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Business Organizational Choices: Taxation and Responses to Legislative Changes

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Summary

In the United States, how a business is taxed at the federal level is partly dependent on how it is organized. Publicly traded corporations known as subchapter C corporations are taxed once at the corporate level according to the corporate tax system, and then a second time at the individual-shareholder level according to the individual tax system when corporate dividend payments are made or capital gains are realized. This leads to the so-called "double taxation" of corporate profits. Businesses that choose any other form of organization are, in general, taxed only once at the individual level. That is, the income of certain businesses passes through to the individual business owners and is taxed according to the individual income tax system. Examples of these alternative "pass-through" forms of organization include sole proprietorships, partnerships, subchapter S corporations, and limited liability companies.

This report summarizes the general tax treatment of corporate and pass-through businesses and analyzes the most recent business data from the Internal Revenue Service (IRS). Analysis of the data shows that the majority of businesses in this country are small. The analysis also reveals that most businesses are of the pass-through variety, which raises the likelihood that a large fraction of businesses are taxed according to the individual tax system, not the corporate tax system. Businesses that do pay the corporate income tax (i.e., C corporations) are, however, much larger and account for the majority of business activity, which indicates that their share of business taxes paid is likely higher than non-corporate entities. Extending the analysis back to 1980 makes it clear that the pass-through forms of organization have increased in popularity over time at the expense of the corporate form.

Understanding how businesses are taxed provides context for understanding current and future proposals to adjust either the individual or corporate income tax rates. Currently, both the top individual and the top corporate tax rates are 35%. However, President Obama's FY2011 budget proposes allowing the top individual tax rate to revert to its pre-2001 level of 39.6%. Future proposals in Congress could be similar to the Administration's proposal, or, if past proposals are any indication, move in the opposite direction. For example, in the 110th Congress then-Chairman of the House Ways and Means Committee Charles Rangel introduced a proposal (H.R. 3970) that would have lowered the top corporate tax rate from 35% to 30.5%.

In response to either an increase in the top individual tax rates or a decrease in the top corporate tax rate, economic theory and data would suggest that some pass-through businesses could choose to reorganize as C corporations to take advantage of the more favorable corporate tax schedule. In addition, although the President's budget proposal would raise individual tax rates, it could have the effect of raising taxes on some businesses because data presented in this report indicate that most businesses are likely taxed according to the individual income tax schedule, and may be at the top bracket.

More recently, S. 2343, the Stop the Student Loan Interest Rate Hike of 2012, would reduce the interest rate from 6.8% to 3.4% on Subsidized Stafford Loans made to undergraduate students during academic year 2012 - 2013. To offset the increase in mandatory spending, the bill would require taxpayers with modified adjusted gross income in excess of $250,000 to pay self-employment taxes (Social Security and Medicare) on certain income currently exempt from self-employment taxes if that income is received from a professional service partnership or a professional service S corporation in which at least 75% of gross income is attributable to three or fewer shareholders. The offset is estimated to raise $9.0 billion from FY2012 to FY2022.

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In the United States, how a business is taxed at the federal level is partly dependent on how it is organized. Publicly traded corporations known as subchapter C corporations are taxed once at the corporate level according to the corporate tax system, and then a second time at the individual-shareholder level according to the individual tax system when corporate dividend payments are made or capital gains are realized. This leads to the so-called "double taxation" of corporate profits. Businesses that choose any other form of organization are, in general, taxed only once at the individual level. That is, the income of certain businesses passes through to the individual business owners and is taxed according to the individual income tax system. Examples of these alternative "pass-through" forms of organization include sole proprietorships, partnerships, subchapter S corporations, and limited liability companies.[1]

Economic theory and historical data suggest that businesses may respond to tax policy changes by reorganizing to reduce their tax liability. For example, an analysis of the most recent Internal Revenue Service (IRS) data indicates that such a response seems to have occurred following the Tax Reform Act of 1986 (TRA86; P.L. 99-514). Among other things, TRA86 lowered the top individual tax rate below the top corporate tax rate. This appears to have provided an incentive for some C corporations to reorganize as pass-throughs to take advantage of the lower individual rates. In line with this reasoning, the fraction of businesses organized as C corporations had fallen from 14.9% to 10.3% (or 31%) within five years of the rate changes.

While both the top individual and the top corporate tax rates are currently 35%, there have been recent proposals made by the Administration and in Congress to change these rates. President Obama's proposed FY2011 budget would allow the top individual tax rate to revert to its pre-2001 level of 39.6% while leaving the top corporate rate at 35%. In the 110th Congress, then-Chairman of the House Ways and Means Committee Charles Rangel introduced H.R. 3970, the Tax Reduction and Reform Act, which would have lowered the top corporate tax rate from 35% to 30.5%. Future proposals could use H.R. 3970 as a template. In response to either one of these proposals, past behavior and economic theory would indicate that the number of C corporations as a fraction of total businesses could increase.

More recently, S. 2343, the Stop the Student Loan Interest Rate Hike of 2012, would reduce the interest rate from 6.8% to 3.4% on Subsidized Stafford Loans made to undergraduate students during academic year 2012-2013. To offset the increase in mandatory spending, it would require taxpayers with modified adjusted gross income in excess of $250,000 to pay self-employment taxes (Social Security and Medicare) on certain income currently exempt from self-employment taxes if that income is received from a professional service partnership or a professional service S corporation in which at least 75% of gross income is attributable to three or fewer shareholders. The offset is estimated to raise $9.0 billion from FY2012 to FY2022.[2]

[1] Sole proprietorships and single member limited liability corporations are technically disregarded entities. As the first paragraph notes, economists usually group these business types in with the pass-through businesses. For a disregarded entity there is no entity level tax return. All income is reported on the individual's personal tax return, aggregated with other income, and taxed according to individual tax rates.

[2] Congressional Budget Office and staff of the Joint Committee on Taxation, *Estimate of Budgetary Effects of S. 2343, the Stop the Student Loan Interest Rate Hike Act of 2012, as Introduced on April 24, 2012*, prepared, 112th Cong., 2nd sess., April 25, 2012, http://www.cbo.gov/sites/default/files/cbofiles/attachments/s2343.pdf.

This report provides a general overview of the tax treatment of the major forms of business organization. Included in the overview presented in the body of the report is a discussion of sole proprietorships, partnerships, C corporations, subchapter S corporations, and limited liability companies. Other less popular, but still important, forms of business organization are discussed in the **Appendix**.

This report also analyzes the most recent data from the IRS on business organization. The analysis shows that the majority of businesses in this country are and historically have been of the pass-through variety. That is, most businesses in the United States are likely to be taxed according to the individual tax system, not the corporate tax system. Businesses that do pay the corporate income tax (i.e., C corporations) are, however, much larger and account for the majority of business activity, which indicates that their share of business taxes paid is likely high. The analysis also shows that the distribution of businesses has changed over time, in what many economists view as a response to certain legislative changes that affected businesses.

