



Taxing Businesses Through the Individual Income Tax

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Summary

Since the individual income tax was instituted in 1913, the profits of most businesses have been allocated, or “passed through,” to their owners and subjected to that tax—rather than to the corporate income tax. However, most business activity has occurred at firms subject to the corporate income tax (C corporations) because those firms tend to be larger than pass-through entities. Over the past few decades, the proportion of firms organized as pass-through entities and their share of the revenues that businesses receive from sales of goods and services—that is, business receipts—have increased substantially: In 1980, 83 percent of firms were organized as pass-through entities, and they accounted for 14 percent of business receipts; by 2007, those shares had increased to 94 percent and 38 percent, respectively. This report examines those shifts in organizational structure, the effect they have had on federal revenues, and the potential effects on revenues and investment of various alternative approaches to taxing businesses’ profits.

Changes in Businesses’ Organizational Structure

The trends in the way businesses are organized and the resulting income taxes to which they are subject are linked to the growing popularity of entities such as S corporations (those organized under the rules of subchapter S of the Internal Revenue Code) and limited liability companies (LLCs) that have arisen mainly in the past 30 years. Those newer organizational forms provide owners with the same protection from liability for the debts of the firm that the owners of C corporations receive but in addition offer

Note: Numbers in the text and tables may not add up to totals because of rounding.

more favorable tax treatment. Spurring those shifts in organizational form have been, in particular:

- Changes in the tax code—particularly the enactment of the Tax Reform Act of 1986, which lowered the top marginal rate in the individual income tax (that is, the rate that applies to an additional dollar of income) to below the top marginal rate in the corporate income tax; and
- The trend in the United States away from an economy based primarily on manufacturing and toward one based for the most part on providing services—an activity that derives fewer benefits from the C-corporation structure.

Effects of Changes in Structure

One effect of the growth of newer types of businesses is that total federal revenues have been reduced relative to a world in which C corporations still earned over 85 percent of all business receipts. The Congressional Budget Office (CBO) estimates that if the C-corporation tax rules had applied to S corporations and LLCs in 2007 and if there had been no behavioral responses to that difference in tax treatment, federal revenues in that year would have been about \$76 billion higher. Behavioral responses—for example, owners of S corporations might have reduced those corporations' taxable income by reporting larger amounts for their compensation (which would have raised payroll taxes and lowered corporate income taxes relative to CBO's estimate)—would have changed the amount of additional tax revenue that would have been collected. Furthermore, the estimate does not account for interactions with other tax provisions, such as the alternative minimum tax. Despite those complications, however, it is clear that the growth of newer types of businesses not subject to the corporate income tax has significantly reduced federal revenues relative to what would otherwise have occurred.

The increased share of business activity attributable to pass-through firms not only reduces federal revenues but also increases the extent to which businesses similar in size and in the same industry are being taxed differently. Nevertheless, the trend toward pass-through entities' accounting for a larger share of business activity has some positive aspects. For example, it has probably reduced the overall effective tax rate on businesses' investments, thus encouraging firms to invest. (The effective tax rate combines statutory rates with other features of the tax code into a single tax rate that applies to the total income generated over the life of an investment.) The shift in activity toward pass-through firms has also reduced at least two biases associated with the current corporate income tax that influence what businesses do with their earnings and how they pay for their investments:

- The bias in favor of retaining earnings rather than distributing them, which results from taxing dividends immediately but deferring the taxation of capital gains; and

- The bias in favor of debt financing, which results from allowing businesses, when they calculate their taxes, to deduct from their income the interest they pay to creditors but not the dividends they pay to shareholders.

Possible Approaches for the Future

Reducing the distortions caused by the current rules for taxing businesses' income would increase businesses' incentives to allocate their investments more efficiently—that is, in a way that maximizes the production of goods and services given the available resources. CBO examined three potential approaches to the taxation of businesses' profits:

- *Limiting the use of pass-through taxation.* Policies following that approach would increase federal revenues but probably also raise effective tax rates on businesses' investments and exacerbate the inefficiencies associated with the two biases described above.
- *Integrating the individual and corporate income taxes.* That approach, which includes alternatives that achieve only partial integration, would increase the use of pass-through taxation and have the opposite effects of the first approach. That is, it would probably lower federal revenues, reduce effective tax rates, and lessen the biases described earlier.
- *Unifying taxes on businesses in a new entity-level tax.* That approach is designed to reduce or even eliminate the two biases—particularly the bias in favor of debt financing. Such a change could either raise or lower revenues and effective tax rates, depending on its details.

Taxing Businesses Through the Individual Income Tax

How Businesses Are Organized and Taxed

The owners of businesses may organize their enterprises in a variety of ways, subject to the applicable laws of their state. Typically, they choose a form that reflects their needs for capital, for structural flexibility, and for personal protection from the liabilities that the business takes on. To a large extent, that choice of organizational form determines how a business will be taxed at the federal level—that is, whether its profits will be subject to the corporate income tax or be “passed through” to its owners and taxed through the individual income tax. Indeed, the method of taxation may strongly affect a business's choice of organizational form.

Organizational Forms

The most fundamental organizational decision the owners of a business must make is whether to incorporate. *Corporations* may have any number of owners (including one), but they typically have four defining characteristics:

- Limited liability—each owner’s liability for the debts of the firm is limited to the amount of his or her investment;
- Centralized management—decisionmaking authority resides with a board of directors rather than with the general ownership;
- Free transferability of interest—each owner may sell his or her interest without the permission of the other owners; and
- Continuity of life—the firm does not automatically dissolve upon the death, bankruptcy, or withdrawal of an owner.

Unincorporated businesses may have some or none of those characteristics. At one extreme, *general partnerships* and *sole proprietorships* have no corporate features. Each general partner and sole proprietor is fully liable for the debts of the firm, and general partners and sole proprietors are the only ones with decisionmaking authority. Moreover, general partnership interests may be transferred only with the permission of the other partners, and such arrangements are automatically dissolved upon the death, bankruptcy, or withdrawal of a partner (see [Table 1](#)). Those characteristics make the general partnership and sole proprietorship forms of organization unpopular choices for owners that need easy access to capital markets and have little taste for risk.

In contrast, limited partnerships and limited liability companies (LLCs) are unincorporated businesses that have some of the characteristics of corporations. *Limited partnerships* have both general partners, who are fully liable for the debts of the firm and are typically responsible for managing it, and limited partners, who enjoy limited responsibility for the firm’s financial obligations. *Limited liability companies*, by comparison, extend limited liability to all “members” (the term by which the owners of such companies are known); LLCs have no equivalent for the general partner who assumes full liability. LLCs do have flexibility with regard to management: All members may participate in those activities, or a centralized management committee may be appointed.

Taxation of Businesses

The decision of whether or not to incorporate is a key factor but not the only factor in determining how a business is taxed. For income tax purposes, all unincorporated businesses are taxed in the same way, but not all corporations are taxed in the same manner. In contrast, for payroll tax purposes, all owners of corporations are treated the same, but owners of unincorporated businesses may be treated differently. Furthermore, other characteristics, such as size, affect how a business is taxed.

Corporations that are taxed under subchapter C of the Internal Revenue Code (C corporations) generally pay corporate income tax on their profits at rates up to 35 percent.¹ Those corporations may choose to retain their after-tax profits for future investment, which tends to increase the value of the corporation's stock, or they may distribute the profits as dividends to shareholders. Shareholders pay individual income tax on corporate dividends at rates of as much as 15 percent. Shareholders also pay tax—at rates up to 15 percent—on any capital gains they realize when they sell their shares of stock in the corporation.² Either way, the profits of C corporations are taxed once at the level of the firm, under the corporate income tax, and again at the level of the shareholder, under the individual income tax.

In contrast, those corporations that are taxed under subchapter S of the Internal Revenue Code (S corporations) do not pay corporate income tax on their profits. Instead, those businesses pass all profits through to their shareholders, who then pay individual income tax on them (whether or not the profits are actually distributed) at rates that currently can be as high as 35 percent. Only corporations that meet certain criteria can choose to be taxed under subchapter S. Specifically, a qualifying firm may have only one class of stock and no more than 100 shareholders, none of which can be another for-profit business or a nonresident alien (that is, a citizen of another country who resides outside the United States). Because of those restrictions, the typical S corporation is smaller than the typical C corporation. However, in every respect other than how they are taxed, S corporations and C corporations are legally identical.

Unincorporated businesses are not subject to federal income tax at the firm level unless they choose to be (and very few do). Instead, they are taxed on a pass-through basis, in the same way as S corporations.

Other income tax rules, such as those for measuring income, calculating depreciation, and accounting for inventory, are generally the same for C corporations and pass-through businesses. However, special rules may apply to firms that fall below certain size thresholds (measured in various cases by receipts, assets, or number of employees).³ Although not all C corporations are large and not all pass-through businesses

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1. Rates above 35 percent apply to certain ranges of income. Specifically, a rate of 39 percent applies to taxable income between \$100,000 and \$335,000, and a rate of 38 percent applies to taxable income between \$15,000,000 and \$18,333,333. Corporations pay taxes on net income in excess of \$18,333,333 at a rate of 35 percent.
 2. In 2013, the tax rate on dividends is scheduled to revert to the same rate as that on ordinary income—potentially as high as 39.6 percent. The tax rate on capital gains is scheduled to increase to a maximum of 20 percent.
 3. For example, the Americans with Disabilities Act of 1990 (as amended) provides a credit to certain firms for complying with its requirements for workplace accessibility. Only firms with annual receipts of less than \$1 million or with fewer than 30 employees, regardless of organizational form, may claim the credit. For further discussion of differences in tax treatment and other federal policies among firms of different sizes, see Congressional Budget Office, *Small Firms, Employment, and Federal Policy* (March 2012).

are small, pass-through entities are more likely than C corporations to qualify for those special rules.

The rules for Social Security and Medicare payroll taxes also differ by type of business entity but not in the same way as the rules governing income taxes. The tax code considers owners of both C and S corporations who perform services for the firm to be employees covered under the Federal Insurance Contributions Act (FICA). Thus, their compensation is subject to the same Social Security and Medicare payroll taxes that other workers pay (historically, a combined 15.3 percent of earnings, split equally between employees and their employers).⁴

In contrast, the tax code generally considers owners of unincorporated businesses to be self-employed, which means they are covered under the Self-Employment Contributions Act (SECA). The SECA tax rate is equal to the combined FICA tax rate paid by employees and their employers. (To provide parallel treatment with the taxes that employers pay under FICA, which they subtract in calculating their taxable profits, self-employed people may deduct half of their SECA taxes from their taxable income.) All net income from sole proprietorships is considered self-employment income and is subject to SECA taxes, even though that income includes the return on any capital the business may have invested in.⁵ For partnerships, the definition of self-employment income differs depending on whether an owner is classified as a general or a limited partner. For general partners, both net income and guaranteed payments (that is, compensation for services that is due even if the partnership has no net income) are considered self-employment income; for limited partners, only guaranteed payments are subject to the SECA tax.

The Evolution of Pass-Through Entities

Pass-through entities—businesses whose profits are subject to the individual income tax—have existed since the introduction of that tax, in 1913. But different organizational forms subject to such taxation have emerged over time, as firms sought to combine the benefits of pass-through taxation, the limited liability of corporations, and the structural flexibility of unincorporated businesses.

