreign limited liability partnerships). Texas and Florida applied a corporate franchise tax to LLCs (in Florida’s case in effect a 5.5 percent corporate income tax) but have no income tax that would apply to partnerships. Tex. Tax Code Ann. section 171.001(a)-(b) (West 1992); Fla. Stat. Ann. sections 608.471, 220.02 (West 1989 and 1993, respectively). Florida repealed its franchise tax as to LLCs effective July 1, 1998. Fla. Stat. Ann. section 608.47 (1999 Supp.). Before the amendment, Florida’s corporate filings compared to LLC filings were 50:1 for 1997 (115,835 to 2,357). 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). Id. Similarly, Pennsylvania originally taxed LLCs generally like corporations except for LLCs set up by professionals, which were taxed like limited partnerships. 15 Pa. Cons. Stat. sections 8925, 8997 (1995) (treating LLCs like corporations for tax purposes and taxing professional LLCs as limited partnerships), repealed insofar as it conflicted with Act of May 7, 1997, P.L. 85, No. 7, Sec. 35.1(b). Section 8925 was repealed effective January 1, 1998. Act of May 7, 1997, P.L. 85, No. 7, section 35.1(b) (amending the Act of March 4, 1971 (P.L. No. 2)). For 1998, new corporate filings in Pennsylvania dropped, new LLC filings increased by roughly the same number, and the ratio of new corporate to LLC filings dropped from 20:1 to 7:1.
II. The Myth of Double Taxation

A. Use of Inside Corp. Rates: Ultimate Tax Shelter

Double taxation of private C corporations is mostly a myth. As of 1993, 61 percent of C corporations reported zero income or losses\(^8\) and 37 percent, or around 750,000, small-income (mostly private) C corporations reporting less than the phaseout of the graduated corporate tax exemption amount ($335,000) accounted for 5.3 percent of C corporation income.\(^6\)

\(^6\)IRC section 11(b) (1) (A). 1993 Statistics of Corporate Income, supra note 6, at 245 (lines 66 less 69), reveals that for 1993, C corporations having net income reported $571,922,088,000 ($658,666,005,000 (all corporate income))-$86,743,917,000 (S corporation income)). Recall that the 61 percent 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 percent of the income for all active C corporations reporting net income is $30,311,870,000 (5.3 percent 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).

The entire group of profitable C corporations with taxable income above $335,000 is 2 percent of all C corporations according to the JCT, Small Business, supra note 5. That number is 41,264 (2,063,124 x 2 percent). The approximately 4,000 profitable corporations with assets (adjusted basis) from $100 million to $250 million paid 6.2 percent of all corporate income taxes; the approximately 2,000 profitable corporations with assets from $250 million to $500 million, 5.3 percent; and the approximately 2,000 profitable corporations with more than $500 million, 71.2 percent. Joint Committee on Taxation Staff, Selected Materials Relating to the Federal Tax System Under Present Law and Various Alternative Tax Systems 60 table C-22 (March 14, 1996), Doc 96-7976 (96 pages), 96 TNT 53-8 ("JCT, Federal Tax System").

Subtracting from 41,264 the 7,774 profitable large-asset (and income) C corporations [(8,000 large asset corporations, JCT, Federal Tax System, supra; less 226 large-asset profitable S corporations, 1993 Statistics of Corporate Income, supra note 6 at 497 line 1] leaves 33,490 moderate-asset profitable C corporations (the loss C corporations — large, moderate, and small asset — are included in the 61 percent no income or losses corporations).

For 1993 C corporations with assets of $100 million and above reported income of $474,691,930,000. See 1993 Statistics of Corporate Income, supra note 6, at 245 (line 66 less line 69). All C corporation income amounted to $571,922,088,000, see supra note 7. Therefore such large-asset C corporations reported 82.9 percent of C corporation income for 1993 ($474,691,930,000 + $571,922,088,000 = 82.9 percent); see also JCT, Federal Tax System, supra note 8 at 60, Table C-22 (8,000 largest-asset corporations paid 83.7 percent of corporate taxes in 1993. Small-income C corporations reported 5.3 percent of C corporation income. See JCT, Small Business, supra note 6, at 5 n.8. Therefore, moderate income/asset C corporations reported 11.8 percent of C corporation income. (100 percent - 82.9 percent - 5.3 percent = 11.8 percent) All C Corporate income amounted to $571,922,088,000; 11.8 x $571,922,088,000 = $67,486,808,344. 67,486,808,344 ÷ 226 = $2,915,343.

\(^8\)IRC section 11(b) (1). 1993 Corporation Source Book of Statistics of Income 1, 481 (Pub. 1053 revised March 1993), reveals that for 1993 there were 3,964,629 active corporations including 1,901,505 S corporations. There thus were 2,063,124 active C corporations. 2,063,124 x 0.37 = 763,356.

with average income of less than $40,000,\(^7\) thus subject on the average to a 15 percent rate. Additionally, I reckon that as of 1993 around 33,500 moderate-income C corporations (from $335,000 to less than $10 million) C corporations reported around 11.8 percent of C corporation income with an average income of about $2 million\(^9\) a year taxed at the flat 34 percent inside corporate rate. The owners of these mostly private\(^10\) moderate-income C corporations paid to principals into pro rata share subject to income-based taxation system in Connecticut and explaining that S corporations also must bring back compensation and I am estimating from income shares, I expect the results would not vary very much.

\(^7\)Conn. Gen. Stat. 12-214 and 217(c) (1) (1998 Supp.) (providing a flat 34 percent tax rate on taxable income above the graduated corporate tax exemption amount ($335,000) for the 1998-1999 tax years).