A number of important issues relating to business taxation are beyond the scope of this paper, including the economic efficiency of the current tax treatment of businesses, the "integration" of the corporate and individual tax systems, and the economics of small business taxation. These and other issues are addressed in CRS Report RL33171, *Federal Business Taxation: The Current System, Its Effects, and Options for Reform*, by Donald J. Marples; CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle and Thomas L. Hungerford; and CRS Report RL32254, *Small Business Tax Benefits: Overview of Current Law and Economic Justification*, by Gary Guenther.

Forms of Business Organization

The five major forms of business organization are sole proprietorships, partnerships, C corporations, S corporations, and limited liability companies.[3] While a number of factors come into play when choosing how to organize, two of the most important are how the business will be treated for tax purposes and legal purposes. The laws covering the various forms of organization evolved separately and have never been fully integrated. The following section provides a general overview of the differences that exist among the most popular organizational forms.

Sole Proprietorships

A sole proprietorship is an unincorporated, single-owner business that is treated as identical with its owner. That is, a sole proprietorship is "disregarded" as separate from its owner for federal tax purposes. The sole proprietorship is the most common and basic form of business organization. Unlike some other forms of business organization, a sole proprietorship does not provide its owner with limited liability. The business assets of the proprietorship as well as the personal assets of its owner may be used to settle any legal judgment against the business. In contrast, limited liability provides some protection for the personal assets of an owner from judgments against the business.

[3] There are several other, less prevalent, forms of organization available to businesses including cooperatives, mutual organizations, credit unions, trusts, and estates.

The business income of a sole proprietorship is reported on the owner's individual income tax return and taxed at the applicable individual income tax rates. Taxable business income includes net profits distributed to the owner as well as retained earnings. In addition, a sole proprietor is responsible for paying the self-employment tax. The self-employment tax rate is 15.3% and is composed of two parts: a Medicare tax (2.9%) and a social security tax (12.4%). In 2009, only the first $106,800 of self-employment income is subject to the social security portion of the tax. The tax is analogous to the combined employer's and employee's share of the Social Security and Medicare taxes, half of which is a payroll tax withheld by most employers.

Partnerships

A partnership is a joint venture consisting of at least two partners organized to operate a trade or business with each partner sharing profits, losses, deductions, credits, and the like.[4] A partner is an investor in such an entity and may be an individual, a trust, a partnership, a corporation, another entity (such as a limited liability company), or a broker that is holding the ownership interest of an unnamed partner. Partnerships are established under the individual laws of each state, although their tax treatment at the federal level is determined by the Internal Revenue Code (IRC). The most common partnerships, which are discussed below, include general partnerships, limited liability partnerships, limited partnerships, publicly traded partnerships, and electing large partnerships.

One of the most important components of a partnership is the partnership agreement.[5] The partnership agreement is a comprehensive agreement among the partners that specifies such things as the partnership's name and purpose, partner contributions, management responsibilities, and continuity of the partnership should a partner leave.[6] Most importantly, the partnership agreement specifies in what ratio business income, losses, deductions, and credits are passed-through the partnership and split among the partners. It is common for these items to be divided according to the ownership interests of the partners, although there is no requirement that this be the case.

Tax Treatment of Partnerships

Partnerships themselves are not taxable; instead all tax items such as income, losses, deductions, and credits, pass through the partnership to the partners. The partnership reports each partner's allocation to the IRS and to the partners according to the partnership agreement. The partners then include their share of income or loss on their own tax return, even if there was no actual distribution of income to the partners. As long as there are no corporate partners, taxable business income is taxed only once according to the individual income tax schedule. When a partnership does have a corporate partner, the share of income allocated to that partner may eventually be taxed at corporate rates.

[4] 26 U.S.C. §7701(a)(2) defines a partnership as "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation."

[5] While important, a partnership agreement is not legally required. In its absence either the Uniform Partnership Act (UPA) or the Revised Uniform Partnership Act (RUPA) would provide default rules. UPA was adopted by all states, while RUPA has been adopted by many, but not yet all. Where adopted, RUPA would apply if there were no partnership agreement.

[6] John E. Moye, *The Law of Business Organizations* (NY: West Legal Studies, 2004), p. 57.

Although the partnership agreement determines the final allocation of tax items to each partner, the partnership must distinguish between ordinary income and separately stated items when making the allocation. Some items must be stated separately because the partners may face limitations to the degree to which they may utilize certain tax items. For example, a capital loss may affect partners differently if some are able to use it to offset a capital gain. Separately stated items include capital gains and losses, dividends, tax-exempt interest, rents, royalties, deductions attributable to portfolio income, charitable contributions, foreign taxes paid, and special allocation items determined by the partnership agreement. Ordinary income is the sum of income, gains, losses, and deductions that need not be separately stated.[7]

In addition to being entitled to a share of the partnership's profits or losses, partners may also be given guaranteed payments for their contributions of capital or service. Such payments are fixed and do not depend on the profitability of the firm. Fringe benefits such as health insurance are also considered a guaranteed payment. The partnership deducts guaranteed payments as ordinary business expenses, and the partners include them as ordinary income. To the extent that the guaranteed payments are for personal services performed by a partner, the income would be subject to self-employment tax.

General Partnerships

A general partnership is one in which all partners are liable for the actions and debts of the business.[8] That is, the business assets of the partnership, as well as the assets of the partners, may be used to settle a legal judgment against the business. Each partner is also responsible for the management of the company and for the tax reporting required of the partnership to the IRS.[9] If there is disagreement among the partners, the IRS considers them all responsible. The defining features of a general partnership make it useful to consider it a direct extension of a sole proprietorship to multiple individuals.

Limited Liability Partnerships

A limited liability partnership (LLP) is a general partnership, usually a professional firm, in which the partners are mutually liable for the partnership debts but are protected from the harmful actions of the other partners. Each partner is liable only for damages arising from his or her own harmful actions and those of their subordinates. However, there are differences regarding liability that vary from state to state. In all other ways, an LLP is like a general partnership.

LLPs are a recent creation of state law, but they have become especially popular with legal and accounting firms. The organizational form of choice for large accounting firms is currently the LLP.[10]

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[7] Kenneth E. Anderson, Thomas R. Pope, and John L. Kramer, et al., *Federal Taxation 2004: Corporations, Partnerships, Estates, and Trusts* (Upper Saddle River, NG: Prentice Hall, 2004), pp. D-6.

[8] Partners may be jointly and severally liable (if RUPA is applicable) or equally liable (if UPA is applicable).