At one time, businesses were either incorporated (according to the laws of their particular state) or unincorporated, and they were taxed—or not taxed—at the federal level accordingly. The modern federal income tax, first imposed in 1909, applied only to incorporated businesses. But the enactment of the 16th Amendment in 1913 instituted

4. For 2011 and 2012, lawmakers reduced the employee's share of the FICA tax by 2 percentage points.

5. The mix of capital and labor income in the SECA tax is discussed in Congressional Budget Office, *The Taxation of Capital and Labor Through the Self-Employment Tax* (September 2012).

an individual income tax that treated unincorporated businesses such as sole proprietorships and general partnerships as pass-through entities.

Initially, the structure of the individual income tax resulted in similar treatment of the profits distributed to owners of corporations and partnerships alike. By 1917, however, corporate profits distributed as dividends were taxed more heavily than were profits distributed by partnerships.⁶ That lack of tax neutrality spurred a demand for hybrid entities that provided both liability protection for owners and the tax benefits of partnerships.

Limited Partnerships

At about the same time that federal tax rules made the treatment of corporate dividends less favorable than the treatment of partnership distributions, the National Conference of Commissioners on Uniform State Laws drafted the Uniform Limited Partnership Act (ULPA) of 1916. ULPA was not a federal law but rather a model statute that was eventually adopted by 49 states and the District of Columbia.⁷ It granted protection from liability to certain “limited” partners that was similar to the protection granted to corporate shareholders, provided that the partners did not take part in the “control of the business.” More recent versions of ULPA have loosened the definition of limited partner, culminating in the 2001 draft (adopted by 18 states and the District of Columbia by the end of 2011) that explicitly permits limited partners to participate in the management of the firm.⁸ The remaining “limit” on such partners is that they may not enter into binding contracts on behalf of the entire partnership.

Because limited partnerships still had to have at least one fully liable general partner, they were not a particularly attractive alternative to incorporation, and they never became a popular form of organization for profitable companies. Over time, however, certain industries obtained favorable tax treatment that allowed firms in those industries to persistently generate negative taxable income (that is, losses) while remaining viable businesses. Limited partnerships were largely concentrated in industries—most notably, real estate—that received favorable tax treatment for passed-through losses. The Tax Reform Act of 1986 (TRA-86) substantially reduced the incentive for limited partnerships to generate tax losses. However, because of organizational inertia, limited

6. For more detail on the taxation of businesses' profits before 1935, see Richard Winchester, “Parity Lost: The Price of a Corporate Tax in a Progressive Tax World,” *Nevada Law Journal*, vol. 9, no. 1 (2008), pp. 130–184, http://works.bepress.com/richard_winchester/1/.

7. Louisiana was the exception. See Robert W. Emerson, *Business Law*, 4th ed. (Barron's Educational Series, Inc., 2004), p. 318, http://books.google.com/books/about/Business_Law.html?id=jWRq7-NLmjC.

8. For further updates on the adoption of the 2001 ULPA, see the Uniform Law Commission's Legislative Fact Sheet at <http://uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Partnership%20Act>.

partnerships persisted as largely profitable entities and remained the dominant form of organization in the real estate industry for more than 15 years thereafter.

S Corporations

Lawmakers first addressed the demand for entities benefiting from both protection against liability and pass-through taxation in 1958, when they added subchapter S to the tax code. Few S corporations were established, though, largely because the rules were so complex that firms could inadvertently disqualify themselves.⁹ It was not until the rules were simplified, in 1982, that S corporations began to attract attention.

Unlike other pass-through entities, S corporations remain subject to the same requirements for governance that other corporations chartered in the same state must abide by. In most states, those requirements involve cumbersome procedures, such as filing extra reports with the state and holding annual meetings at which the shareholders elect a board of directors to oversee the corporation's managers (even though those three groups frequently consist of the same people). Furthermore, S corporations must allocate profits in proportion to owners' shares of the business, whereas partnerships have the flexibility to allocate profits according to any formula that is agreeable to all of the partners.

Owners of S corporations are not subject to SECA taxes. Instead, they are required to pay themselves "reasonable compensation" for services they render to the firm—an amount that is subject to FICA taxes just as if it were a salary.¹⁰ However, S-corporation owners have an incentive that does not arise for most owners of C corporations who perform services for their company—namely, to underestimate their reasonable compensation, because doing so reduces their tax liability under FICA without affecting their (or the firm's) tax liability under the individual income tax.¹¹

Beginning in 2013, the differential between the taxes levied on owners of C corporations and those levied on owners of S corporations will increase. A 3.8 percent tax on unearned income (such as dividends and interest) will apply starting in that year to taxpayers with total income in excess of \$200,000 (or a combined income of \$250,000 for married couples filing joint returns). That tax will apply to dividends received from

9. Deborah H. Schenk, *Federal Taxation of S Corporations* (ALM Properties, Inc., Law Journal Press, 2005), p. 1–6, http://books.google.com/books/about/Federal_Taxation_of_S_Corporations.html?id=7elUL18imQEC.

10. In principle, such compensation is the amount one would have to pay an employee to perform the same services. In practice, firms can apply a "facts and circumstances" test that may legitimately result in the compensation's being either higher or lower than that amount.

11. For further discussion, see Nicholas Bull and Paul Burnham, "Taxation of Capital and Labor: The Diverse Landscape by Entity Type," *National Tax Journal*, vol. 61, no. 3 (September 2008), p. 402, [http://ntj.tax.org/wwwtax%5Cnjrec.nsf/OD11F36B232E9CF8852574F300419117/\\$FILE/Article%2004-Bull.pdf](http://ntj.tax.org/wwwtax%5Cnjrec.nsf/OD11F36B232E9CF8852574F300419117/$FILE/Article%2004-Bull.pdf).

C corporations but will not affect passed-through profits from S corporations as long as the owner has been active in running the business.¹²

Limited Liability Companies and Limited Liability Partnerships

In the wake of tax rate changes in TRA-86 that were favorable to pass-through entities, interest in such forms of organization grew rapidly. However, because of the restrictions on eligibility for S-corporation status, the relative inflexibility of that organizational form, and the exposure to liability of general partners in limited partnerships, such interest shifted toward full liability protection in a noncorporate environment. The result was the enactment, by 1997, of statutes authorizing and regulating LLCs in every state and the District of Columbia. LLCs provide liability protection for owners comparable to that offered by a corporation—no member is required to assume full liability. Furthermore, the LLC structure offers certain advantages over that of S corporations: Unlike those corporations, LLCs can have any number of members (including for-profit businesses and nonresident aliens) and can allocate their profits in any way that is agreeable to the membership. However, the body of common law concerning LLCs is relatively underdeveloped, resulting in enough uncertainty that some businesses that might benefit from adopting that organizational form have declined to do so.

The first LLC statute was enacted by Wyoming, in 1977, but was neither used widely nor emulated by many other states because it was unclear how the Internal Revenue Service (IRS) would treat LLCs for tax purposes. That ambiguity was eliminated in 1988, when the IRS issued a ruling establishing conditions under which LLCs would be treated as pass-through entities rather than as corporations. Shortly thereafter, states increasingly began to enact LLC statutes, with most doing so between 1993 and 1995. A 1996 regulation adopted by the IRS allowed an LLC (and virtually any other unincorporated business) to decide for itself—or, as it is commonly known, to “check the box”—whether to be treated as a corporation or as a pass-through entity.¹³

One remaining source of uncertainty is how LLCs’ members should be treated under SECA. The Social Security statutes mention only general and limited partners—not LLC members. In 1997, the Department of the Treasury proposed regulations that would clarify the status of LLC members’ income under SECA. Those regulations would have deemed any partner’s or LLC member’s share of their business’s income to be subject to SECA taxes if the individual met certain conditions. The regulations were never

12. The same exemption will apply to passed-through partnership profits and losses received by limited partners. Income (above the income thresholds) that sole proprietors and general partners receive will not be subject to the tax on unearned income, even if that income derives from capital investments rather than those individuals’ labor. Instead, it will be subject to an increase in the SECA tax of 0.9 percentage points. That increase will bring the total SECA tax rate for that income range to 3.8 percent—the same rate as the tax on unearned income.

13. The primary exception to the check-the-box option is the publicly traded partnership. Such firms must receive 90 percent of their income from qualified sources (such as interest, dividends, rents, capital gains, and income associated with natural resources) to avoid being taxed as a corporation.

finalized, but for many years, most tax practitioners believed they would not be challenged by the IRS if they followed the proposed 1997 regulations with respect to LLCs.¹⁴

An even newer form of organization, first authorized in Texas in 1991, is the limited liability partnership (LLP). LLPs are found mostly in professional services industries. Like LLCs, they provide liability protection for all partners (although such protection does not extend to a partner's own negligence or malpractice) and are treated as pass-through entities for tax purposes. But whereas LLCs seem to be primarily an alternative to S corporations and limited partnerships, LLPs are a substitute for general partnerships; virtually all firms that convert to LLP status were previously general partnerships. In an LLP, partners generally take an active role in the operations of the firm—for example, by providing professional services to clients. In those instances, as the Tax Court clarified in 2011, a partner's labor contribution matters more than his or her limited exposure to liability when determining the partner's SECA tax status.¹⁵ Thus, a working partner in an LLP is treated as a general partner for the purposes of SECA taxation. Some tax professionals believe that the ruling applies to LLC members as well.¹⁶

Measuring the Shift of Activity to Pass-Through Entities

According to data from the IRS, the nation saw an increase between 1980 and 2007 in the share of business activity attributable to firms organized as pass-through entities. That growth can be seen both in the share of firms with particular organizational structures and in the share of business receipts (gross revenues from the sale of goods and services) that those firms accounted for. For example, since 1980, the share of business receipts that pass-through entities account for has more than doubled. CBO found that two types of changes in tax policy are associated with the periods of fastest growth in the shift in business receipts to such entities: changes that set the top rate in the individual income tax equal to or lower than the top rate in the corporate income tax, and increases in the maximum number of shareholders that an S corporation may have.¹⁷

The Integrated Business Dataset (IBD) created by the IRS provides the most complete set of measures for tracking changes in the shares of U.S. business activity attributable to different types of entities.¹⁸ Specifically, the IBD breaks down the number of businesses

14. *Kiplinger Tax Letter*, vol. 78, no. 13 (June 20, 2003).

15. *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. No. 7 (2011).

16. Claire Y. Nash, "Partners' Limited Liability and Self-Employment Tax," *The Tax Adviser* (July 1, 2011), www.aicpa.org/Publications/TaxAdviser/2011/July/Pages/nash_jul2011.aspx.

17. In this report, the "top" tax rate refers to the statutory rate on income in the highest tax bracket. It is not necessarily the highest tax rate paid on any income. Higher statutory rates apply in lower tax brackets in the corporate income tax; also, higher rates result from the phaseouts of personal exemptions and of itemized deductions in the individual income tax.

18. Internal Revenue Service, *SOI Tax Stats—Integrated Business Data*, www.irs.gov/uac/SOI-Tax-Stats---Integrated-Business-Data.

and business receipts by type of entity for the period from 1980 to 2007. Both of those measures show growth in the share attributable to pass-through entities over that time span. The IBD also provides data on total receipts (which include income from non-business activity, such as investments) and net income—that is, total receipts minus the cost of operating the business—but those measures are not consistent among the various types of entities and were not part of CBO’s analysis.¹⁹

The Trend in the Percentage of Businesses That Are Pass-Through Entities

Most businesses are organized as sole proprietorships. The share of all businesses that are organized in that way remained fairly steady between 1980 and 2007, ranging between 70 percent and 75 percent (see the top panel of [Figure 1](#)). Among other forms of organization, however, shifts in their shares of the total number of businesses were much more significant. In particular, the percentage of businesses organized as C corporations declined from 17 percent in 1980 to 6 percent in 2007. That change was more than offset by the increase in the hybrid forms described earlier—specifically, limited partnerships, S corporations, and LLCs; that set of entities increased from 5 percent to 20 percent of all businesses during the 1980–2007 period. (The growth of limited partnerships, S corporations, and LLCs in excess of the decline in C corporations appears to have occurred at the expense of general partnerships, whose share shrank from 9 percent to 2 percent over the period.)