\(^8\)See Joint Committee on Taxation Staff, Impact on Small Business of Replacing the Federal Income Tax 7 n.8 (JCS-3-96 April 23, 1996), Doc 96-12163 (132 pages), 96 TNT 81-16 ("JCT, Small Business").

\(^9\)Id. 1993 Corporation Source Book of Statistics of Income 1, 481 (Pub. 1053 revised March 1993), reveals that for 1993 there were 3,964,629 active corporations including 1,901,505 S corporations. There thus were 2,063,124 active C corporations. 2,063,124 x 0.37 = 763,356.

\(^10\)The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question, 95 Mich. L. Rev. 393, 422 n.145 (1996) (calculating that approximately 10 percent of medium asset corporations are publicly traded, thereby implying that the other 90 percent are privately held). While not exact, this result might not exactly correspond because she is using asset size categories and perhaps the varying degrees of inertia among the small business practitioners and possibly clients as well. It may be that high corporation-to-LLC formation ratios correlate with importance of manufacturing, which is more likely to be conducted in corporate form, and as in New York (5:1), New Jersey (3:6:1), and Ohio (3:1) (1997). Delaware’s corporation-to-LLC ratios of 2.5:1 for 1997 and 1:6:1 for 1998 are less important than the high numbers of formations in both categories, probably reflecting the fact that it is the jurisdiction of choice as to both corporations and LLCs for many out-of-state businesses.
corporations would be taxed at the top individual rates if this corporate income were taxed directly to them.

The top 10 percent of households by wealth own 80 percent of small firms and the top 2 percent own 45 percent of small firms. Treasury’s distribution tables show that as of 1995 the top 1 percent of families consist of 700,000 families, beginning at $349,438 of income (subject to the 39.6 percent rate before phaseouts and wage taxes); the top 5 percent consists of 2,300,000 families, beginning at $145,412 of income (subject at least to the 36 percent rate); and the top 10 percent consists of 3,500,000 families, beginning at $108,704 of income (subject at least to the 31 percent rate). Thus the owners of small income private C corporations mostly would be taxed from 31 percent to 39.6 percent (or even 45 percent taking account of phaseouts and wage taxes) on any marginal income such as profits they have split with their small-income C corporations if they instead reported it directly.

B. Avoidance of Shareholder-Level Outside Tax

The dread second, outside tax on the inside income of these small- and moderate-income private C corporations is largely avoided by holding the stock (or merging with a public firm and holding that stock) until death, usually without paying formal dividends; or selling it as a long-deferred capital gain taxed at 18 to 20 percent. This gives rise to at least a $3 billion a year or more tax subsidy for the small-income C corporations and probably an equal subsidy for the moderate-income C corporations. In short, the true tax policy issue for private C corporations is not double taxation, but whether the Treasury will get the equivalent of one tax one time. It has not been able to do so for the last 80 years. The transactional costs of this inside shelter may, however, be high with many of the complexities of corporate taxation generated by its use (e.g., accumulated earnings and personal holding company tax), or by attempts to with-
draw the accumulations at preferential rates (e.g., redemptions, liquidation-reincorporations, small corporation spin-offs, unreasonable compensation, and constructive dividends).19

C. Inside Tax Shelter as Violating Tax Equity

When small- and moderate-income firms with active high-income owners choose private C corporations, they violate both horizontal and vertical tax equity — a very bad policy result. In 1978, when public20 and private C corporations rejected President Jimmy Carter’s well-intentioned calls for corporate-shareholder integration, Secretary of the Treasury Mike Blumenthal passionately described to a Senate Finance Committee private C corporations as a device already advertised widely as the ‘ultimate tax shelter’ [. Thus a] graduated corporate rate structure raises troubling questions of tax equity. . . . [I]ndividual owners of closely-held corporations . . . are generally in higher income tax brackets than the owners of publicly-held companies. . . . To many owners of closely held corporations, the corporate tax income tax — far from being an additional burden — is actually a relief from taxes which they would otherwise pay if all of the income of their corporation were attributed directly to them.21

Why else do you think that well-tax advised private C corporations were then and still are formed?22 Why else did Congress fashion the tax law this way?23 Commissioner Guy Helvering had similarly explained to Senate Finance Committee members 40 years earlier the use of private C corporations to shelter income. 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 enhancing the value of the stock.24 The commissioner viewed this as a violation of ability to pay, i.e., vertical equity. “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 individual income surtaxes.”25 Furthermore, 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,

19Hearings on Master Limited Partnerships before the House Ways and Means Subcomm. on Select Revenue Measures, 100th Cong., 1st Sess. 341, 348 (1987) (Statement of Professor Lee) (“MLP Hearings”). The leading tax audit issue of private C corporations is and has long been unreasonable compensation. General Accounting Office, Tax Administration, Recurring Issues in Tax Disputes Over Business Expense Deductions 10 (GAO/GGD-95-232 Sept. 1, 1995), Doc 95-8866 (26 pages), 95 TNT 189-39 (Section 263 capitalization is leading issue for public C corporations; section 162 reasonable compensation, for private C corporations; and section 274 substantiation, for proprietorships); Joint Committee on Taxation Staff, Issues in Simplification of the Income Tax Laws, 95th Cong., 1st Sess. 32-3 (1977) (“compensation” is one of the eight most significant issues at the IRS appellate level).

20Hearings on the President’s 1978 Tax Reduction and Reform Proposals Before the House Ways & Means Comm., 99th Cong., 2d Sess. (Part I) 94, 95, 102, 468-88 (1978) (statement of W. Michael Blumenthal, Treasury Secretary); id. (Part 9) at 6144-51 (statement of Professor Michael J. Graetz).