[9] In some cases, a tax matters partner is named.

[10] William H. Hoffman, William A. Raabe, and James E. Smith, et al., *Corporations, Partnerships, Estates, and Trusts*, ed. 2003 (Thomson Southwestern, 2003), pp. 10-4.

Limited Partnerships

A limited partnership consists of at least one general partner and one or more limited partners. The general partners oversee the management of the business and are liable for the partnership's debts. The liability of the other partners is limited to their capital contribution and any additional amounts specified in the partnership agreement. Limited partners cannot take part in the management of the partnership. The general partners are responsible for the all partnership filings required by the IRS. The partnership's income and losses are allocated among the general and limited partners according to the partnership agreement. Partners are each responsible for any income tax on their share of the partnership income. However, limited partners who do not perform a service for the partnership are not considered self-employed and therefore are not responsible for self-employment tax unless they receive guaranteed payments for services performed for the partnership.

Limited partnerships are often used as investment vehicles, for example, in oil and gas exploration. In such a case, the actual drilling parent company serves as the general partner, and the investors owning shares of the venture are treated as limited partners.

Publicly Traded Partnership

A publicly traded partnership (PTP) is one whose ownership interests are traded on an established exchange or in a secondary market or its equivalent. In general, a PTP is treated as a C corporation (discussed below) for tax purposes, and therefore subject to the corporate income tax. There are, however, two exceptions to this general rule. The first exception affects partnerships with at least 90% of their gross income from passive investments, such as dividends, interest, rents, capital gains, and mining and natural resource income.[11] A passive loss generated by a publicly traded partnership may not be used to offset income from other investments, only passive income from the corresponding PTP. The second exception affects partnerships that were publicly traded on December 17, 1987. These partnerships may elect to retain partnership status by paying a tax equal to 3.5% of gross income from the active conduct of business as long as the line of business is unaltered.[12]

Electing Large Partnerships

Under certain circumstances a partnership may elect to be treated as a large partnership with simplified tax reporting requirements. Generally, a non-service partnership with at least 100 partners may elect large partnership status. The category "electing large partnerships" was created by the Taxpayer Relief Act of 1997 (P.L. 105-34) to simplify the reporting requirements for investors in large partnerships.

Electing to be treated as a large partnership simplifies reporting by reducing the number of tax items that must be reported separately at the partnership level. A separate allocation is required only for tax-exempt interest, passive loss limitation and alternative minimum tax items, foreign taxes, and some tax credits.[13] Everything else is netted at the partnership level, and net income or

[11] *See* 26 U.S.C. §7704(c).

[12] *See* 26 U.S.C. §7704(g).

[13] *See* 26 U.S.C. §772 for a detailed list.

loss is allocated to the partners.[14] Most tax audits and tax adjustments take place at the partnership level, with partners notified of their share of any changes.

C Corporations

An alternative to the sole proprietorship or partnership forms of organization is the corporate form. Two types of corporate forms exist: C corporations, which are discussed in this section, and S corporations, which are discussed in the following section. C corporations, also known as ordinary corporations, are named for Subchapter C of the IRC, which details their tax treatment. Businesses incorporate under state law, and the exact requirements for incorporation may vary from state to state. Generally, in order to incorporate, a business must first file articles of incorporation at the state level.[15] The articles of incorporation generally state the name of the corporation, describe the general business or trade that will be conducted, authorize the number and type of shares to be issued, and define the powers of the board of directors.

For legal purposes, a C corporation is an entity that is separate from its owners (shareholders). As a result, shareholders are generally not liable for the actions of the corporation. Shareholders elect a board of directors, which in turn appoints and oversees the corporation's officers (e.g., CEO, COO, and CFO), who are responsible for the day-to-day management of the business. Shareholders can influence the operation of a corporation directly through their right to vote on certain matters, including the removal of elected corporate officials.

The corporate form of organization allows a business to take advantage of a number of benefits not available with other forms of organization. A C corporation, unlike an S corporation, faces no limits with respect to the number of shareholders it may have, the classes of stocks it may issue, or citizenship of its shareholders. Shares of C corporation stock are also traded on well developed exchanges, which allows ownership interests to be transferred readily and at low transaction costs. As a result, C corporations have the ability to raise capital globally from a variety of investors.

Tax Treatment of C Corporations

For tax purposes, the distinguishing feature of a C corporation is that it is a taxable entity. Income and other tax items (deductions, credits, etc.) do not flow directly through the corporation to its owners, as is the case with a sole proprietorship or partnership. Instead, business income is subject to taxation at the corporate level according to the corporate income tax schedule. Any after-tax income that is then distributed to shareholders in the form of dividends is taxed again according to the personal income tax schedule. This extra layer of taxation gives rise to what is known as the "double taxation" of corporate profits.

Because a corporation itself is a taxable entity and directly responsible for paying taxes, taxable income is computed at the corporate level. A corporation begins by aggregating all sources of

[14] Except large oil and gas partnerships, which must continue to report depletion and intangible drilling costs under the old rules for some partners.

[15] While a business may choose any state in which to incorporate, Delaware is by far the most popular. According to Delaware's Division of Corporations, 63% of Fortune 500 companies chose Delaware as their state of incorporation. See http://corp.delaware.gov/.

business income to arrive at total income. Income sources include sales revenue, investment income, royalties, rents, and capital gains. To arrive at taxable income, the corporation then deducts business expenses and other special deductions. Deductions include such things as salaries and wages, bad debts, depreciation, advertising costs, and a portion of domestic production activities, among others. Corporations are also allowed to deduct interest paid to bond holders although not dividend payments made to shareholders. As a result, corporations may rely more on debt financing than they otherwise would.

Like individuals, a corporation may be required to compute its income tax liability twice, once according to the regular corporate tax, and again according to the corporate alternative minimum tax (AMT). A corporation must pay the higher of the two taxes. The AMT is designed to guarantee that corporations are subject to a minimum rate of taxation by limiting the degree to which they can utilize tax deductions and credits.

S Corporations

An S corporation is a closely held corporation that elects to be treated as a pass-through entity for tax purposes. S corporations are named for Subchapter S of the IRC, which details their tax treatment. By electing S corporation status, a business is able to combine many of the legal and business advantages of a C corporation with the tax advantages of a partnership.

Several criteria must be met if a corporation wishes to elect S corporation status. The corporation must be incorporated and organized in the United States. An S corporation can only issue one class of stock and is limited to no more than 100 shareholders.[16] The shareholders must be individuals, estates, certain types of trusts, tax-exempt pension funds, or charitable organizations. All shareholders must be U.S. citizens or residents. Certain banks, insurance companies, possession corporations, and other select business operations are ineligible to elect S corporate status.