The Trend in the Share of Business Receipts Attributable to Pass-Through Entities

Although the majority of businesses are organized as sole proprietorships, C corporations account for more than three-fifths of the country’s business receipts. But the decline over approximately the past 30 years in the share of businesses organized as C corporations has been mirrored in their share of those receipts—which shrank from 86 percent in 1980 to 62 percent in 2007. In contrast, the share of receipts generated by pass-through entities more than doubled over the period—from 14 percent to 38 percent.

The data suggest that the gain in the share of business receipts attributable to S corporations and LLCs roughly offsets the loss in the share of receipts attributable to C corporations. Between 1980 and 2007, the combined share of receipts for C corporations, S corporations, and LLCs averaged 89.3 percent, and that proportion did not deviate by more than 1.2 percentage points in any year (see the bottom panel of [Figure 1](#)). That finding suggests that, collectively, sole proprietorships, general

19. At one extreme, sole proprietorships report as net income an amount equal to their profits plus the labor income of the owner, but the owner’s portfolio income (interest, dividends, capital gains, and so forth) is not included in either total receipts or net income. At the other extreme, the amount reported by C corporations as net income excludes the labor income of owners (which is deducted like any other salary) but includes all of the corporation’s portfolio income as part of total receipts. Because of those inconsistencies, this analysis focuses on business receipts rather than total receipts or net income.

partnerships, limited partnerships, and LLPs played virtually no role in the expanded activity of pass-through entities.

Because publicly traded companies generally cannot be organized as pass-through entities, a “natural limit” restricts how much activity can shift to pass-through firms—namely, the activity undertaken by privately held companies.²⁰ The IRS in its statistics does not distinguish between privately held and publicly traded C corporations; however, smaller firms are much less likely than larger firms to be publicly traded. Drawing on that observation, CBO calculated a possible upper bound on pass-through entities’ share of business receipts in 2007 under the assumption that every C corporation with less than \$100 million in assets switches to pass-through status.²¹ If that were the case, pass-through entities would account for half of all business receipts (compared with their actual share of just over one-third).

What Caused the Shift to Pass-Through Entities?

The shift in business activity toward pass-through entities was spurred by two distinct phenomena. First, some C corporations were reorganized as either S corporations or LLCs. Second, entrepreneurs were more likely to organize new firms as S corporations and LLCs than as C corporations.

One cause of the trend toward pass-through entities—accomplished through the start-up of new firms—has been the economy’s tilt toward the provision of services rather than the production of goods. In addition, researchers have found that changes in tax

20. In theory, publicly traded companies could reorganize themselves into one or more privately held firms whose majority owner was a publicly traded holding company. However, a review of the share of net income attributable to partnerships and LLCs that was allocated to corporate partners between 2000 and 2007 showed no evidence that corporate partners were becoming more common. See the annual tables in Internal Revenue Service, *SOI Tax Stats—Partnership Statistics by Sector or Industry*, “Partnerships with Income (Loss) Allocated to Partners,” www.irs.gov/uac/SOI-Tax-Stats-Partnership-Statistics-by-Sector-or-Industry. Because the use of that reorganization strategy does not appear to be on the rise, CBO did not account for the possibility that pass-through entities might break through the so-called natural limit by taking that approach.

21. The distribution of corporations’ business receipts by asset class was taken from the U.S. totals in Table 1 of Internal Revenue Service, *2007 Corporation Source Book of Statistics of Income*, [www.irs.gov/uac/SOI-Tax-Stats---Corporation-Source-Book:-Agriculture-to-Construction-\(sectors-11-23\)](http://www.irs.gov/uac/SOI-Tax-Stats---Corporation-Source-Book:-Agriculture-to-Construction-(sectors-11-23)). Table 3 from the same source provided the distribution for S corporations; the distribution for C corporations was calculated as the difference between the figures in Tables 1 and 3. The distribution of LLCs’ business receipts by asset class can be found in the limited liability company tables at www.irs.gov/uac/SOI-Tax-Stats---Partnership-Data-by-Size-of-Total-Assets. CBO selected a threshold of \$100 million because it was the top of the highest bounded asset class for both S corporations and LLCs, thus allowing calculation of the shares of business receipts accounted for by C corporations both above and below the threshold. Among businesses with receipts below the \$100 million threshold, C corporations held 39 percent of all assets; for businesses with receipts above the threshold, that figure was 92 percent. The differential implies considerably more flexibility to convert to pass-through status for firms with receipts below the threshold than for those with receipts above it.

policy sometimes influence the choice of businesses' organizational form, but their studies do not provide definitive information about the extent of the changes' effects. CBO's analysis offers evidence that certain federal tax changes—especially adjustments made by TRA-86 to individual and corporate income tax rates—have played a role in inducing reorganizations. But neither changes in the structure of the economy nor modifications to federal tax law entirely explain the shift to pass-through organizational forms. Some analysts have pointed to the states' adoption of LLC statutes as a potential explanatory factor, but those legislative changes do not coincide with a period in which the shift was unusually rapid.

Restructuring of the U.S. Economy Toward Providing Services

According to the Department of Commerce's Bureau of Economic Analysis, the share of the private economy that goods-producing industries account for shrank from 35 percent in 1980 to 22 percent in 2007.²²

C corporations are a more dominant form of organization in goods-producing industries than in service-providing industries.²³ Typically, such corporations have accounted for a share of business receipts in goods-producing industries that is 10 percentage points larger than the corresponding share in service-providing industries (as an example for one year, see [Table 2](#)).²⁴ At the same time, S corporations and LLCs have been more common in service-providing industries than in goods-producing industries. Therefore, the prevalence of C corporations has diminished, and the prevalence of S corporations and LLCs has increased, as the economy has shifted toward service-oriented businesses. Nevertheless, the swing in activity toward pass-through entities implied by the economy's restructuring explains less than 10 percent of the change in the organizational form of businesses between 1980 and 2007. Furthermore, that factor provides no insight into why the shift to pass-through entities has occurred in every industry.

Changes in Federal Tax Laws

Because C corporations and pass-through firms receive dissimilar treatment under the tax code, changes in tax laws appear to have contributed to the shift in organizational forms. By lowering the top rate in the individual income tax to a level below the top rate

22. Department of Commerce, Bureau of Economic Analysis, "Value Added by Industry," *Gross-Domestic-Product-by-Industry Accounts, 1947–2009* (December 14, 2010, release). The latest release of data is available at www.bea.gov/iTable/index_industry.cfm.

23. Goods-producing firms are more likely to be organized as C corporations than are service-providing firms largely because of their requirements for capital. Manufacturing firms are, on average, larger than firms in any other industry except utilities. The capital to sustain large firms is difficult to raise privately. Given the need to access capital markets, the average firm in a manufacturing sector is more likely than the average firm in another industry to organize as a publicly traded C corporation.

24. Similar results were obtained for 1998 and 2002.

in the corporate income tax, TRA-86 apparently accelerated the trend toward businesses' organizing as pass-through entities. Since that law's enactment, though, the effect of tax legislation appears to have been a smaller factor in that trend. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) seems to have accelerated the shift by equalizing the top individual and corporate tax rates after a period in which the top individual rate had been higher. Otherwise, the strongest effect from tax laws enacted since 1986 has come from legislation that facilitates the formation of S corporations by increasing the maximum number of shareholders.

The Tax Reform Act of 1986. The biggest increase in the share of receipts received by pass-through entities—more than five times the average increase in other years—occurred in 1987, immediately after enactment of TRA-86 (see [Figure 2](#)).²⁵ TRA-86 reduced the top rate in both the individual and corporate income taxes but by different amounts. It reduced the top individual rate—50 percent before the law's enactment—to 38.5 percent in 1987 and then to 28 percent in 1988. And it lowered the top corporate rate—46 percent before the law was enacted—to 40 percent in 1987 before dropping it to 34 percent in the following year. Thus, the top rate in the individual income tax dropped 1.5 percentage points below the top rate in the corporate income tax in 1987 and 6 percentage points below that top rate in 1988.

The number of S corporations rose by almost 37 percent between 1986 and 1987, the largest annual increase in such entities during the 1980–2007 period. That growth occurred after the enactment of TRA-86 signaled an impending change in the tax rates but before the biggest change in the rates actually took effect. Many C corporations probably converted to S-corporation status in 1987 in anticipation of the larger rate gap in 1988 and beyond. Some firms, however, waited for the rate change to take effect; the shift occurring in 1988 was the second largest during the 1980–2007 period. In fact, four of the remaining five years in which the number of S corporations grew by more than 10 percent were during the span between 1986 and 1990, when the gap between the top rates in the corporate and individual income taxes was the widest (or, in the case of 1986, when the gap could be anticipated).²⁶

Another provision of TRA-86 that might explain some of the shift to pass-through status was the repeal of the *General Utilities* doctrine (named for a 1935 Supreme Court decision and codified in the Internal Revenue Act of 1954). The doctrine stated that

25. For further discussion of the effects of TRA-86, see Roger Gordon and Joel Slemrod, "Are 'Real' Responses to Taxes Simply Income Shifting Between Corporate and Personal Tax Bases?" in Joel Slemrod, ed., *Does Atlas Shrug: The Economic Consequences of Taxing the Rich* (Russell Sage Foundation, 2000), pp. 240–279; and James M. Poterba, "Why Didn't the Tax Reform Act of 1986 Raise Corporate Taxes?" *Tax Policy and the Economy*, vol. 6, no. 1 (January 1992), pp. 43–58, www.nber.org/chapters/c10839.pdf.

26. The only other year since 1980 in which the growth in the number of S corporations exceeded 10 percent was 1983, when lawmakers increased the maximum number of shareholders to 35 and relaxed other qualifications for S-corporation status.

C corporations could, under certain circumstances, distribute appreciated assets (that is, assets worth more than the value the company had reported on its balance sheet) to shareholders without having to realize the excess value as taxable income (although shareholders did have to pay tax on the distributions). The repeal of the doctrine meant that more of the firms that made such distributions had to pay corporate income tax on the appreciated value, thereby subjecting that portion of the assets' value to the same two-level tax levied on other corporate profits. The repeal thus created an incentive to avoid the second layer of tax on distributions of appreciated assets, which, by itself, would have contributed to the trend toward pass-through organizational forms in two ways:

- By encouraging C corporations to convert to S-corporation status, and
- By discouraging new firms from organizing as C corporations.

However, another provision of TRA-86 sought to recover the revenues that would be lost through direct conversions to S-corporation status.²⁷ That provision substantially reduced the incentive for existing C corporations with significant amounts of appreciated assets to convert to a pass-through form.²⁸ Nevertheless, the disincentive for new firms to organize as C corporations has probably advanced the shift to pass-through status gradually, over time.

Changes in Tax Laws After 1986. The effects that tax laws other than TRA-86 had on businesses' organizational form are less clear. The gap of 6 percentage points between the top rate in the corporate income tax and the top rate in the individual tax lasted only three years. In 1991, lawmakers increased the top individual rate to 31 percent, reducing the gap by half. In 1993, they increased it again, to 39.6 percent—4.6 percentage points higher than the top corporate rate (which they simultaneously increased to 35 percent). The top rate in the individual income tax remained higher than the top rate in the corporate income tax through 2002.