21Id. 94-5 (statement of Blumenthal); see Tax Expenditures Compendium, supra note 14 at 255 (corporate rate graduation can be used as a tax shelter, benefitting high-income owners of small corporations); Staff of Senate Finance Comm., Preliminary Report on the Reform and Simplification of the Income Taxation of Corporations, 98th Cong. 88 (Comm. Print 1983) (“private law often leaves taxpayers better off, on balance, than would they be if no corporate level tax were imposed”). Gravelle, supra note 11 (given the passthrough S corporation (and LLC) alternative, the main reason for choosing the private C corporation is “tax avoidance”).

22John W. Lee, “Capital Gains Exception to the House’s General Utilities Repeal: Further Indigences From Overly Processed Corp Products,” Tax Notes, Mar. 31, 1986, pp. 1375, 1384 at n.39 (Lee, “General Utilities Repeal”); Hearings on H.R. 12395 (Revenue Act, 1936) before the Senate Finance Committee, 74th Cong., 2d Sess. 160 (1936) (statement of Senator Hugo Black, D-Ala.); Internal-Revenue Hearings before the Senate Finance Committee on the Proposed Revenue Act of 1921, 67th Cong., 1st Sess. 453 (1921) (statement of Robert M. Miller, formerly Solicitor of Internal Revenue) (with outside individual rates proposed to remain as high as 40 percent, “it is clear that some balancing tax must be put on corporations, so as to avoid forcing all businesses to incorporate. Otherwise the great advantage of the corporate form would compel a general shift in business forms.”). The outside individual rate initially was reduced from 72 percent to only 50 percent, no balancing tax was imposed, and such a general shift did occur. “[I]n the year 1926 the number of copartnerships and corporations was 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.” See 1936 Senate Hearings, supra at 20 (statement of Commissioner Guy T. Helvering); Hearings on Revenue Act, 1936 before the House Ways and Means Comm., 74th Cong., 2d Sess. 584 (1936) (statement of Acting Chief Counsel Arthur H. Kent).


241936 Senate Hearings, supra note 22, at 22-23 (“What this means in simple terms is the privilege of reinvesting earnings without the payment of surtaxes on them, a privilege of very great monetary value…”). Individual capital gains were then taxed under a sliding scale dependent on the holding period much lower than ordinary income tax rates with a maximum rate of 20.1 percent at the highest ordinary income tax bracket after a 10-year holding period. John Lee, “President Clinton’s Capital Gains Proposals,” Tax Notes, June 27, 1993, p. 1399 at 1403 (Lee, “Capital Gains Proposals”); Lee, “Capital Gains Contentions,” supra note 12, at 34 n.123.

251936 Senate Hearings, supra note 22, at 24 (statement of Commissioner Helvering).
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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.”

General Counsel Herman Oliphant stated well the underlying tax policy: “business profits, by whomever derived and from whatever form of business derived, should all bear the same tax burden, just because it is right. . . .” That is horizontal equity.

Of course, Treasury was correct as a matter of tax policy in the 1930s, 1970s, and 1980s.

Criticism of the inside graduated rates/small-income corporate tax shelter as violating vertical equity resurfaced again in the 1984 Treasury I Tax Reform Proposals:

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, non-essential consumption. These concepts have no relevance to corporate 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.

Of course, Treasury was correct as a matter of tax policy in the 1930s, 1970s, and 1980s. Use of a private C corporation as an inside tax shelter is inconsistent with vertical equity or ability to pay. Once populists in Congress too had raised against the inside tax shelter. By the 1980s, however, small business enjoyed bipartisan support, most strikingly in a 92-0 Senate roll call vote in 1981 increasing the inside corporate rate preference.

Thus, tax politics easily trumped tax policy in the Tax Reform Act of 1986, which, instead of repealing the inside graduated corporate rates as Treasury proposed, actually doubled the base for the inside corporate rate of 15 percent from $25,000 to $50,000.

Tax politics easily trumped tax policy in TRA ’86, which, instead of repealing the inside graduated corporate rates as Treasury proposed, actually doubled the base for the inside corporate rate of 15 percent.

CRS and commentators conclude that all of the rationales for granting graduated rates to small business corporations (other than the difficulty of raising out-

...
side capital) are myths or rhetoric. 32 Probably the determinative factor beyond the mystique of small business, however, is that small business people that tend to be local “opinion leaders” who influence local voting patterns and make political contributions. 33 These are the people that members of Congress (from both parties) talk to about taxes in their visits home. 34

D. Dry C Corp. Paying Out All Profits

Historically a private C corporation paying out all of its business income either as compensation or deductible fringe benefits has been used to obtain deductions for certain fringe benefits, including premiums paid for health and accident insurance and group-term life insurance, paid on behalf of its shareholder-employees and received tax free by such shareholder-employees, then deducted by the corporation. 35 Currently, lesser amounts of health and accident insurance premium paid by an LLC on behalf of a member-employee or an S corporation on behalf of a 2-percent-or-more shareholder-employee are deductible. 36 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 2003, or most likely sooner, of a full deduction for health insurance costs of self-employed individuals — thus ending the horizontally preferential treatment of private C corporation employees-shareholders, may be expected to reduce the allure of private C corporations 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 1.2 percent decline for 1999-2005 in the number of smallest income (mostly private) corporation returns, Form 1120-A (filed by C corporations with gross receipts, total income, and assets each not in excess of $500,000). 37 This asset category shows disproportionate losses and a very small share of corporate income. 38