An eligible corporation that seeks S corporation status must file a timely election with the IRS. Each shareholder must consent in writing to the election. The shareholders agree to report and pay tax on their shares of the corporation's income. The election can be revoked with the consent of shareholders holding more than 50% of the outstanding shares of stock. If an S corporation election is revoked, the corporation cannot elect S status for five years without the consent of the IRS.

Tax Treatment of S Corporations

S corporations generally do not pay income taxes. As with partnerships, operating income and loss are computed at the corporate level and passed through to the shareholders, while other items with special tax attributes are passed through separately. Separately stated items include portfolio income, capital gains and losses, passive income and losses, charitable contributions, foreign taxes paid, and the like. These tax items retain their character in the hands of the shareholders, who report allocations on their own returns, where the income is taxed for individuals. If the shareholder is a pass-through entity, the income is passed through the shareholder to the income beneficiaries of the pass-through entity.

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[16] Shareholders may, however, have different voting rights.

An S corporation is not afforded the same flexibility as a partnership with respect to allocations amongst its owners. Because an S corporation is only permitted to issue one class of stock, all allocations must be proportionate to ownership. S corporation shareholders are not subject to self-employment taxes on items passed through the corporation. Like partners, shareholders who are also employees of the corporation may receive guaranteed salaries and fringe benefits. The corporation may deduct these expenses but must also pay employment taxes and withhold income and payroll taxes.

An area of contention between S corporations and the IRS is the structure of employee-shareholder compensation. Compensation in the form of regular wages or salary is generally subject to payroll taxes and unemployment taxes. Dividend compensation, however, avoids these taxes. This provides an incentive for S corporations to pay and employee-shareholders to receive dividends in lieu of wages or salary. The IRS has attempted to address this issue by reminding S corporations that they must pay "reasonable compensation" (subject to employment taxes) to shareholder-employees in return for services, before dividend compensation.[17] Compensation is considered reasonable when it matchers what the market return would be to the services provided by the employee. Failure to follow the IRS's suggestion could result in the reclassification of dividend compensation as wage or salary compensation for tax purposes.

More recently, S. 2343, the Stop the Student Loan Interest Rate Hike of 2012, would reduce the interest rate from 6.8% to 3.4% on Subsidized Stafford Loans made to undergraduate students during academic year 2012-2013. To offset the increase in mandatory spending, it would require taxpayers with modified adjusted gross income in excess of $250,000 to pay self-employment taxes (Social Security and Medicare) on certain income currently exempt from self-employment taxes if that income is received from a professional service partnership or a professional service S corporation in which at least 75% of gross income is attributable to three or fewer shareholders. The offset is estimated to raise $9.0 billion from FY2012 to FY2022.[18]

An S corporation may be subject to the corporate income tax in certain instances. One such instance is the realization of a built-in-gain. A built-in-gain is realized when an S corporation, during the first 10 years of being an S corporation, disposes of an asset that had appreciated in value while the business was organized as a C corporation.[19] The tax rate on a built-in-gain is equal to the highest corporate tax rate (currently 35%). To the extent that built-in-gain exceeds the corporate tax owed on it, the built-in-gain passes through to shareholders who must report it as taxable income. Taxes may also be imposed to recapture previous benefits from the use of investment credits or the last-in-first-out inventory method by the C corporation. Finally, in instances where more than 25% of a converted corporation's gross receipts consist of "passive investment income," a corporate income tax may be imposed. The tax is equal to the highest corporate tax rate and is applied to net income attributable to the excess over 25% of gross receipts. Passive investment income includes such things as dividends, interest, rents, royalties, and capital gains.

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[17] Internal Revenue Service, *Paying Reasonable Compensation to the S Corporation Shareholder-Employee*, Stakeholder Headliners, vol. 32, Washington, DC, December 10, 2002.

[18] Congressional Budget Office and staff of the Joint Committee on Taxation, *Estimate of Budgetary Effects of S. 2343, the Stop the Student Loan Interest Rate Hike Act of 2012, as Introduced on April 24, 2012*, prepared, 112th Cong., 2nd sess., April 25, 2012, http://www.cbo.gov/sites/default/files/cbofiles/attachments/s2343.pdf.

[19] The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) reduced the 10-year realization period to 7 years for gains recognized in 2009 and 2010.

Limited Liability Companies

A limited liability company (LLC) combines the favorable tax treatment of a partnership with the limited liability features of a corporation.[20] An LLC, like a partnership, is provided the flexibility to allocate income, losses, deductions, and credits in an amount different than members' ownership interests.[21] The income of a C corporation, on the other hand, is generally distributed to its shareholders in a manner predetermined by rights inherent in each class of stock and the amount of each class of stock a shareholder owns. An S corporation is similarly constrained in the allocation of income, losses, and deductions to its shareholders.

For legal purposes, an LLC, like a corporation, is an entity that is separate from its owners (members). As a result, members are generally provided limited liability protection from the debts of the company. There is no limit to the number of members an LLC may have, unlike with an S corporation. In addition, LLCs are permitted to have multiple classes of ownership interests.

For many years, the IRS had held that any organization would be taxed as a corporation if it had the major characteristics of a corporation. LLCs were designed to lack enough corporate characteristics to avoid such a classification. In most cases, this was accomplished in one of three ways: having the company nominally cease to exist upon the withdrawal of a member; placing restrictions on the transferability of ownership interests; or designating all members as nominal managers.

In 1997, the IRS issued final regulations that in effect allow companies to elect how they will be taxed by simply checking a box on a form.[22] These regulations are typically referred to as "check-the-box" regulations. A single-owner LLC can elect to be taxed as either a corporation or a sole proprietorship. A multi-owner LLC can elect to be considered either a partnership or an association taxable as a C corporation. These rules apply to any entity that is not otherwise required to file as a corporation or a trust. In general, a business may not change its classification during the 60 months following a check-the-box election.

LLCs are relatively recent creations. Wyoming was the first state to allow LLCs in 1977, followed by Florida in 1982.[23] By the mid-1990s, LLC laws had been enacted in all states.[24]

Tax Treatment of LLCs

The IRC does not contain a section pertaining directly to LLCs. As a result, LLCs must elect to be treated as either a corporation or a partnership.[25] Most LLCs elect to be treated as a partnership and are therefore subject to all of the partnership rules discussed above. In such a case, an LLC is able to achieve the limited liability of a corporation without the double taxation and the

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[20] John E. Moye, *The Law of Business Organizations*, 6th ed. (Clifton Park, NY: Thomson Delmar Learning, 2004), p. 121.

[21] The owners of an LLC are referred to as "members."

[22] Treas. Reg. §301.7701-3.

[23] Larry E. Ribstein, "The Emergence Of The Limited Liability Company," *The Business Lawyer*, November 1995, p. 1.