None of those changes had any discernible effect on the rate at which pass-through entities displaced C corporations. Indeed, even in 1989 and 1990—the last two years during which the top rate in the corporate income tax exceeded the top rate in the

27. Specifically, a C corporation that converts to an S corporation must determine whether its assets have increased in value between the time they were acquired and the time of the conversion. If so, the corporation must pay a tax of 35 percent on any such gains that are realized (by selling the assets) over the next 10 years. However, the tax in any given year cannot exceed what would have been owed if the firm had remained a C corporation.

28. Researchers have found that among C corporations in natural resources industries, those whose asset values most exceeded their book values were the least likely to convert to S-corporation status following TRA-86's enactment. See Thomas C. Omer, George A. Plesko, and Marjorie K. Shelley, "The Influence of Tax Costs on Organizational Choice in the Natural Resource Industry," *Journal of the American Taxation Association*, vol. 22, no. 1 (2000), pp. 38–56, <http://web.mit.edu/gplesko/OldFiles/www/papers.htm>.

individual tax by 6 percentage points—that displacement rate had nearly reverted to its pre-TRA-86 levels (see [Figure 2](#)).

In enacting EGTRRA in 2001, lawmakers once again reduced the top rate in the individual income tax. Initially, they scheduled it to decline to 35 percent (the same as the top corporate rate) over a six-year period. But then, in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), they implemented the 35 percent rate immediately. The prospect of a reduction in the top rate in the individual income tax and neutrality between the top rates of the individual and corporate income taxes probably stimulated the growth of pass-through entities. In fact, the years with the greatest shift in the share of business receipts toward pass-through firms after 1987 and 1988 were 2001 and 2002—the first two years since 1993 in which the tax code reflected the prospect of such neutrality.

Finally, lawmakers increased the maximum number of S-corporation shareholders twice after 1986. The number rose from 35 to 75 in 1997, through the Small Business Job Protection Act of 1996, and from 75 to 100 in 2005, through the American Jobs Creation Act of 2004. Those two expansions correspond to above-average changes in the share of business receipts going to pass-through entities, presumably because more firms had become eligible for pass-through status. However, the first of those increases occurred just after the bulk of the state LLC statutes were enacted and at roughly the same time as the check-the-box regulations were issued, which makes it difficult to disentangle the effects of the various policy changes.

Research Findings. Whether tax policy affects a business's choice of organizational form has been the topic of several academic studies. One of them found "strong support" for forecasts that profitable firms would shift out of the C-corporation form when the total tax on corporate income (including the tax on dividends at the individual level) most exceeded the tax on the income of pass-through firms, and vice versa. However, that study does not cover TRA-86, whose enactment coincides with the biggest movement to pass-through organizational forms.²⁹ Two other studies that focused on differences among state tax systems found that the relationship between corporate and personal income taxes affects decisionmaking by businesses regarding the type of organizational form they choose.³⁰ However, neither study distinguished between C and S corporations, which makes it difficult to generalize their results to all types of pass-through firms.

29. Jeffrey K. Mackie-Mason and Roger H. Gordon, "How Much Do Taxes Discourage Incorporation?" *Journal of Finance*, vol. 52, no. 2 (1997), pp. 477–505.

30. See Austan Goolsbee, "The Impact of the Corporate Income Tax: Evidence from State Organizational Form Data," *Journal of Public Economics*, vol. 88, no. 11 (2004), pp. 2283–2299; and LeAnn Luna and Matthew N. Murray, "The Effects of State Tax Structure on Business Organizational Form," *National Tax Journal*, vol. 63, no. 1, part 2 (December 2010), pp. 995–1022.

Because none of those studies simultaneously addressed the period during which the key changes occurred and covered all types of pass-through entities, CBO performed a simple statistical analysis of all types of pass-through firms for the period between 1983 and 2007. Unlike the previous studies, CBO's analysis focused on year-to-year changes in the share of business activity that pass-through entities accounted for rather than on the annual levels of activity. As the measure of activity, CBO used business receipts—a concept that was consistent across all types of entities (see [Appendix A](#) for details of the statistical analysis).

Over the 1983–2007 period, the share of business receipts received by pass-through entities increased by an average of about 1 percentage point per year. CBO's statistical analysis suggests that about three-fifths of that shift would have occurred even in the absence of any change in policy that might have affected the share by inducing C corporations to convert to a pass-through form. Among the factors that might explain that phenomenon were the shift in the economy toward providing services rather than producing goods and the longer-term effects of policy changes (such as the repeal of the *General Utilities* doctrine) that provided incentives for new firms to organize as pass-through entities but did not provide incentives for existing C corporations to convert to a different organizational form.

CBO's analysis identified two types of policies that affected year-by-year changes in the share of business activity that pass-through entities account for. Most significant were changes in relative tax rates, which accounted for about one-fifth of the shift. However, that conclusion applies only to changes that resulted in the top rate in the individual income tax dropping to a level equal to or less than the top rate in the corporate income tax (as enacted in TRA-86 and EGTRRA); changes that affected the relationships between the top individual and corporate tax rates in the other direction (such as the 1991 and 1993 legislation) had no discernible effect.³¹ Changes in the rules for S-corporation eligibility also had a small but measurable impact. In contrast, the enactment of state LLC statutes had no statistically detectable effect.³²

By using year-to-year changes, CBO focused on direct conversions of C corporations to pass-through entities. That approach, however, is less well suited to picking up the effects of the other mechanism by which the pass-through share of business activity has

31. To some extent, that asymmetry may reflect an asymmetry in the rules for electing to organize a business as an S corporation. C corporations that convert to S corporations may switch back at will (although they may owe tax on capital gains that had not been realized at the time they reverted), thus minimizing the risk associated with a bad decision. By comparison, S corporations that convert to C corporations may not switch back for five years. If the owners of S corporations had believed that the tax increases of 1990 and 1993 might be temporary, the restriction on switching back within five years would have deterred them from converting to C-corporation status.

32. Collectively, the provisions of TRA-86 that do not involve changes in relative tax rates also had a measurable effect on the shift to pass-through organizational forms, but it is not possible to statistically identify which specific provisions played a role.

increased: the larger percentage of new firms that organize as pass-through entities rather than as C corporations. CBO's approach can identify those effects only when a policy stimulates either the rapid decline and shutdown of existing C corporations or the immediate start-up of new pass-through entities and the faster growth of existing ones. Similarly, the approach that CBO used is not well suited to identifying the effect of the shift toward a services-based economy. That economic trend matches up well with the shift to pass-through entities over time, but year-by-year fluctuations in the two trends do not closely correspond.

Implications for Federal Revenues of the Shift to Pass-Through Entities

The rise in the share of business receipts accruing to pass-through entities has significantly reduced the amount of revenue coming to the federal government. The change in the share of receipts attributable to pass-through firms affects revenues from the corporate and individual income taxes and from payroll taxes for Social Security and Medicare. Specifically, the decline in the share of business receipts that C corporations account for has reduced the corporate income tax base and, consequently, corporate tax revenues. Conversely, because all taxable income of S corporations and LLCs flows through to the owners of those businesses and is taxed under the individual income tax, the shift in business receipts has increased individual income tax revenues.³³ The different treatment of LLC members under the payroll tax has also affected revenues.

Using data for 2007, CBO estimates that if the C-corporation tax rules had applied to S corporations and LLCs in that year and if there had been no behavioral responses to that difference in tax treatment, total federal revenues would have been about \$76 billion higher. That estimate is based on several assumptions:

- Half of all profits for those firms are distributed annually; the rest are retained, with shareholders realizing capital gains equal to the retained earnings after an average of eight years.
- Corporate taxpayers deduct approximately one-sixth of their losses immediately but either use the rest to offset profits in future years or let it go unused.
- LLC members are compensated in the same way as are owners of similarly sized S corporations in the same industry.
- LLC members that are nonprofit organizations (and therefore tax-exempt) retain their ownership interests when the LLC is taxed as a C corporation, even though that means they bear some of the corporate tax burden.

33. CBO limited its analysis to S corporations and LLCs because their growth closely tracks the decline of C corporations. The analysis excluded limited partnerships because their growth seems to have come at the expense of general partnerships rather than C corporations.

The most obvious source of the estimated higher revenues is the double taxation of the S corporations' and LLCs' profits: The profits would be subject first to the corporate income tax and then to the individual income tax, when the remaining profits were distributed to shareholders or realized as capital gains. Also affecting overall revenues would be the different tax rates applied directly to businesses' profits under the corporate and individual income taxes together with the differences in the amount of income subject to Social Security and Medicare payroll taxes. In addition to constructing this specific estimate, CBO considered the possible effects on the estimate of various ways that the businesses' owners might have responded to the difference in tax treatment (see [Appendix B](#) for details of CBO's analysis).

The Corporate Income Tax

The profits of S corporations and LLCs are not subject to entity-level taxes. In contrast, the profits of C corporations (including the interest and other passive investment income they receive) are subject to the corporate income tax. Applying rates from the corporate income tax to the profits of S corporations and LLCs would have yielded revenues of approximately \$219 billion in 2007, CBO estimates (see [Table 3](#)). However, applying those rates to the losses of unprofitable S corporations and LLCs would have reduced that amount by the equivalent of \$32 billion. The net effect would have been an increase in corporate income tax revenues of \$187 billion.

The Individual Income Tax

The profits of S corporations and LLCs are passed through to their owners and—if the owners are individuals—are subject to the individual income tax at ordinary rates. Furthermore, any dividends and long-term capital gains earned by an S corporation or partnership are passed through to owners separately from the business's profits and, in 2007, were taxed at a lower statutory rate.³⁴ CBO estimates that profitable S corporations and LLCs in that year generated approximately \$188 billion of revenue through the individual income tax (see [Table 4](#)).

If, instead, the profits of S corporations and LLCs had first been taxed at the level of the firm, the way the profits of C corporations are, the amount subject to the individual income tax would have been different. Specifically, it would have been lower by the amount of the firms' corporate income tax liability and would not have included the portion distributed to or realized by tax-exempt owners (such as nonprofit organizations). Furthermore, the entire amount would have been taxable at the lower rate on dividends and capital gains (and the tax on capital gains would have been deferred). In CBO's estimation, those dividends and capital gains would have generated the equivalent of approximately \$60 billion in revenues in 2007—\$128 billion less than

34. Interest, royalties, and short-term capital gains were also passed through to owners separately from businesses' profits but were taxed at the same rate as those profits. Net rental income was passed through to owners as part of businesses' profits.

was generated by the direct taxation of the businesses' net income under the individual income tax.

CBO estimates that businesses' losses that were passed through to owners reduced their overall liability under the individual income tax by approximately \$19 billion in 2007 (see [Table 4](#)). Had the losses of S corporations and LLCs been included in the corporate tax base, however, they would have reduced owners' individual income tax liability by only \$5 billion—\$14 billion less than under current law because they could not have been used to offset nonbusiness income. The net effect after combining the estimates for profitable and unprofitable firms would have been a decrease in individual income taxes of \$114 billion.

Payroll Taxes

Owners of S corporations—like the owners of C corporations—pay Social Security and Medicare taxes on the compensation they receive in exchange for providing services. Thus, even if S corporations had been subject to the corporate income tax, their owners would have seen no change in their Social Security and Medicare payroll taxes because they were already taxed for those purposes in the same way as the owners of C corporations.