III. S Corporation: Most Popular New Entity

A. Fastest Growing Small Business Tax Entity

LLCs clearly are not supplanting S corporations. The growth rate of S corporations exceeds the growth rate for all partnership forms and applies to a larger base. The number of S corporations increased around 10 percent from 1,901,505 in 1993 to 2,153,119 in 1995 and 2,304,416 in 1996. 39 For 1997 1,755,000 partnership returns were filed as contrasted with 2,450,000 S corporation returns. 40 SOI projects that for 1999-2005 partnership and S corporation returns will increase at annual average rates of 4.04 and 4.16 percent, respectively. 41 SOI estimates that S corporation filings will first exceed C corporation filings in 2000, and projects that S corporations will be the fastest growing type of business tax entity from 1999 through 2005. 42 S corporations are accounting for an increasing percentage of total corporate-sector income, from 11 percent in 1993 to 17.6 percent for 1996. 43 SOI data shows that for 1995, 10.8 percent of S corporation net income was reported by the “finance, insurance, and real estate” industrial group, 44 which reported 61.9 percent of the net rental income of S corporations.


34 See, e.g., 1978 House Hearings, supra note 20 (Part 2), at 1253-54 (statement of Representative Ed Jenkins, D-Ga. (sympathizing with the tax and regulatory burdens faced by small business owners), (Part 5) at 2802-03 (statement of Rep. Ed Jenkins) (explaining that small business owners in his district “showed great interest in the issue . . . of capital gains taxation”).


36 See IRC section 162(l) (60 percent is deductible for 1999, 70 percent in 2002, and 100 percent in 2003, and thereafter).
corporations. The significantly greater percentage of partnerships versus S corporations in this industrial group, as discussed below, 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 pass-through of real estate losses.

B. Life Cycle of Private Corporations

Before 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; and 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 taxed at lower graduated inside corporate rates. 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 that would benefit the owner-entrepreneur if passed through.

Consistent with the first stage of initial pass-through 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. Of the 1,901,505 active S corporation returns filed for 1993, 1,015,324 reported net income. Thus, 53.4 percent reported no income or incurred a loss.

In contrast, and consistent with the third stage, 68.1 percent of C to S conversions for 1987 reported positive income (almost 2/3 of the remaining 31.9 percent C to S conversions reporting a loss in 1986 also reported a loss in 1987). This indicates that perhaps a third of C to S conversions are made to pass through otherwise operating losses trapped in a C corporation. This is likely a problem of substantial magnitude since 61 percent of C corporations for 1993 reported no income or incurred losses.

In recent years between one-quarter and one-third of new S elections have been 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. Of the more than 268,000 returns filed by new S corporations for 1996, 71.6 percent were filed by newly incorporated businesses and 28.4 percent were filed by C to S conversions of nearly 270,000 returns filed by new S corporations for 1995, 70.7 percent were filed by newly incorporated businesses, the rest by C to S conversions of 255,600 returns filed by new S corporations for 1994, 41 percent were filed by newly incorporated businesses, the rest by C to S conversions of 250,000 returns filed by new S corporations for 1993, 75 percent were filed by newly incorporated businesses, the rest by C to S conversions; and of 241,600 returns filed by new S corporations for 1992, 2/3 were filed by newly incorporated businesses, the rest by C to S conversions.

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, probably reflecting the substantial

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43Id. at 47.
44Id. 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).
45Joint Committee on Taxation Staff, Present Law and Proposals Relating to Subchapter S Corporations Home Office Deductions 2 (JCS-16-95 May 24, 1995), Doc 95-5239 (44 pages), 95 TNT 102-23. 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) (the fact that losses are passed-through to each partner is a reason to organize real estate ventures as partnerships).
46See, e.g., Lee, “Entity Classification,” supra note 18, at 91 n.130 and authorities collected therein; Allen Fishman Column, “Fit the Form of Your Business to Your Special Circumstances,” St. Louis Post-Dispatch 22 (Nov. 19, 1990) (“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.”).
47See Lee, “Entity Classification,” supra note 18, at 91 n.130.
491993 Statistics of Corporate Income, supra note 6, at 497.
failure rate in small businesses\textsuperscript{60} and perhaps some second stage S to C conversions.

\section*{C. Reasons for S Corporations Flourishing}

The story of the S corporation’s continued flourishing contrary to conventional wisdom apparently rests on (1) over 50 percent of S corporations in general (and probably much higher in newly formed S corporations) having only one shareholder\textsuperscript{61} so that the S corporation capital, ownership, and income allocation restrictions are academic; (2) substantial inertia, leaning to the familiar and usually cheaper (as to formation costs) S corporation, motivating both tax advisors and their small-business clients;\textsuperscript{62} and (3) many, virtually all in


\textsuperscript{61}JCT, \textit{S Corporations}, supra note 47 (“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. More than 90 percent of S corporation assets are in firms with 10 or fewer shareholders.”). This same pattern continued for 1995 and 1996. \textit{See} Wittman, “S Corporation Returns, 1995,” \textit{supra} note 44 at 45 (in 1995, 52 percent of S corporations had one shareholder; 30 percent, two shareholders; 7.6 percent, three shareholders; and 7.6 percent, four to 10 shareholders); Wittman and Grant, \textit{supra} note 39, at 43 (showing that in 1996, 53.3 percent of S corporations had one shareholder; 29.9 percent, two shareholders; 7.7 percent, three shareholders; and 8.3 percent, four to 10 shareholders); \textit{see also Symposium, “Check-the-Box and Beyond: the Future of Limited Liability Entities,” 52 Bus. Law. 605, 623 (1997) (Professor George Yin observes that partnerships follow a similar pattern with 50 percent having only two partners, 75 percent, four or fewer partners; and 90 percent, 10 partners or fewer).}