[24] Paul A. McDaniel, Martin J. McMahon, and Daniel L. Simmons, *Federal Income Taxation of Business Organizations*, 3rd ed. (New York: Foundation Press, 1999), p. 8.

[25] Single-member LLCs must elect to be treated as either a corporation or a sole proprietorship.

restrictions on the pass-through of losses of a C corporation. The members of an LLC may be subject to self-employment taxes, as active partners in a partnership are, but shareholders in an S corporation are not. The ownership interest in most LLCs cannot be traded on a market (otherwise the LLC would be treated as a publicly traded partnership and taxed as a corporation anyway).

Analysis of IRS Business Data

This section analyzes the most recent IRS business data. The analysis begins by summarizing the size of businesses by business type. Because of the delay in the release of certain information, this portion of the analysis is restricted to using data from 2003. Next, a snapshot of how business financial items were distributed across business types in 2006 is provided. The analysis then turns to understanding how businesses have changed over time, particularly between 1980 and 2006. Legislative changes that have affected business decisions are also discussed.

How Big Are Businesses?

A business's size can be measured in a number of ways. Three common measures are a firm's assets, receipts, and number of employees. The Small Business Agency (SBA) uses all three to construct its definition of small business, although assets are normally only considered for financial services/banking firms. Even the SBA, however, does not have a single small business definition. Generally, a firm can have anywhere between 100 and 1500 employees, and between $0.75 million and $35.5 million in average annual receipts and still be considered a small business depending on the industry.

Table 1. Distribution of Businesses Size by Receipts and Type, 2003

Business Type	Number	Less than $250,000	$250,000—$1 million	$1 million—$2.5 million	Greater than $2.5 million
All	27,486,691	87.2%	8.2%	2.5%	2.1%
Sole Proprietorship	19,710,079	96.1%	3.4%	0.4%	0.1%
Partnership	2,375,375	81.9%	10.9%	3.8%	3.5%
S Corporation	3,341,606	59.6%	24.7%	8.7%	6.9%
C Corporation	2,059,631	52.7%	25.0%	11.1%	11.1%

Source: CRS calculations from Internal Revenue Service's Integrated Business Data, http://www.irs.gov/pub/irs-soi/03ib01ty.xls

Table 1 uses business receipts to break down the distribution of businesses according to their size. According to the data, there were roughly 27.5 million businesses operating in the United States in 2003.[26] The overwhelming majority of these businesses were small; at least 87.2%, by

[26] This figure excludes farm sole proprietorships.

the most conservative measure. Most people associate small businesses with pass-throughs and **Table 1** certainly supports this notion. More than 90% of sole proprietorships and partnerships, and more than 80% of S corporations had receipts of less than $1 million. Perhaps less well known is the fact that more than 75% of C corporations also fall under the $1 million threshold. Taken together, the data show that across all forms of organization, most businesses are small.

Still, large firms are responsible for most business activity. **Table 2** summarizes the distribution of business receipts according to business type. The top row, last column of the table shows that a majority of all receipts (78.3%) were generated by businesses with $10 million or more in business receipts. The distribution was particularly skewed for C corporations and partnerships; nearly 90% of C corporation business activity and nearly 80% of partnership business activity occurred among firms with more than $10 million in receipts. The distribution was slightly less skewed for S corporations, although more than half of receipts still accrued to the largest firms. Roughly 78% of sole proprietorship business activity occurred among firms with less than a $1 million in receipts, with slightly under half (49.5%) accruing among firms with less than $250,000 in receipts.

Table 2. Distribution of Receipts By Business Type and Size, 2003

Business Type	Business Receipts	Less than $250,000	$250,000—$1 million	$1 million—$2.5 million	$2.5 million—$10 million	Greater than $10 million
All	$21,860,208,610	3.5%	5.0%	4.8%	13.2%	78.3%
Sole Proprietorship	$1,050,202,446	49.5%	28.2%	10.4%	7.4%	4.5%
Partnership	$2,545,612,266	1.5%	4.0%	4.0%	9.3%	80.3%
C Corporation	$14,112,028,796	0.5%	1.9%	2.6%	5.2%	89.9%
S Corporation	$4,152,365,102	3.3%	10.3%	10.8%	19.1%	56.6%

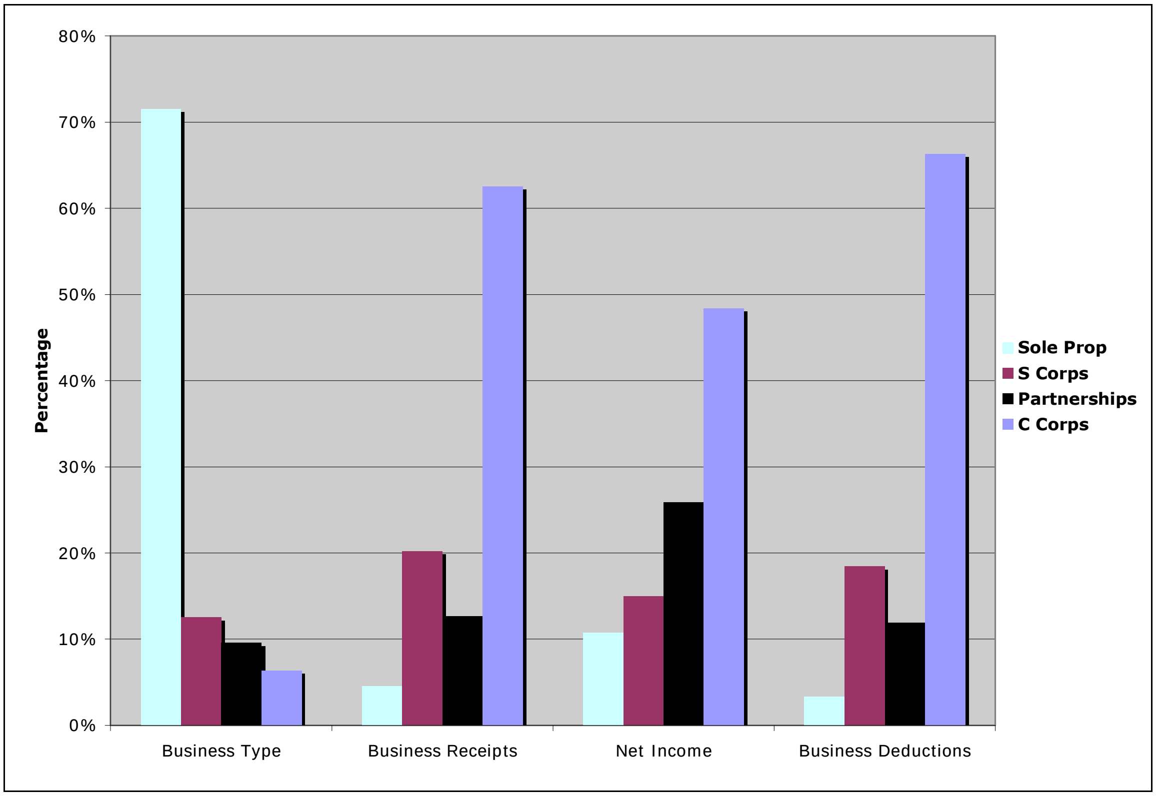
Source: CRS calculations from Internal Revenue Service's Integrated Business Data, http://www.irs.gov/pub/irs-soi/03ib01ty.xls