Payroll taxes would have changed, though, for members of LLCs. CBO in its analysis assumed that members of LLCs paid tax under SECA on their guaranteed payments and their share of businesses' net income.³⁵ But as owners of C corporations, they would have been paid "reasonable compensation," which like any other wages would have been subject to FICA taxes. In the case of profitable LLCs, the reasonable compensation of their members would usually have been less than the amount on which they would have been taxed under SECA (because that compensation would exclude income from capital), thereby reducing their tax liability. For members of unprofitable LLCs, however, paying FICA tax on reasonable compensation would have increased their tax liability: Owners could no longer have used losses they incurred as members of an LLC to offset taxable income generated by their other businesses. In fact, CBO estimates, the increase in tax liability from unprofitable LLCs (\$6 billion) would have exceeded the decrease from profitable LLCs (\$3 billion; see [Table 5](#)). The net result of switching from SECA to FICA tax treatment for LLCs would have been an overall tax increase for members of \$3 billion.

35. The appropriate amount of income subject to the SECA tax for LLC members was legally ambiguous in 2007. In CBO's September 2012 study *The Taxation of Labor and Capital Through the Self-Employment Tax*, the agency found that LLC members more often behaved like general partners (who pay SECA taxes on both their guaranteed payments and their share of net business income) than like limited partners (who pay SECA taxes only on their guaranteed payments). Therefore, CBO treated LLC members in this analysis as if they were general partners.

Summary of Effects on Revenues

If S corporations and LLCs had been taxed as C corporations in 2007, the combined effects from all taxation (corporate and individual income taxes and payroll taxes) would have yielded an estimated gain of \$76 billion in federal revenues (see [Table 6](#)). That estimate, however, is strictly a mechanical application of an alternate hypothetical tax law without any consideration of how owners might respond to it or how it might interact with other tax provisions, such as the alternative minimum tax, nonrefundable tax credits, and so forth.

CBO can hypothesize certain responses to the alternate tax policy and thus estimate the associated effects on revenues (see [Appendix B](#)). For example, because imposition of the corporate income tax makes it more difficult for a firm to reduce the tax liability of its owners by understating reasonable compensation, owners of S corporations would probably have complied much more closely with the reasonable compensation standard than they currently do. That compliance would have increased owners' taxes under FICA but reduced the corporate income taxes that owners paid (because deductions for the compensation of officers would have increased). The net result would have been an additional loss of revenues of less than \$1 billion.

Also, if firms had been taxed as C corporations, they could have distributed more or less than 50 percent of their profits as dividends. Retaining more profits would have effectively reduced the current income tax liability of the firms' owners by deferring more tax to some point in the future, when those profits would finally be paid out or realized as capital gains when shares of stock were sold. In contrast, distributing more profits would have lessened that deferral and increased the owners' current tax liability. Under those extreme assumptions about the distribution of profits, the federal government's loss of revenues would have been between \$61 billion (no profits distributed) and \$91 billion (all profits distributed).

Tax-exempt owners would probably have responded to the imposition of the corporate tax by selling at least some of their holdings to taxable entities. That strategy would have subjected more dividends and capital gains to the individual income tax and boosted revenues.

Other responses to the alternate tax policy are possible as well, but CBO did not examine them.

Potential Policy Approaches for the Future

Going forward, lawmakers could proceed in a number of directions. One possibility would be to do nothing and allow the pass-through trend to run its course. As discussed earlier, the share of business activity that can take place in pass-through companies is limited. Approximately half of all business receipts are earned by publicly traded firms, which must be C corporations under most circumstances. Hence, it is

unlikely that under current law, pass-through entities will ever account for more than half of all business receipts (they accounted for roughly one-third in 2007).

Alternatively, lawmakers might choose to change the way businesses' income is taxed. CBO considered three general approaches to pass-through taxation and multiple ways of implementing each approach. The first approach would reverse the current trend by limiting pass-through taxation and making the profits of more firms subject to the corporate income tax. That would boost revenues to some extent but could also reduce the incentive of firms' owners to invest and to allocate resources efficiently. A second approach—integrating the corporate and individual income taxes—would have the opposite consequences: That is, it would reduce federal revenues, increase incentives to invest, and lessen inefficiency. A third approach would unify the levies on businesses in a new entity-level tax that would mitigate some of the distortions to businesses' incentives—particularly the incentive to finance investment with debt—that the current tax system introduces. That approach could either raise or lower revenues, depending on the details of a policy.

Evaluating the Alternatives

CBO used three criteria in addition to the effects on revenues to evaluate the three approaches to pass-through taxation and various ways of implementing them. Specifically, it considered:

- How an approach to pass-through taxation would affect the average effective tax rate (ETR) on the income from businesses' investments;³⁶
- How such an approach would affect businesses' financial decisions; and
- How an approach to pass-through taxation would treat businesses in the same industry that are similar in size but that are organized differently.

Effective Tax Rates on Income from Businesses' Investments. By lowering the ETR on the income from investments that businesses undertake, certain policies encourage businesses to invest more, which is likely to increase economic output.³⁷ The profits of pass-through entities are not subject to the second level of taxation that is imposed on the profits of C corporations. Furthermore, the graduated rate structure of the individual income tax lowers the average marginal tax rate that passed-through profits face

36. Effective tax rates as defined in this report differ from marginal tax rates in that they measure the difference in before- and after-tax rates of return over the life of an investment. They are distinct from tax-rate measures (occasionally called "effective tax rates" in other publications, including some from CBO) that are calculated for a single year and reflect only the income received and taxes paid during that year.

37. Government spending in such areas as ensuring the safety of the public and improving infrastructure can also increase economic growth, and that kind of spending ultimately requires tax revenues to fund it. For the purposes of this study, however, CBO considered only the direct effects of taxation.

compared with the 35 percent rate that applies to most of a C corporation's profits. For those reasons, the overall ETR on income from investments by pass-through entities is lower than that on income from investments by C corporations. Policies favoring the formation of pass-through entities instead of C corporations could thus increase investment.

Effect on Businesses' Financial Decisions. Two-level taxation of the income earned by C corporations distorts two significant decisions that owners of businesses make about their organization's finances: whether to distribute profits or retain them for reinvestment and whether to fund investment with equity (for example, by selling stock) or with debt. Those distortions can lead to investment decisions that reduce economic output—in other words, that are inefficient.

Ideally, the owners of a C corporation would collectively make decisions on the basis of which alternative would provide them with the highest rate of return. The tax system encourages firms to retain their profits because distributing them immediately subjects those gains to the individual income tax. Retaining the profits, in contrast, does not generate taxable income until the stock is sold and a capital gain is realized—a delay that reduces the ETR on corporate earnings.³⁸ Furthermore, if the lower tax rate on dividends that was extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 is allowed to expire as scheduled, dividends will once again be taxed at a higher statutory rate than is levied on capital gains, which will increase firms' incentive to retain profits. Pass-through entities do not face that retention-or-distribution dilemma. Their profits are taxed at regular rates, whether or not they are distributed. That frees the company's owners to make decisions on the basis of what is best for the company and themselves, with minimal regard for the tax consequences.

The decision of whether to finance new investment with debt or with equity also differs for pass-through entities and C corporations. Neutrality—meaning the absence of any tax advantages for either debt or equity financing—would allow a business owner's taste for risk to determine the choice of financing; debt financing would increase both the risk and the reward relative to equity financing.³⁹ Under current law, the tax system favors debt because interest payments are tax-deductible whereas dividends are not, a circumstance that could lead to riskier behavior than would otherwise be optimal. The

38. Capital gains that accrue during an owner's lifetime on stock that is then left to the owner's heirs are not taxed at all under the individual income tax (although the estate tax may capture some of those gains). That feature of the tax code further reduces the ETR on corporate earnings.

39. Consider a \$10,000 investment that might yield either a 10 percent rate of return or no return at all. If the investment was financed with equity, after one year the owners would end up with either \$11,000 or \$10,000. If they borrowed an additional \$10,000 at an interest rate of 5 percent, they would, over the same period, end up with either \$11,500 (\$22,000 minus the \$10,000 principal minus \$500 paid in interest) or \$9,500 (\$20,000 minus the \$10,000 principal minus \$500 in interest). Thus, in this example, debt financing offers the potential reward of an additional \$500 but at the risk of losing \$500.

tax bias in favor of debt, however, is less pronounced among pass-through entities. CBO found that among C corporations in 2012, the ETR on equity-financed investment was 34 percent, and the corresponding rate on debt-financed investment was -9 percent—a difference of 43 percentage points.⁴⁰ (The negative ETR on debt-financed investment reflects the combination of the full deductibility of interest expenses at the corporate rate of 35 percent and three other factors: the sheltering in retirement accounts of 30 percent of the interest income received by individuals from C corporations; the average individual income tax rate of 27 percent, at which the remaining 70 percent is taxed; and rules allowing accelerated depreciation.) For pass-through firms, the ETRs on equity- and debt-financed investment were 28 percent and 5 percent, respectively—a difference of 22 percentage points.

The smaller bias in favor of debt financing for pass-through entities relative to that for C corporations has multiple causes. The ETR on income from equity-financed investment is lower for pass-through entities because that income is taxed only at the individual level and the average marginal rate at the individual level is lower than the average corporate tax rate. Moreover, the ETR on income from debt-financed investment is higher for pass-through entities largely because of two factors:

- The lower marginal tax rates of the individual income tax reduce the value of interest deductions for pass-through entities compared with their value for C corporations; and
- More of the interest payments from debt issued by pass-through entities is taxable because recipients of those payments (banks, frequently, rather than bondholders) maintain a smaller portion of the entities' debt in tax-favored retirement accounts.

Of course, businesses do not necessarily first choose the organizational form their firms will take and then choose the methods they will use to finance investments. It could be that firms that prefer to use debt financing choose to be C corporations and benefit from the negative effective tax rates, whereas those that prefer to use private equity financing choose to organize as S corporations or LLCs.

Similar Treatment of Similar Businesses. Some observers have questioned whether it is appropriate that two firms of the same size in the same industry should be taxed differently just because one is a corporation and the other is not. It is unclear, however, whether the characteristics of size and industry on their own are enough to establish that two businesses are sufficiently similar that they should be taxed identically. A large corporation, for example, has access to capital markets that a similarly sized partnership or LLC does not have. A portion of the higher taxation of corporations (albeit a small one) could be viewed as offsetting the cost of regulating those capital

40. Those rates were calculated for CBO's analysis of the President's fiscal year 2013 budget (see *The Economic Impact of the President's 2013 Budget*, published in April 2012) but were not discussed explicitly in that report.

markets. The different tax systems also reflect a degree of choice on the part of businesses and their owners. For example, many small corporations qualify for S-corporation status but remain C corporations. To the extent that such choices reflect the best interests of the businesses' owners rather than inertia, unifying the individual and corporate income tax systems would appear to make those owners worse off.⁴¹

Limiting the Use of Pass-Through Taxation

To limit the use of pass-through taxation, lawmakers could change the tax treatment of firms that were larger than a certain size or that had some other shared characteristic, such as the presence of limited liability. Some observers have proposed that all publicly traded firms be subject to the corporate income tax, but such a policy would affect few firms not already subject to the corporate tax.

Treat Large Pass-Through Entities as C Corporations. Taxing large pass-through entities in the same way that C corporations are taxed would have certain advantages and disadvantages.⁴² Whether the threshold for such an approach was defined in terms of receipts, assets, or number of owners, the practice would generate additional revenue and restore tax neutrality among large firms that were similar in size and engaged in similar activities. Without the tax benefits of pass-through status, large partnerships and LLCs might decide to incorporate, giving those firms better access to capital markets. However, this variation of the approach would increase the ETR on income from capital, which would probably reduce investment. In addition, taxing large pass-through entities as C corporations would strengthen the tax system's biases against distributing profits and using equity financing.