\textsuperscript{62}\textit{Symposium, supra} note 61, at 624-5, 629-30 (Professor Carol R. Goforth; Ira Meislik, Esq.; Professor Judith Ribstein; Jude Lemke, corporate counsel; Dale G. Schleder, Esq.; and Irving Schloss, Esq.); \textit{accord}, Franklin A. Gevurtz, \textit{Business Planning} (2d ed. 1993), 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-term future. \textit{Symposium, supra} at 630; \textit{accord}, Douglas E. Starcher, “Limited Liability Company May Be Good Incorporation Alternative,” \textit{Orlando Sentinel}, March 24, 1997, at 32; \textit{Symposium, supra} at 625, 631 (Lemke, Meislik, and Schleder) (weighing the additional costs of new forms and “tailor-made” language). \textit{See generally} Phillip J. Baptiste and Tracy J. Monroe, “Negative Aspects to Using LLCs for Operating Companies,” \textit{27 Tax Adviser} 472 (1996) (listing familiarity, drafting, and return preparation expense factors as reasons to avoid LLCs); Cheryl A. Cruz and John E. Karayan, “Should Your Firm Operate as a LLC?,” \textit{21 (California State University, Los Angeles) Business Forum} 16 (June 22, 1996) (learning curve problems). This factor may cut toward choice of 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. \textit{Symposium, supra} at 626-627 (William R. Asbell, Esq.; Michael Bamberger, Esq.).


\textsuperscript{64}\textit{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.\textsuperscript{65}

\textsuperscript{65}### Footnote 62 continued in next column.

\textsuperscript{66}### Footnote 64 continued on next page.
The Commissioner lost in Keller because the professional services corporation paid all of its earnings out as compensation or contributions to a qualified retirement plan. Id. at 1028-29. Congress’s unhappiness with the “result” in Keller lead to section 269A. See H.R. Conf. Rep. No. 97-768, at 634 (1982) (Congress intended that this provision would “overturn the results reached in cases like Keller v. Commissioner, 77 T.C. 1014 (1982), where 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 note 35 and accompanying text.

Cases conflict over whether the shareholder and the corporation are two commonly controlled businesses for purposes of section 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). The Service properly refuses to follow this holding. Rev. Rul. 88-1, 1988-1 C.B. 246; Ronald H. Jensen, “Schaefer v. Commissioner: Continuing Confusion Over the Assignment of Income Doctrine and Personal Service Income,” 1 Fla. Tax Rev. 623, 667-68 (1993) (section 482 is unimpaired by Fogelsong because the common law assignment of income doctrine achieves 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 section 482 with Fogelsong and illustrating the failures in the court’s reasoning). The Fogelsong review court overlooked that being an employee of a corporation itself constitutes a trade or business. Prinath 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.”).

Such reallocation would affect FICA wage taxes. Section 482 might not apply to undercompensation for wage tax purposes under the rationales that it is limited to clearly reflecting income for income tax purposes or is predicated on the shareholder-employee not working exclusively for the service 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 extended to fix what is reasonable compensation for wage tax purposes. The sensible answer of course is contained in President Clinton’s stillborn health bill: treat 2 percent or more S corporation shareholders as partners for SECA purposes.

IV. LLCs as Entity of Choice for Some Firms

A. Where LLCs Prevail

The number of partnerships of all types 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 percent annual increase for 1999-2005. 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...
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 and thus probably tended to take more from other forms of partnerships — or what would have been other partnerships — than from C or S corporations. LLCs thus do not appear to be the wave of the future supplanting both C and S corporations.

To the extent that LLCs do partially supplant private C corporations from 1999 through 2005, it may be for the wrong reason: the myth of double taxation. This is not a bad result, since all private firms (a more administrable surrogate for separation of ownership from management) should be taxed the same as pass-through entities, i.e., at individual rates. Similarly, while con-

See Wheeler, “Partnership Returns, 1994,” supra note 71, at 76, 78 fig. D (reporting that for 1993, finance, insurance, and real estate accounted for 54.2 percent of all partnerships, while services account for 17.5 percent and together they accounted for almost 75 percent 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 according to SOI data. Such real estate and services market segments dominate all partnerships.

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 in the number of limited partnerships. Partnerships have gone from reporting a net loss (reflecting the shelter years) to reporting substantial positive income — $106.8 billion.

Significantly, in 1996, more than 70 percent of the LLCs were concentrated in “finance, insurance, and real estate” and services — around 50 and 20 percent, respectively. Real estate businesses constituted almost 80 percent of the “finance, insurance, and real estate” SOI category and the industry group as a whole made up over 53.9 percent of all partnerships in 1996. Note that 80 percent of the income of services partnerships was attributable to the professions of law, health, and accounting according to SOI data. Such real estate and services market segments dominate all partnerships.


See Zempel, supra note 70, 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).

Amy Hamilton, “Partnership Profits in 1995 Largest in History, IRS Data Show,” Tax Notes, Jan. 12, 1996, p. 148 (increase in partnership profits to $106.8 billion for 1995 compared with 1994 was the largest in history, continuing trend of large percentage increases in overall net income first observed in 1991).