Summary of Data in 2006

There were just under 31.8 million businesses in the United States in 2006.[27] **Figure 1** shows that sole proprietorships represented the largest single fraction of businesses (71.6%), followed by S corporations (12.6%), partnerships (9.6%), and C corporations (6.3%). **Figure 1** also makes clear that, as was the case in 2003, the distribution of business receipts tended to be concentrated among C corporations. So too was the distribution of business income and business deductions claimed. For example, C corporations generated 62.5% of business receipts, 48.4% of net business income, and claimed 66.3% of all business deductions, while only accounting for 6.3% of all businesses. Sole proprietorships, partnerships, and S corporations collectively generated 37.5% of business receipts and 51.6% of business income, while claiming 37.5% of business deductions.

[27] CRS calculations for the IRS's Business Tax Statistics, various tables.

Figure 1. Distribution of Business Types and Business Financial Items in 2006



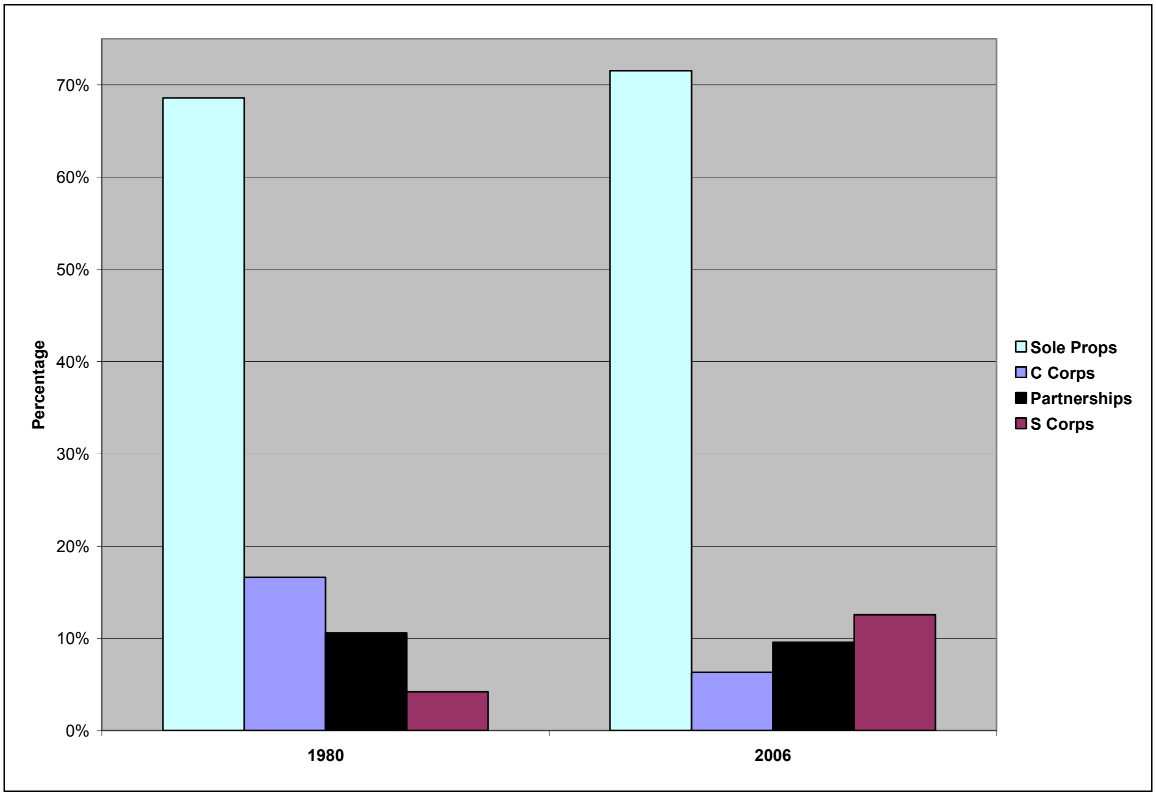
Source: CRS calculations from Internal Revenue Service's Business Tax Statistics, various tables, http://www.irs.gov/taxstats/bustaxstats/index.html.

Note: Net income is measured as net income less deficit.

Distribution of Business Data Over Time

The distribution of businesses has changed somewhat over time. **Figure 2** shows that in 1980 the majority of businesses in the United States were organized as sole proprietorships, followed by C corporations, partnerships, and finally S corporations. **Figure 2** also shows that while the sole proprietorship still remained the most popular form of organization in 2006, the fraction of businesses organized as C corporations had been reduced by more than half, from 16.6% to 6.3%. At the same time, the fraction of businesses choosing to organize as an S corporation tripled over the 1980-2006 period, increasing from 4.2% to 12.6%. The number of partnerships fell slightly since 1980, leading S corporations to eventually outnumber partnerships.

Figure 2. Distribution of Business Types in 1980 and 2006



Source: CRS calculations from Internal Revenue Service's Business Tax Statistics, various tables, http://www.irs.gov/taxstats/bustaxstats/index.html.