In addition to considerations related to revenues and efficiency, a size threshold that was applied on an annual basis would raise some administrative concerns. Firms whose size was close to the annual threshold would face uncertainty about which tax regime applied to them in any given year: In one year, they could fall on one side of the limit and be taxed as a pass-through entity, whereas a spurt of growth the next year could subject them to the corporate income tax. Furthermore, this variation of the approach would probably induce firms to artificially (and inefficiently) manipulate their size to avoid the corporate tax treatment. Designing a threshold that provided stability in a firm's taxes from year to year, however, would introduce additional complexity to the tax code.

41. Victor Fleischer summarizes the rationale for new firms to organize as C corporations despite the tax disadvantage; see *The Rational Exuberance of Structuring Venture Capital Startups*, Law and Economics Research Paper 03-20 (University of California at Los Angeles, School of Law, August 7, 2003), <http://ssrn.com/abstract=432840>.

42. *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, issued by the President's Economic Recovery Advisory Board in August 2010, discusses taxing large pass-through entities as C corporations on pages 74 through 76. For the full report, see www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report_for_final_vote.pdf.

Eliminate the Subchapter S Option and Tax LLCs as Corporations. Limiting pass-through taxation by abolishing corporations' ability to be taxed under subchapter S and taxing LLCs as C corporations would have many of the same qualitative effects as taxing large pass-through entities as C corporations. That is, federal revenues would increase, investment would probably decline, and the biases inherent in the tax code against distributing profits and using equity financing for investment would be exacerbated. The "similar treatment of similar businesses" argument, however, would be slightly different under this variation. Instead of focusing on taxing firms of the same size and in the same industry in the same fashion, this variation concentrates on ensuring that all firms with limited liability would be taxed in the same way.

The administrative challenges of this variation of the approach would be significantly less than those associated with a policy requiring enforcement of a size threshold. Furthermore, firms would have much greater confidence about how they would be taxed in any given year. In addition, if they wanted to avoid the corporate income tax by reorganizing as partnerships or sole proprietorships, at least one owner would have to actually give up limited liability. This variation, however, would force even the smallest firms to pay the corporate income tax if they wanted limited liability—a requirement that could deter the formation of new businesses.

Integrating the Corporate and Individual Income Taxes

Efforts to address the inefficiencies of the corporate income tax—particularly the bias it creates against distributing profits—often involve integrating the individual and corporate income taxes, an approach sometimes known simply as "corporate integration." The Treasury Department conducted a comprehensive study of corporate integration in 1992, evaluating the alternatives discussed here: establishing universal pass-through treatment of businesses' profits and applying partial-integration methods (exempting dividends from the individual income tax, granting a credit at the individual level for corporate taxes paid, and allowing a deduction at the corporate level for dividends paid).⁴³

Establish Universal Pass-Through Treatment. Eliminating the corporate income tax altogether and passing all profits through to owners would, in theory, maximize the gains in efficiency that are associated with the pass-through structure (albeit at the cost of significant revenues, given the tax rates in effect in 2012). A study in 1981 considered how such universal pass-through treatment (or "full integration") would affect the well-being of consumers, which in that report reflected the amount of goods and services they consumed and the value of their leisure (that is, time spent away from work). Researchers found that full integration would increase consumers' well-being by the equivalent of between 0.7 percent and 1.3 percent of their consumption.⁴⁴ Estimates from the Treasury's 1992 study suggested that full integration (accompanied

43. Department of the Treasury, *Taxing Business Income Once* (January 1, 1992), www.treasury.gov/resource-center/tax-policy/Pages/integration-paper.aspx. Part V contains the efficiency analysis.

by a revenue-neutral increase in the individual income tax rate) would boost consumption by between 0.08 percent and 0.72 percent (results varied on the basis of the model that was used). Estimates made today, however, would probably be lower because some of those gains have already been realized by the shift in business activity to pass-through entities that has occurred since those earlier studies were conducted.

Simply treating C corporations as if they were S corporations or partnerships presents some formidable challenges. Among the issues to be resolved would be how to treat foreign and tax-exempt shareholders who are not subject to the individual income tax, how to allocate profits and losses among shareholders when there are multiple classes of stock, and whether to apply to passed-through corporate losses the rules limiting the use of losses from passive activities to offset unrelated income.

Apply Partial-Integration Methods. The Treasury's 1992 study also evaluated a variety of alternatives that would approximate full integration but avoid some of its pitfalls.⁴⁵ The option that the study ultimately recommended would exclude dividends from the individual income tax. That option, proposed by President Bush in 2003, would have permitted shareholders to exclude all corporate dividends from the individual tax provided that the corporation paying the dividends had paid corporate income tax on its earnings. The proposal would not favor foreign or nonprofit shareholders, nor would it require any special rules to deal with multiple classes of stock or the use of passed-through losses. It would, however, require some extra administrative effort on the part of firms to identify the dividends that qualified for such treatment. (Lawmakers instead enacted a provision as part of JGTRRA that reduced the maximum income tax rate on qualifying dividends to 15 percent. That lower rate is scheduled to expire after 2012.)

Among the other alternatives that the Treasury's study presented, one option would have granted a credit at the individual level for taxes paid at the corporate level, and another would have provided a corporate-level deduction for dividends that firms paid.⁴⁶ Numerous countries, including the United Kingdom, Canada, and Mexico, have implemented versions of the first option, but the Treasury deemed it too complex. The second option, though much less complicated, has been criticized on the basis

44. Don Fullerton and others, "Corporate Tax Integration in the United States: A General Equilibrium Approach," *American Economic Review*, vol. 71 (September 1981), pp. 677–691. The results were rendered in 1973 dollars—\$6.2 billion and \$11.1 billion, respectively.

45. See part II of Department of the Treasury, *Taxing Business Income Once* (January 1, 1992), www.treasury.gov/resource-center/tax-policy/Pages/integration-paper.aspx.

46. Those options are also discussed in two 2010 publications. The President's Economic Recovery Advisory Board, in *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation* (August 2010), pp. 76 and 77, www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report_for_final_vote.pdf, discusses the option for a credit on the individual income tax. The dividend deduction option is discussed in Reuven Avi-Yonah and Amir Chenchinski, *The Case for Dividend Deduction*, University of Michigan Public Law Working Paper No. 220 (September 22, 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1680219.

of its cost, largely because it treats tax-exempt and foreign shareholders at least as favorably as it treats taxable domestic shareholders.

Unifying Taxes on Businesses in a New Entity-Level Tax

Moving to corporate integration would reduce but not eliminate the tax code's bias in favor of debt financing—a bias also associated with the current pass-through treatment. The two alternatives presented below would tax all businesses in the same manner and eliminate the biases against equity financing and distributing profits.

Enact a Comprehensive Business Income Tax. The Treasury's 1992 report describes what it calls a comprehensive business income tax (CBIT), which would subject all but the smallest firms to an entity-level tax and not allow deductions for interest or dividends paid. Furthermore, such an option would exclude interest, dividends, and capital gains from taxable income under the individual income tax. That structure would eliminate the tax bias in favor of debt financing over equity financing and the bias in favor of retaining earnings rather than paying dividends. If lawmakers used the current corporate tax rate for the entity-level tax, this variation of the approach would increase revenues. However, the version evaluated in the Treasury's report used a revenue-neutral tax rate. Because that rate was lower than the corporate income tax rate, the proposal would probably have reduced the ETR on income from capital and boosted investment. Thus, a carefully designed CBIT might present an opportunity to simultaneously eliminate the bias in favor of debt financing, raise investment, and increase revenues.

Like other alternatives that feature integration, the CBIT would add complexity to the tax code. For example, it would require a mechanism to track businesses' payments of interest and dividends to ensure that income that was not taxed (because of exclusions or credits) at the time the CBIT was introduced did not escape taxation altogether. Also, the CBIT would have to be phased in over a relatively long period to avoid penalizing firms with large amounts of debt for decisions made under the current tax regime. During the phase-in period, gains in economic efficiency would be limited because firms would probably retain debt-financed assets longer than they ordinarily might to take full advantage of the phase-in provisions. Revenues during the phase-in period would also be significantly reduced.

Establish a Business Enterprise Income Tax. The Business Enterprise Income Tax (BEIT) is a different approach to a comprehensive business income tax.⁴⁷ The BEIT retains partial pass-through treatment for all businesses, including corporations. That is, each firm could deduct from its taxable income a cost-of-capital allowance, equal to a percent-

47. Edward D. Kleinbard, "The Business Enterprise Income Tax: A Prospectus," *Tax Notes*, vol. 106, no. 97 (January 3, 2005), pp. 97–107, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=642742. For a critique thereof, see Alvin C. Warren, "The Business Enterprise Income Tax: A First Appraisal," *Tax Notes*, vol. 118, no. 9 (February 25, 2008), pp. 921–939.

age of its assets, that was deemed to represent a “normal” rate of return on its financial and tangible capital. Shareholders and bondholders alike would then include their proportionate share of that allowance in their taxable income at the individual level, regardless of the size of any actual interest or dividend payments. The remaining profits of each firm would then be subject to an entity-level tax, which would effectively apply to the profits the business received that exceeded the designated normal rate of return.

Like the CBIT, the BEIT would eliminate the tax biases in favor of debt financing over equity financing and in favor of retaining earnings over distributing dividends. It could also be designed to simultaneously reduce the overall ETR on income from capital and increase federal revenues. However, a BEIT would add more complexity to the tax system than would the CBIT described in the Treasury’s report because it would require a firm to compute a so-called normal rate of return to pass through to its individual owners and to deduct from its taxable profits. Because the BEIT approach would retain a deduction that would cover at least a portion of a firm’s interest payments on debt, the transition from the current system to the BEIT would be less difficult than the transition to a CBIT. A BEIT’s effects on revenues would depend on the rate selected for the entity-level tax, but it would probably raise more in revenues than a revenue-neutral CBIT with the same rate because more income would be subject to the higher individual income tax rates.

Appendix A: Estimating the Effects of Changes in Policy on the Share of Business Receipts Attributable to Pass-Through Entities

Over the past few decades, businesses whose profits are “passed through” to their owners—meaning that they are taxed through the individual income tax rather than through the corporate tax—have claimed an increasing share of total business receipts (gross revenues from the sale of goods and services) generated in the United States. The Congressional Budget Office (CBO) performed a statistical analysis to estimate how much of the increase in that share of receipts could be attributed to specific changes in federal policies. The analysis used the Internal Revenue Service’s Integrated Business Dataset for the years between 1982 and 2007.⁴⁸ During that period, the share of business receipts accounted for by pass-through entities increased by 24.4 percentage points—from 13.5 percent to 37.9 percent (see [Table A-1](#)).

48. CBO omitted data for 1980 through 1982, although that information was part of the dataset, because the determinants of pass-through activity appear to be completely different before and after enactment of the Subchapter S Revision Act of 1982. Those three years are not a sufficiently large sample to identify what was going on before that major change in tax law.

CBO investigated the impact of changes in two types of federal policies (the relationship between the corporate and individual income tax rates, and the maximum number of shareholders in corporations taxed under subchapter S of the Internal Revenue Code—firms known as S corporations) and one type of change in policy at the state level (allowing the formation of limited liability companies, or LLCs).⁴⁹ The analysis used the method of ordinary least squares to estimate the parameters of the different versions of the regression equation.