See Zempel, supra note 70, at 48; Wheeler, “Partnership Returns, 1995,” supra note 69, at 45 (in 1995, 5% of LLCs were found in these three areas). A June 1999 study of registration for 1,252 LLCs in 43 states found a large portion were professional service firms. In the sample 26 percent consisted of engineering and management support companies; 19 percent, real estate businesses; 12 percent, construction; and 9 percent, investment companies. In a similar sample of 680 limited liability partnerships, 29.7 percent consisted of law firms; 28.5 percent, medical firms; 12.1 percent, accounting firms; and 9.7 percent, real estate services. Conrad S. Ciccotello and C. Terry Grant, “LLCs and LLPs: Organizing to Deliver Professional Services,” Business Horizons (Mar. 1, 1999).

See Zempel, supra note 70, at 50, fig. F (allowing the reader to calculate this figure by dividing the total number of business in these three categories by the number of those business which were real estate businesses). Using 1990 SOI data, the General Accounting Office reported that real estate accounts for 44 percent of “partnerships”; financial and insurance, 7 percent; services, 18 percent; retail trade, 10 percent; and agriculture, 8 percent. General Accounting Office, Tax Administration: IRS Partnership Compliance Activities Could Be Improved, Table I-2 (GAO/GGD-95-151 June 16, 1995), Doc 95-6038 (36 pages), 95 TNT 118-21. See also “California Franchise Tax Board Report on Calculation of the Adjustment to the Limited Liability Company Fees for 1999,” Doc 1999-5719 (31 original pages), 1999 STT 31-5 (more than 30 percent of LLCs are in the real estate industry, 27 percent are in the service industry, 6 percent in manufacturing, and the rest are in other industries).

See Zempel, supra note 70, at 46 fig. B.
trary to conventional wisdom, LLCs are not supplanting S corporations due to restrictions on capital and allocations (since 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 lurching toward rational self-selection along complex/simple business lines—not a bad result either. A thesis of Professors Yin and Shakow’s 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. 80

B. Flexibility of LLCs for the Tax Sophisticated

One of the most significant choice of tax entity differences between subchapters S and K is that an S corporation cannot make inside basis adjustments to its assets on the death of a shareholder or a transfer of her interest, as a partnership can. 81 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, preclude for S corporations the partnership flexibility of allocating items of income or loss to different investors and especially allocation of losses disproportionately to, for example, a capital partner followed by a later charge back of income. 82 Furthermore, S corporation liabilities are not included in a shareholder’s basis in her stock interest, which serves as a ceiling on current deductability of passed-through S corporation losses. 83 In contrast, partners can take deductions supported by partnership liabilities. 84 Shareholder loans to an S corporation support a loss deduction for that shareholder only, unlike the partnership rules under which such debt (except nonrecourse debt) is “shared” by all partners like any other debt for basis purposes. 85 These differing liability sharing rules play a significant role in an entity’s choice between subchapter S and subchapter K as the best vehicle for holding depreciable real estate. 86 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) non-partner/employee capacity transactions with the entity; (5) retirement payments to former principals; and (6) debt-equity lore where appreciated property is transferred to lock in character of gain, among others. 87

80See IRC section 1366(d)(1); id. section 1367 (listing items included in shareholder basis, and omitting liabilities of an S corporation from the list).
81JCT, S Corporations, supra note 47.

85Compare IRC sections 1366(a) (1) and 1377(a) (1) with Treas. reg. sections 1.704-1(b)-(c); see also JCT, S Corporations, supra note 47; Gevirtz, supra note 62 at 80-82, 166-69; William J. Rands, “Pastthrough Entities and Their Unprincipled Differences Under Federal Tax Law,” 49 SMU L. Rev. 15, 18-19 (1995).
87Compare IRC sections 1366(a) (1) and 1377(a) (1) with Treas. reg. sections 1.704-1(b)-(c); see also JCT, S Corporations, supra note 47; Gevirtz, supra note 62 at 80-82, 166-69; William J. Rands, “Pastthrough Entities and Their Unprincipled Differences Under Federal Tax Law,” 49 SMU L. Rev. 15, 18-19 (1995).
Appendix I. C versus K/S Passthrough Checklist

A. Inside Tax Shelter in Small C Operation (At a Profit)

1. Inside Shelter:
   a. Graduated inside rate on taxable income
      (section 11)
      15 percent on first $50,000
      25 percent on next $25,000
      34 percent on excess of $75,000
      39 percent on excess of $100,000 until
      $11,750 is "clawed back"
      35 percent on excess of $10,000,000
   b. Graduated outside rate
      (joint return regular rates) on
      taxable income
      15 percent up to $36,900
      28 percent up to $89,150
      31 percent up to $140,000
      36 percent up to $250,000
      39.6 percent above $250,000
   c. Tax savings inside may be compounded by investment in high-dividend-yielding stocks or tax-exempts. (If so, corporate AMT and possibly PHC or accumulated earnings tax problems may then arise.)
   d. A (Dis)Qualified personal service corporation (doctors, lawyers, and such, but not cowboys) is taxed at a flat 35 percent on retained earnings. Section 11(B)(2).

2. Outside Shareholder Taxation on "Distribution/Realization": Zero if die with it, minimal if sufficiently deferred.
   a. If shareholder holds stock until death, outside tax on appreciation — retained earnings is eliminated with date-of-death step up. Section 1014
   b. Outside individual capital gains tax rate usually is 20 percent of gain; but if stock is "Qualified small business stock" (active C corporation not engaged in services, financing, farming, mining, or hospitality businesses) held for five years the maximum individual capital gains rate is 14 percent (subject to AMT rules). Section 1202. If sufficiently deferred but stock sold prior to death, the discounted present value of this outside tax may be de minimis.
   c. It (and the inside anti-General Utilities tax) may be viewed as equivalent to "deficit restoration/minimum gain change back" in a subchapter K tax shelter. You don’t have to believe it’s real, until you sell it. And if you defer it long enough it does not really matter. But when you actually pay it, it hurts.