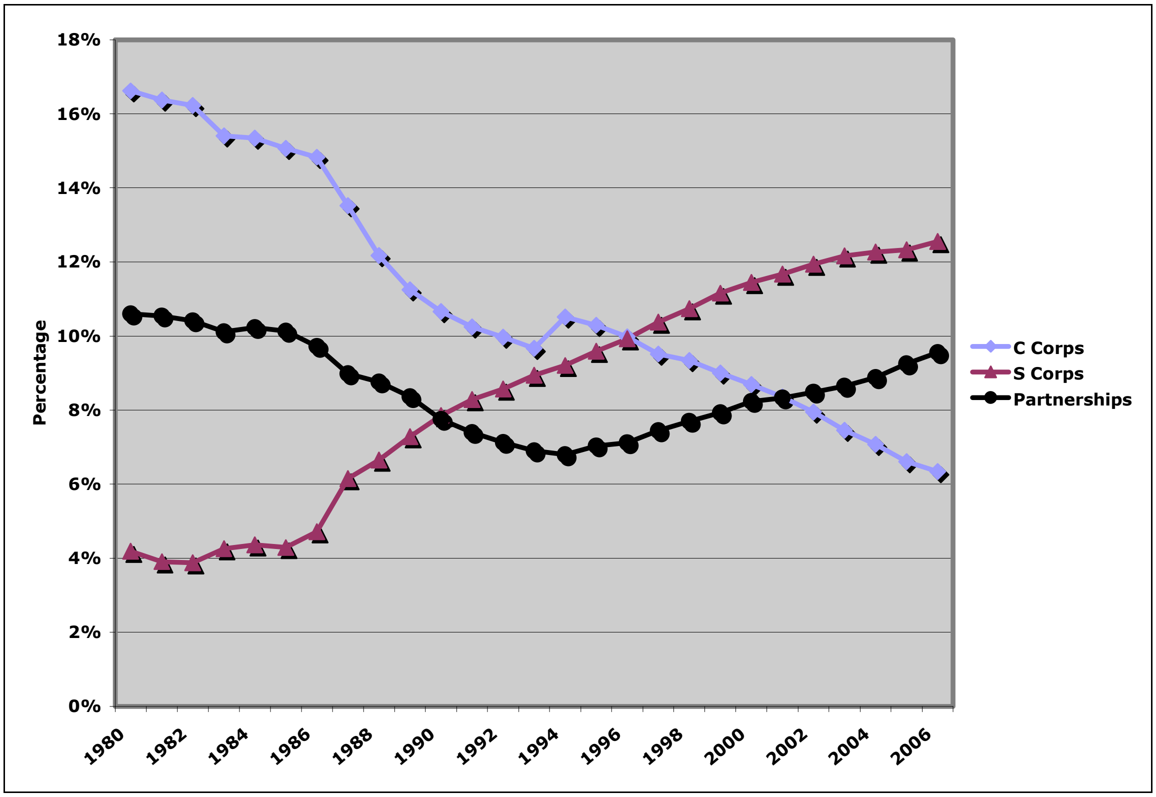
Some of the trend away from C corporations and partnerships in favor of S corporations may be attributed to a number of legislative changes that occurred in the mid-1980s. The Tax Reform Act of 1986 (TRA86; P.L. 99-514), which implemented broad changes to the tax code, increased the appeal of being taxed under the individual income tax rather than the corporate income tax. Prior to TRA86, the highest individual income tax rate was 50%, whereas the highest corporate income tax rate was 46%. TRA86 eventually lowered the highest individual tax rate to 28% and the highest corporate tax rate to 34%. An IRS study found that the more favorable tax treatment under the individual tax schedule after TRA86 induced certain businesses organized as C corporations to reorganize as S corporations.[28] In-line with this explanation, **Figure 3** shows a distinct movement away from C corporations in favor of S corporations in the years immediately following the enactment of TRA86.

Figure 3 also displays a downward trend in the fraction of businesses that chose to organize as partnerships beginning after TRA86. Until 1986, partnerships had been popular among some taxpayers because of the opportunity they presented to claim tax credits and deductions generated by the partnership with little or no active engagement in the partnership's operation. As a result, some partnerships were viewed as "tax shelters" with few benefits beyond reducing its members' tax liability. In an attempt to curb the use of tax shelters, TRA86 instituted limitations on the amount of credits and deductions passive investment partners could claim to reduce their non-

[28] Susan M. Whittman and Amy Gill, "S Corporation Elections After the Tax Reform Act of 1986," *SOI Bulletin*, publication 1136 (Spring 1998).

passive income tax liability. As a result, the attractiveness of partnerships for such taxpayers was reduced.

Figure 3. Distribution of C Corporations, S Corporations, and Partnerships, 1980-2006



Source: CRS calculations from Internal Revenue Service's Business Tax Statistics, various tables, http://www.irs.gov/taxstats/bustaxstats/index.html.

Note: Sole proprietorships are excluded from the figure because they remained a relatively constant fraction of all businesses at around 70%.

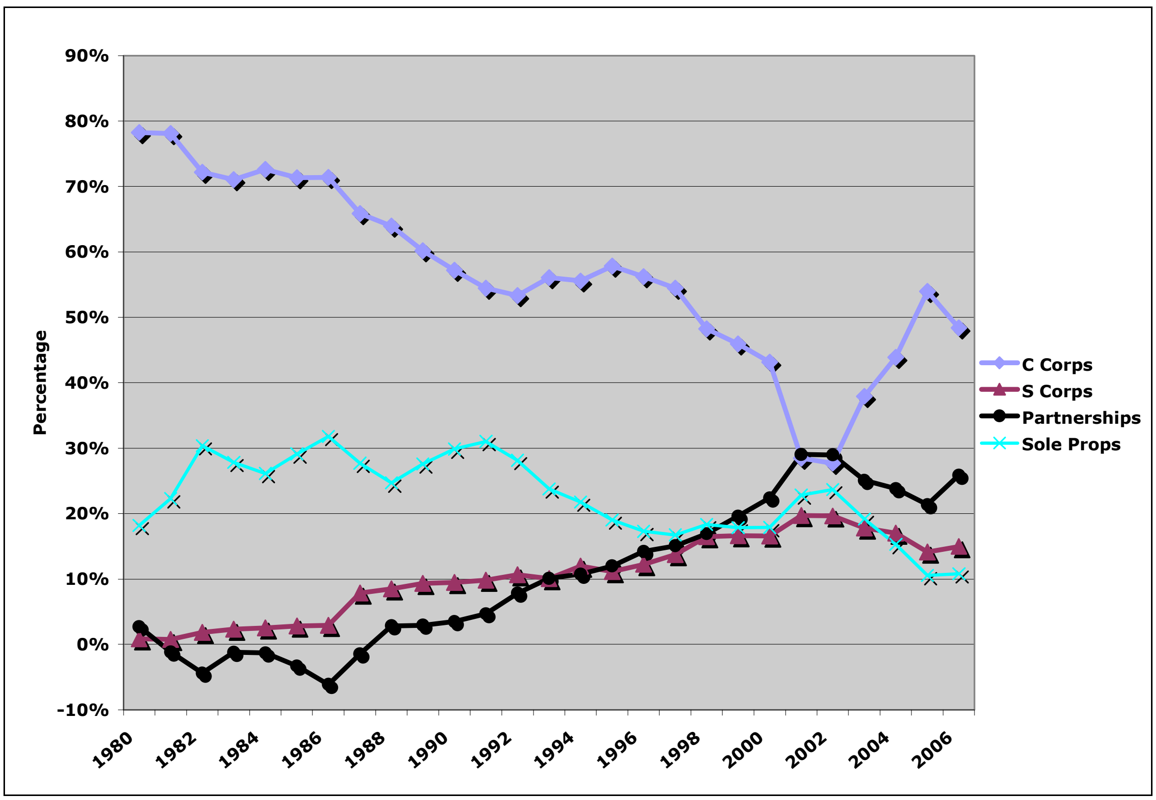
Legislative changes throughout the 1990s continued to impact businesses. By 1993, the more favorable treatment previously afforded business income under the individual tax system had disappeared as the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) and the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) eventually pushed the top individual tax rate above the top corporate tax rate. Although there was a temporary increase in the percentage of C corporations around this time, it did not appear to greatly affect the number of S corporations, which continued to increase in popularity.