Changes in Relative Tax Rates

Previous research has shown that the difference between corporate income tax rates and individual income tax rates affects decisions about the organizational form a business takes and thus whether it ends up being taxed according to subchapter C of the Internal Revenue Code (such firms are known as C corporations) or on a pass-through basis. Those studies used differences between individual and corporate income tax rates to estimate relative levels of business activity by form of organization (for example, the 20.9 percent share of business receipts going to pass-through entities in 1987). CBO's study, in contrast, seeks to explain annual changes in relative activity levels (for example, the 4.8 percentage-point increase in that share between 1986 and 1987). The focus on annual changes captures short-term responses to changes in policy, responses that mostly take the form of C corporations' converting directly to a pass-through status. However, the use of annual changes does not capture the net shift that occurs over longer periods, as larger shares of start-up companies organize as pass-through entities because of conditions created by legislation enacted many years earlier.

CBO specified the variable for a change in relative tax rates as follows:

$$\text{Change in relative tax rates } (Tchg_t) = (TC_t - TP_t) - (TC_{t-1} - TP_{t-1}),$$

where TC is the tax rate a firm would face as a C corporation, TP is the tax rate a firm would face as a pass-through entity, the t subscript represents the period after the change in law, and the $t-1$ subscript represents the previous period. Because the actual values of TC and TP are not known to firms when the decision concerning organizational form is made, CBO used the top marginal rates in the corporate and individual income taxes as proxies.⁵⁰ When the gap between TC and TP expands from one period to the next (or switches from negative to positive), then $Tchg$ is positive, and higher values for the share of business receipts accounted for by pass-through entities ($PTshrchg$) are to be expected.

49. **Table 1** of the text summarizes the key characteristics of S corporations and LLCs.

50. The use of proxies follows the practice established in Jeffrey K. Mackie-Mason and Roger H. Gordon, "How Much Do Taxes Discourage Incorporation?" *Journal of Finance*, vol. 52, no. 2 (1997), pp. 487–488.

The interpretation of $Tchg$ and its components is not straightforward. CBO investigated three issues that owners of businesses face when they choose between different forms of organization:

- Do business owners consider the tax on dividends levied through the individual income tax as part of the tax on the profits of C corporations (TC) when they evaluate how a change in relative tax rates will affect them?
- In considering tax rates, do owners evaluate the effects of tax rates that are phased in fully (which might not occur for several years) or the rates that are in effect in the year their decision is being made?
- Do owners give the same weight to negative values of $Tchg$ that they give to positive values?

On the first question, the evidence is mixed. In previous research, analysts have assumed that the tax on dividends is a factor. However, the biggest values of $PTshrchg$ are associated with the Tax Reform Act of 1986 (TRA-86), and only if the tax on dividends is excluded from TC are the highest values of $Tchg$ associated with that legislation. One of the implications of including the tax on dividends is that a drop in TP (as occurred with TRA-86) also reduces TC , thus substantially lowering $Tchg$ compared with its value when TC is independent of TP . Nevertheless, the scope of TRA-86 was so broad that other aspects of the law could, in theory, explain the change in $PTshrchg$ in 1987 that was not explained by $Tchg$ (although identifying the relevant provisions would be difficult).⁵¹ CBO therefore included a dummy variable for TRA-86 to pick up the effect of those unidentified provisions and isolate them from $Tchg$. With that variable in place, excluding the tax on dividends from TC results in a greater share of $PTshrchg$ being attributed to $Tchg$ and a smaller share being attributed to the other provisions of TRA-86 than is the case when the dividend tax is included in TC .

The results are less ambiguous regarding whether owners of businesses are influenced by current-year or fully phased-in tax rates, but those findings are still not clear-cut. If fully phased-in rates are used, $Tchg$ must be accompanied in the regression equation by a one-year lag on $Tchg$ —that is, $Tchg(-1)$ —in order for its coefficient (and that of its lagged value) to be significantly greater than zero (whether or not the dividend tax is included in TC).⁵² If current-year rates are used, the coefficient on $Tchg$ is statistically significant under the following conditions: when the dividend tax is included in TC

51. The repeal of the *General Utilities* doctrine (discussed in the section titled “Changes in Federal Tax Laws”), which has been mentioned by some observers as an explanatory factor, is actually a poor candidate for that role. In the short term, the repeal would deter the conversion of C corporations to S corporations. Only over the longer term would its encouragement of new S corporations become apparent.

52. CBO also tested a two-year lag, but its coefficient was not statistically significant in any version of the equation, and CBO subsequently excluded it.

and a lagged value of $Tchg$ is included in the equation (although the coefficient on the lagged value is not significant) or when the dividend tax is excluded from TC and no lagged value of $Tchg$ is included in the equation. Because only the second set of conditions produces results in which all of the coefficients are significant, CBO discarded the version of the equation that represented the first set of conditions.

Answering the question about the symmetry of responses to increases and decreases in $Tchg$ is easier. CBO split $Tchg$ into its positive ($PosTchg$) and negative ($NegTchg$) components and used both as explanatory variables. In all cases, the coefficients on $NegTchg$ were smaller than those on $PosTchg$ to a statistically significant degree but were not statistically distinguishable from zero. Therefore, CBO subsequently dropped that variable from all versions of the regression equation. The results support a conclusion that owners of businesses are responsive to positive values of $Tchg$ but not to negative values.

The effects of other provisions of TRA-86 were not measured by $PosTchg$ because CBO included a dummy variable to capture those effects. The same is not true, however, of the effects of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) that are not related to changes in tax rates. Thus, the coefficient on $PosTchg$ should be interpreted with caution because it might reflect some of those other provisions of EGTRRA.

Changes in the Maximum Number of S-Corporation Shareholders

CBO defined the S-corporation variable as follows:

$$\text{Change in the maximum number of S-corporation shareholders } (Smaxchg_t) = (Scorpm_{t,1} / Scorpm_{t,1}) - 1,$$

where $Scorpm$ is the maximum number of S-corporation shareholders. The coefficients on that variable (and its one-year lag) were statistically significant in all versions of the regression equation except the version that used current-year tax rates in $Tchg$. Omitting the lagged value of $Scorpm$ from the equation rendered the coefficient on the unlagged value insignificant, implying that the effects of $Scorpm$ emerged gradually, over a two-year period.

Like $PosTchg$, however, coefficients on $Smaxchg$ should be interpreted with caution because they might be picking up effects from other changes enacted at the same time—particularly the enactment by states of statutes governing limited liability companies and the federal statute allowing nonprofit organizations to become shareholders in S corporations.

Limited Liability Statutes Enacted by the States

CBO created a variable to represent the gradual adoption of state LLC laws between 1993 and 1995. The coefficient on that variable was insignificant in all versions of the

regression equation, so CBO dropped the variable. The lack of significance even in the face of rapid LLC growth suggests that although the LLC option did not cause a change in *PTshrchg*, it probably encouraged some pass-through entities to take on the LLC organizational form rather than organize as limited partnerships or S corporations.

Summary of Results

Three different versions of the regression equation emerged from the tests that CBO performed (see [Table A-2](#)). CBO used the coefficients of each equation to retroactively account for the cumulative change in *PTshrchg* resulting from each policy variable. In each case, more than half of the cumulative change in *PTshrchg* (and in one case almost 75 percent) was not accounted for by shifts in policy. That result would be expected if most of the growth in pass-through activity has come from start-up companies' organizing as pass-through firms rather than from C corporations' converting to pass-through status. Nevertheless, two types of policy changes apparently stimulated such conversions. Specifically, each version of the regression equation found some effect from *PosTchg*, with that effect varying from 14 percent to 25 percent. Furthermore, in two of the three versions, the effect of changes in the maximum number of S-corporation shareholders accounted for 10 percent of the cumulative change in *PTshrchg*; in the third version, it did not account for any portion of the change.

Appendix B: Estimating the Implications for Federal Revenues of Pass-Through Status for S Corporations and Limited Liability Companies

The trend of a growing share of businesses being organized as “pass-through entities” (in which profits are passed through to owners and taxed at individual income tax rates) rather than as corporations subject to the corporate income tax (C corporations) has led to lower federal revenues than if that shift had not occurred. As part of its analysis of that trend, the Congressional Budget Office (CBO), using data from the Internal Revenue Service for 2007, estimated the implications for revenues (\$76.3 billion, with no consideration of behavioral responses) of taxing two types of pass-through entities—S corporations and limited liability companies (LLCs)—under the corporate

income tax in that year.⁵³ For that work, CBO had to make several assumptions concerning average corporate and individual income tax rates, the timing of businesses' use of corporate losses, and the timing of the realization of capital gains.

The Corporate Income Tax

To estimate the potential corporate income tax revenues that might be realized by taxing LLCs and S corporations as C corporations, the taxable income of those types of pass-through entities must be multiplied by the average corporate tax rates each would face. However, because the situation is hypothetical, data on the distribution of S corporations and LLCs by corporate income tax bracket do not exist. To estimate the applicable tax rates, CBO relied on published data for C corporations, S corporations, and LLCs that are classified by the amount of assets held by each firm.⁵⁴ First, CBO used the taxable income and tax liability of C corporations to calculate average tax rates for each class of assets. It then applied those rates to the taxable income of S corporations and LLCs in the corresponding asset classes to estimate potential corporate tax liability for each class. Finally, CBO calculated average corporate tax rates for S corporations and LLCs for each type of entity by dividing the sum of potential corporate tax liability over all classes of assets by total taxable income.

Because firms with the most assets typically have the most taxable income, the lower asset classes had lower average tax rates and the higher asset classes had higher rates. In CBO's estimation, the average corporate tax rate for profitable S corporations would have been 29 percent. The average corporate tax rate for profitable LLCs, which tend to be larger than S corporations, would have been 33 percent.

For unprofitable firms, CBO considered two other factors: the timing of when firms use losses to offset some of their profits and the rate at which deferring a loss reduces its present value.⁵⁵ Under the corporate income tax, losses must either be carried back to

53. **Table 1** summarizes the key characteristics of S corporations and LLCs.

54. Tax rates by asset class and the distribution of S corporations' net income by asset class were taken from Table 2 in Internal Revenue Service, *2007 Corporation Source Book of Statistics of Income*, [www.irs.gov/uac/SOI-Tax-Stats---Corporation-Source-Book:-Agriculture-to-Construction-\(sectors-11-23\)-1](http://www.irs.gov/uac/SOI-Tax-Stats---Corporation-Source-Book:-Agriculture-to-Construction-(sectors-11-23)-1). The distribution of LLCs' net income by asset class was taken from Internal Revenue Service, *Partnership Statistics of Income*, Table 19, "Domestic Limited Liability Companies: Total Assets, Trade or Business Income and Deductions, Portfolio Income, Rental Income, and Total Net Income, by Size of Total Assets, 2007," www.irs.gov/pub/irs-soi/07pa19.xls.

55. A present value is a single number that expresses a flow of current and future income, or payments, in terms of a lump sum received, or paid, today; the present value depends on the rate of interest, known as the discount rate, that is used to translate future cash flows into current dollars. CBO used a discount rate of 6.2 percent in its calculations. (Applying that discount rate to a nominal value of \$1,062 available one year from now, for example, results in a present discounted value of \$1,000.) Because the discount rate is applied primarily to capital gains, it reflects the interest rate on 10-year Treasury bonds minus inflation—both of which were taken from Congressional Budget Office, *An Update to the Budget and Economic Outlook: Fiscal Years 2012–2022* (August 2012)—plus an equity premium of 3.5 percent.

offset income in the previous two years or carried forward to offset income in future years. CBO assumed that 15 percent of losses would be carried back (and effectively used immediately), 55 percent would be carried forward for an average of five years, and 30 percent would never be used.⁵⁶ Those assumptions yielded average corporate tax rates of 16 percent and 18 percent, respectively, for unprofitable S corporations and LLCs.