3. General Utilities Repeal: 34 percent inside if sell tomorrow, but will tomorrow ever come?
   Now sections 311, 336, and 338 mean that on a "distribution" (in redemption, dividend, or liquidation) of appreciated property, the "distributing corporation is taxed inside" on such gain while the shareholder is taxed outside on the net gain.
   As with outside tax, if sale of business is sufficiently deferred, present value may be de minimis. I understand that before the 1993 changes, most sales of such business were structured as taxable "asset" sales by the target corporation followed by, an outside shareholder capital gain on liquidation under section 331 by shareholder. Now often stock is sold for capital gains and purchaser of stock does not elect section 338.

4. Hidden Transactional Costs
   a. Laundry list of private C — inside accumulation problems.
      i. denial of inside deduction for unreasonable compensation. Section 162.
      ii. re-allocation to clearly reflect income. Sections 446, 482.
      iii. accumulated earnings tax. Section 531.
      iv. PHC tax. Section 541.
      v. constructive dividends at shareholder level. Section 301.
      vi. bail-out: redemption-termination of interest, liquidation-reincorporation. Sections 302, 361.
      vii. collapsible corporation provisions. Section 341.
   b. Reality: "audit lottery" and pig theory.

5. Payroll Taxes
B. Passthrough of Losses

1. Operational Losses
   a. Formative Stage.
      
      Traditional wisdom is that passthrough entity is ideal for flow-through of initial operating losses for immediate use by owner against outside income.
      
      i. Entity(s) vs. “aggregate” (K) approach to “sharing”; inside liabilities for outside basis favors K over S.
   b. At initial profitability, use of private C (by conversion of S or incorporation of K) was once common.

2. Tax Shelter Losses.
   a. Laundry list of tax shelter loss restrictions leading up to PAL (section 469), e.g., section 1245/1250 recapture; minimum tax, at-risk (section 465), profit-motive, section 183, etc.
   b. Passthroughs pass PAL losses out to owners with same characteristics.
      
      i. Query. Is this a solution for a C with accumulations in excess of reasonable business needs as to current earnings?
      ii. Closely held service corporations are subject to PAL.

C. Metamorphosis: From Separate Tax Entity to Passthrough Entity

1. Separate Tax Entity to Passthrough Entity
   a. Introduction. The setting for C to S or K is when the inside shelter runs out (retained income $100,000 per year or $250,000, etc.) and retained earnings “ceiling” for accumulated earnings approaches.
   b. C to K.
      
      i. Outside: Shareholders section 331
      ii. Inside: Full recognition (section 336, etc.) on appreciation.
      iii. Advantages of step-up; no S shareholder or corporation restrictions; elimination of “C Doppelgänger.”
      iv. Disadvantage of outside tax and inside tax makes such “dis-incorporation” too costly.
   c. C to S Conversion.
      
      i. Outside. Nonrecognition event as to shareholders
      ii. Inside: (1) nonrecognition of tax benefits, assignment of income, recapture, etc. LIFO reserves are picked up now. Watch out for possible future legislation here.
      iii. Timing of S election and short C/S Years.
      iv. S with “C-Doppelgänger” (E&P)
         (1) Ten-year taint of C to S as to built-in gain, worse than C to S. Section 1374
         (2) C E&P
            a) Distributions in excess of AAA. Section 1368(c).
            b) Passive income tax, section 1375, and continuance for three consecutive years results in termination. Section 1363(d)(3).
      v. Qualified Retirement Plan shareholder-loan prohibited transaction problems.
   d. S to K (S to LLC Conversion).
      
      Under current law for full conversion, the S corporation would have to be liquidated with resulting taxation under section 336 that would pass through to shareholders increasing their bases under section 1367(a)(1) and thus decreasing their liquidation gain at shareholder level under section 331 or even creating a capital loss generating a mismatch in the case of S corporation-level gain attributable to deemed liquidating sale of inventory or other ordinary income assets. Treasury once mentioned tax-free conversion from S to LLC for a limited time. There is precedent in a little-used transition rule for tax-free liquidation of professional service corporations in the aftermath of the merger of the corporate and self-employed retirement plan rules in 1982.

2. Passthrough Entity to Separate Tax Entity
   a. Introduction. Traditionally once the formative state of losses was passed, the inside shelter of a small C becomes the next stage of metamorphosis.
b. K to C: section 351 incorporation
   i. Outside. If section 351 is met (“control,” etc.), “partner” — now shareholder has substituted basis, nonrecognition (except for section 351(b) “boot”) subject to varying degrees to the following:
      (1) assignment of income
      (2) tax benefit
      (3) liabilities in excess of basis
      (4) depreciation “recapture” recognized but only to extent of “boot”
   ii. C-Transferee
      (1) carryover basis

   c. S to C
   i. Outside. Nonrecognition event
      (1) Post-Termination Transition Period. Section 1366(d)(3). Grace period for withdrawals of AAA and contributions to increase stock basis for “suspended losses.” Section 1371(e).
   ii. Inside.
      (1) Short S and C years. Section 1362(e)(6).
      (2) No carryover inside of losses, etc.
      (3) Apparently no recapture, tax benefit, assignment of income, etc.
   iii. Timing of “termination” and mechanics
   iv. S corporation status reelection. Section 1362(g).