Figure 3 shows that there was also renewed popularity in partnerships that began in the mid-1990s. LLCs, many of which elect to be treated as partnerships for tax purposes, appeared on the partnership tax form for the first time in 1993. Between 1993 and 2006, partnerships have grown 38%, with most of this growth being attributed to the increase in LLCs.

S corporations also continued to grow in popularity during the 1990s and the early part of this decade, due in part to an expansion in the shareholder limit. The Small Business Job Protection Act of 1996 (SBJPA; P.L. 104-188) raised the shareholder limit from 35 to 75. In 2005, the shareholder limit was raised to 100 as part of the American Jobs Creation Act of 2004 (P.L. 108-357). The effect was to allow S corporations to access larger capital pools and expand in size without needing to reorganize as a C corporation or LLC.

As the distribution of business types has changed so has the distribution of business income. In 1980, C corporations generated nearly 80% of all business profits in the United States (**Figure 4**), while representing just under 17% of all businesses (see **Figure 2**). By 2006, however, C corporations were responsible for slightly less than 50% of all business profits, although this number had fallen to as low as 28% in 2002. The fraction of income generated by sole proprietorships was generally stable until the early 1990s, at which point it began a slight trend downward. The fraction of income being generated by partnerships and S corporations grew steadily for most of the time period. However, the fraction of income attributable to these two business forms has fallen somewhat recently due to the surge in C corporate income.

Figure 4. Distribution of Net Business Income, 1980-2006



Source: CRS calculations from Internal Revenue Service's Integrated Business Data, Table 1, http://www.irs.gov/pub/irs-soi/80ot1all.xls.

Notes: Net income is measured as net income less deficit. This measure of income is different than taxable business income, although the two will generally be close.

Appendix. Additional Forms of Organization

RICs

Regulated investment companies (RICs), most of which are mutual funds or venture capital companies, are corporations or associations that invest their members' money in securities and pass the dividends, interest, and capital gains through to their investors. If they meet the requirements of IRC Sections 851-855, the amounts distributed to investors are not subject to the corporate income tax.

According to the IRC, a RIC must derive at least 90% of its gross income from dividends, interest, gains from the sale of securities, and other income from handling or holding of cash and securities (foreign currency transactions, loans of securities, etc.). At least 50% of its assets must be invested in securities and cash, and no more than 25% can be invested in the securities of one issuer. Except for certified venture capital companies, the company may not own more than 10% of the voting stock of another corporation.

RICs are subject to corporate income tax on undistributed taxable income less capital gains. However, if a RIC distributes each year at least 90% of its income (excluding capital gains) to shareholders as dividends, the amounts distributed are deductible. In fact, almost all mutual funds distribute all of their income (by crediting it to shareholders' accounts) and so pay no corporate income tax. The shareholders include the dividends credited to them in their own incomes and are liable for any tax the dividend income generates.

Capital gains on the company's securities trades are accounted for separately and are paid out to shareholders as capital gains dividends. Capital gains dividends are treated by the shareholder as long-term capital gains. Because a mutual fund's trading activity can generate capital gains even when its own shares have lost value, shareholders can have taxable capital gain dividends in a year when their overall investments in the fund have fallen in value. They cannot net the unrealized loss on their mutual fund shares against their capital gains dividends, which represent realized capital gains.

RICs have the option of retaining capital gains and paying the corporate capital gains tax on them. In this case, the gains are allocated to the shareholders as if paid out in dividends and included in the shareholder's income. However, shareholders are allowed a credit for their share of tax paid by the RIC.

REITs

A real estate investment trust (REIT) is a domestic corporation, trust, or association with at least 100 shareholders that elects to be taxed as a REIT and meets the requirements of IRC Sections 856-859**.** According to the IRC, a REIT must derive at least 95% of its gross income from dividends, interest, capital gains, and qualified real estate income, and at least 75% of its gross income from real estate rents, mortgage interest, sales of real estate and mortgages, and other income related to real estate, including income from foreclosure property. The REIT must not directly perform management or other services for its rental properties. At least 75% of the REIT's assets must consist of real estate and mortgages, cash and cash items, and government securities.

The taxation of a REIT and its shareholders—the IRC calls them "beneficiaries"—is similar to that of a RIC. If the REIT distributes at least 90% (95% before 2001) of its net income to shareholders, it is not subject to corporate taxation on the amounts distributed, which are taxed at the shareholder level. As with RICs, capital gains are accounted for separately and are considered long-term gain when distributed to shareholders. REITs may also elect to retain capital gains and pay a tax at the corporate level, which is then passed on to shareholders as a credit. Like RICs, the majority of REITs distribute all of their income to escape corporate taxation.

Trusts

Trusts are entities that hold title to property for other persons; they are not supposed to be associations or conduct business (IRS Regulation 301.7701-1). They either distribute or credit their income to beneficiaries, who are taxable on it, or pay a tax themselves under a special individual income tax rate schedule (IRC Section 1(e)). There are many kinds of trusts and extensive tax rules to govern them (IRC Subchapter J). (The word "trust" is used in the IRC for many dissimilar entities, some of which are taxed as corporations.)

REMICs

Real estate mortgage investment conduits, or REMICs, are pools of mortgages that sell shares to investors and pass the mortgage interest income through to the investors. Investors holding "regular interests" receive fixed payments, deductible by the REMIC and taxable as interest income to the investor. "Residual interest" holders are allocated a pro-rata share of the remaining income, taxable to them as ordinary income. The REMIC is not allowed to trade in mortgages; such activity would be a "prohibited transaction" and taxed at 100% of any gain. (IRC Section 860A-860G)

FASITs

Financial asset securitization investment trusts, or FASITS, are entities owned by C corporations and used to hold the C corporation's securitized credit card receivables, auto loans, home equity loans, and other consumer debt. Their operation is similar to a REMIC, with "regular interests" receiving fixed payments taxable as interest income and the "ownership interest" (the C corporation) receiving the remainder as taxable income. "Prohibited transactions," including trading securities and receiving income from any other assets, are taxed at 100% of any gain. (IRC Section 860L)

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