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**Appendix II. Passthrough Tax Entities: K or S Checklist**

<table>
<thead>
<tr>
<th>Function</th>
<th>K</th>
<th>S</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Passthrough</td>
<td>Section 702. Conflict over entity-aggregate</td>
<td>Sections 1366(a) and (b), different conflict over entity-aggregate</td>
</tr>
<tr>
<td>2. Account for Income</td>
<td>Section 703, entity</td>
<td>Section 1363, entity</td>
</tr>
<tr>
<td>3. Allocations</td>
<td>Section 704; Section 704(b) implicitly follows entity; should be “aggregate” under “assignment of income” principles</td>
<td>Section 1377(a), pro rata share, strict entity (but what about debt and salary to shareholder employees)</td>
</tr>
<tr>
<td>4. Varying interests</td>
<td>Section 706, aggregate, especially for service partner and retro</td>
<td>Section 1377(a), strict entity</td>
</tr>
<tr>
<td>5. Nonpartner transactions</td>
<td>Section 707, line drawing on partner, aggregate and nonpartner (entity) transactions according to partner-like characteristics of transfer/ performance and risks as to fact and amount payment</td>
<td>No corresponding provisions</td>
</tr>
<tr>
<td>6. Contributions</td>
<td>Sections 721, 704(c), 724, 737, and 752 (in transfers of encumbered property) mandate “aggregate” approach</td>
<td>Sections 351, 357 follow an entity approach with mostly nonrecognition due to “mere change in form”</td>
</tr>
<tr>
<td>7. Distributions</td>
<td>Sections 731, 732, 751(b), aggregate (substituted basis) with entity for disproportionate (section 751(b))</td>
<td>Section 1368, entity with conduit feature of withdrawal of undistributed profits but “C-Doppelgänger” if C E&amp;P. Also inside-entity tax on property distributions. Section 1362(d)</td>
</tr>
</tbody>
</table>
### Appendix II. Passthrough Tax Entities: K or S Checklist (Continued)

<table>
<thead>
<tr>
<th>Function</th>
<th>K</th>
<th>S</th>
</tr>
</thead>
<tbody>
<tr>
<td>8. Sales transfers of interest</td>
<td>Sections 741, 743, 751(a), and 754. Surface entity, with mandatory partial aggregate (section 751(a)) for potential “ordinary income” inside and optional aggregate inside basis adjustments (section 754 and 743)</td>
<td>Pure entity. No inside adjustments. Section 341 may apply outside.</td>
</tr>
</tbody>
</table>

### B. Passthrough Entities: K or S

#### Major Transactional Differences K and S

<table>
<thead>
<tr>
<th></th>
<th>K</th>
<th>S</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Sharing of entity liabilities</td>
<td>“Aggregate” under section 752 turns on recourse-non-recourse, limited-general. Should, but probably won’t, turn on who will carry burden of partnership principal amortization</td>
<td>Entity, too limited, especially in operating business context. And PAL should take care of shelter losses.</td>
</tr>
<tr>
<td>2. Distributions</td>
<td>Aggregate. No gain inside, substituted basis outside as to property distributed; carryover up to outside basis, with outside ceiling as to nonliquidating; constructive cash distributions and section 751(b) necessary to handle flip-flop abuse</td>
<td>Full recognition taint gain inside. Outside, nonliquidating nonrecognition up to outside basis, but FMV basis for property with limited conduit aspects; liquidating, recognition outside and inside. Full entity approach.</td>
</tr>
<tr>
<td>3. Allocations</td>
<td>a. Maximum flexibility (by entity approach; section 1.704(b) regs permit abuse). b. Sections 707(a)(2) and 707(c) permit entity approaches that were functionally equivalent. c. Mandatory aggregate approach as to built-in gain/loss/character of contributed property d. Retroactive allocations for relative “contributions” to profits and not due to varying capital contributions-infusions during year.</td>
<td>On surface, pure entity with strict proportionate sharing of income and loss. Flexibility in year-end bonus, etc. to shareholder-employees and interest on shareholder “debt” as yet uncharted.</td>
</tr>
<tr>
<td>4. Acquisition of Interest</td>
<td>Mistaken entity approach followed in Diamond and by most commentators. Sections 707(a)(2), 704(c), and 724 allow appropriate timing and character. Rev. Proc. 93-27, 1993-24 C.B. 343, Doc 93-6562, 93 TNT 123-7</td>
<td>S requires entity approach and “current” taxation as to interest received for services. Sections 351(d), 83</td>
</tr>
<tr>
<td>5. Inherited interest</td>
<td>Stepped (up) inside basis if section 754 election.</td>
<td>No stepped up inside basis, but if IRD, outside basis reduced. Section 1367(b)(4).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>State</th>
<th>Domestic and Foreign For-Profit Corporations</th>
<th>Domestic and Foreign LLCs</th>
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<tbody>
<tr>
<td>Alabama</td>
<td>8,611</td>
<td>9,976</td>
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<td>Alaska</td>
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<td>1,718</td>
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<tr>
<td>Arizona</td>
<td>13,978</td>
<td>15,402</td>
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<td>Arkansas</td>
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<td>California</td>
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<td>Colorado</td>
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<td>Connecticut</td>
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<td>Delaware</td>
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<td>51,600</td>
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<th>Domestic and Foreign LLCs</th>
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Each IACA Annual Report covers two years. Often the common year for two years’ reports contain conflicting data as to a particular jurisdiction. Furthermore, many of the jurisdictions responded to 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 *, no data was contained in IACA Annual Report and data reported in my questionnaires were used instead. In case of *N/A, data was supplied in IACA Annual Report but inconsistencies from IACA Annual Report to Annual Report and in the questionnaires were so great that the data was treated as N/A or not available.

1Includes LLCs, LPs, and LLPs.
2Apparently combines LLCs and Limited Partnerships.
3Includes LLCs, LPs, and Limited Partnerships.