The Individual Income Tax

In preparing its annual analysis of the President's budget, CBO uses a sample of individual income tax returns (weighted to reflect the entire population) to calculate the average marginal tax rate on each major source of income—a technique known as “microsimulation.”⁵⁷ (CBO calculates rates on positive and negative income separately.) On the basis of those calculations for 2007, CBO estimated that the ordinary individual income tax rate for owners of profitable businesses, whether S corporations or LLCs, was 32 percent and the rate on dividends and capital gains (also applied under the scenario in which those types of entities are taxed as C corporations) was half that, or 16 percent. In its analysis of effects on revenues, CBO assumed that 50 percent of the profits of businesses taxed as corporations would have been distributed and subject to the tax on dividends and that the other half would have been retained and taxed as capital gains when shareholders sold their stock (after holding the securities, CBO assumed, for eight years). In present-value terms, that deferral lowered the tax rate on capital gains to the equivalent of 9½ percent.

As for businesses' losses, CBO assumed that under the current-law scenario, they offset other income subject to the individual income tax that (without the losses) would have been taxed at a rate of 12 percent (or, for capital losses realized in 2007, 6 percent). In including losses of S corporations and LLCs in the corporate income tax base, however, CBO assumed that they would remain undistributed and would be subject (as capital losses) to an individual income tax rate of 3½ percent. That estimated rate reflects both the statutory rate on capital gains and the deferral of the tax for an average of eight years.

Payroll Taxes

S-corporation shareholders and LLC “members,” as they are known, are subject to payroll taxes under the Federal Insurance Contributions Act (FICA) and the Self-

56. Those estimates are based on results from Michael Cooper and Matthew Knittel, “Partial Loss Refundability: How Are Corporate Tax Losses Used?” *National Tax Journal*, vol. 59, no. 3 (September 2006), pp. 651–664.

57. For CBO's latest report, see Congressional Budget Office, *The Economic Impact of the President's 2013 Budget* (April 2012). Broadly speaking, the marginal tax rate is the rate that applies to an additional dollar of income.

Employment Contributions Act (SECA), respectively. For the purposes of this estimate, CBO assumed that the SECA tax base consisted of all business profits of LLCs (not including rental income, which is usually exempt) and guaranteed payments for services provided by members (which are payable even if the business is not profitable). For the FICA tax base under the alternate scenario of corporate income taxation, the key assumption was that LLCs would comply with the reasonable compensation standard to the same extent that S corporations comply with it under current law.⁵⁸ The implication of that assumption, which reflects the observed behavior of S-corporation owners, is that some LLC members will report their compensation to be less than what unbiased observers would judge to be reasonable.

CBO used the same microsimulation-based calculations for computing average payroll tax rates that it used for individual income tax rates. Thus, CBO assumed that owners of S corporations and LLCs would pay an average marginal payroll tax rate of 7½ percent if their firms were profitable and a rate of 13 percent if they were unprofitable. The lower rate for owners of profitable firms reflects the earnings cap on taxes under Social Security's Old-Age, Survivors, and Disability Insurance programs—more owners of profitable firms have untaxed earnings above the cap than do owners of unprofitable firms.

Results Under Alternative Assumptions

To test how sensitive the findings of CBO's analysis were to the use of the above assumptions, CBO recalculated the loss of revenues associated with the shift to pass-through taxation using several alternative assumptions that generally represented extreme cases. With extreme assumptions as the alternatives, the resulting figures can be used to interpolate estimates under more moderate assumptions. Even the most extreme assumptions yielded a loss of revenues of at least \$20 billion.

To begin, CBO tested alternative assumptions about the use of C corporations' losses. At one extreme, CBO found that under an assumption that all losses would be used immediately, the revenue loss of \$76.3 billion that it had originally calculated would have been reduced by \$26.3 billion. At the other extreme—that is, under an assumption that the losses would never be used—the original loss would have been increased by \$31.0 billion.

As an alternative to the original assumption about the distribution of profits (that is, that half of all profits would be distributed and half would be retained), CBO assumed that

58. Owners of S corporations (and members of LLCs that choose to be taxed as S corporations) are not subject to SECA taxes. Instead, they are required to pay themselves "reasonable compensation" for services they render to the firm—in other words, compensation that is roughly what an employee would be paid to perform the same service—and that compensation is subject to FICA taxes just as if it were a salary. That treatment would presumably not change if S corporations were taxed as C corporations.

at one extreme, all profits would be distributed and that at the other extreme, all profits would be retained. In the first case, the loss in revenues would have been \$15.0 billion greater. In the second case, the revenue loss would have been reduced by \$15.1 billion. (In the even more extreme case in which shareholders held their stock until death and thereby avoided paying capital gains tax altogether, the loss in revenues would have been reduced by \$55.3 billion.)

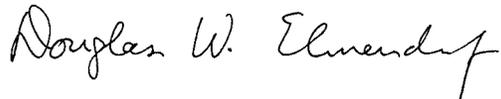
As an alternative to the assumption that compliance with the reasonable compensation standard would approximate the level currently observed among S-corporation owners, CBO tested the assumption that full compliance would be achieved if LLCs and S corporations were taxed as C corporations. CBO found that full compliance would have increased revenues from payroll taxes but reduced revenues from the corporate income tax. On net, the loss in revenues would have been \$0.8 billion greater.

About This Document

This study was prepared at the request of the Chairman of the Senate Committee on the Budget. In keeping with the Congressional Budget Office's (CBO's) mandate to provide objective, impartial analysis, the report makes no recommendations.

Paul Burnham of CBO's Tax Analysis Division wrote the report under the direction of Janet Holtzblatt and Frank Sammartino. Wendy Kiska of CBO, LeAnn Luna of the University of Tennessee, George Plesko of the University of Connecticut, and Richard Winchester of the Thomas Jefferson School of Law provided useful comments. (The assistance of external reviewers implies no responsibility for the final product, which rests solely with CBO.)

Leah Mazade edited the study, and Jeanine Rees and Maureen Costantino prepared it for publication. The report is available on CBO's Web site (www.cbo.gov).



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Director

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Table 1. **Return to Reference 1, 2, 3, 4, 5, 6, 7, 8**
Key Characteristics of Different Organizational Forms for Businesses

	Number of Owners	Liability Protection	Profit Distribution Formula	Taxation of Profits ^a
Sole Proprietorship	One	No	n.a.	Pass-through
General Partnership	More than one	No	Decided by partners	Pass-through
Limited Partnership	One or more general partners and one or more limited partners	No for general partners; yes for limited partners	Decided by partners	Pass-through
Limited Liability Company	One or more	Yes	Decided by members	Pass-through
S Corporation	One or more	Yes	According to ownership share	Pass-through
C Corporation	One or more	Yes	According to ownership share	Entity level

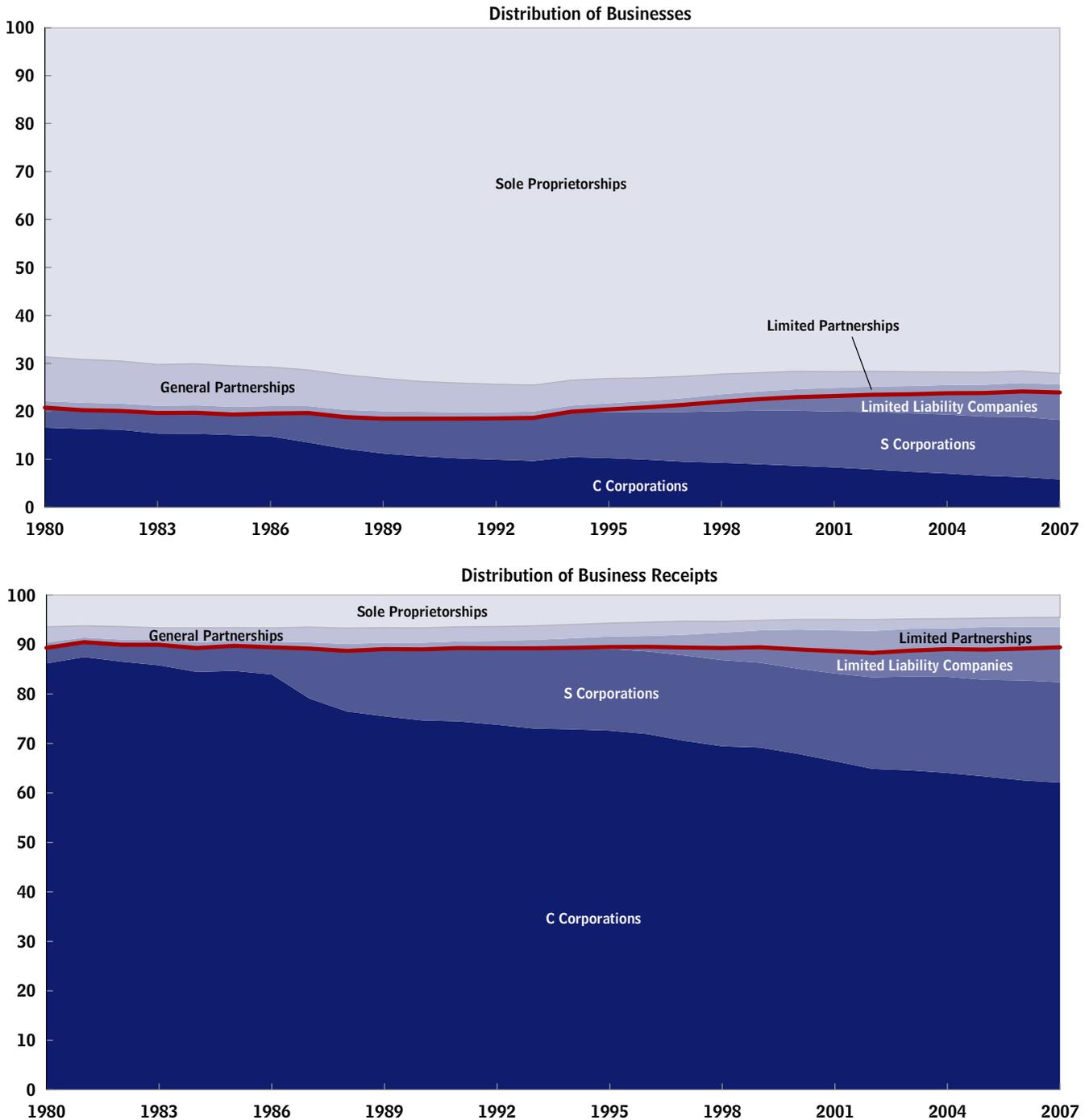
Source: Congressional Budget Office.

Note: n.a. = not applicable.

a. Profits that are passed through to owners (or "members," in the case of limited liability companies) are taxed through the individual income tax. Profits taxed at the level of the entity, or firm, are subject to the corporate income tax.

Figure 1. **Return to Reference 1, 2**
Distribution of Businesses and Their Receipts by Type of Entity

(Percent)



Source: Congressional Budget Office.

Notes: Business receipts are the revenues businesses receive from their sales of goods and services.

Table 1 summarizes the key characteristics of C corporations and the various pass-through entities.

Types of entities that appear above the dark line (specifically, sole proprietorships, general partnerships, and limited partnerships) are those that do not offer full liability protection to owners.

Table 2.**Return to Reference****Business Receipts in 2007 by Industry and Type of Entity**

(Percent)

	C Corporations	All Entities	S Corporations	Pass-Through Entities			
				General Partnerships	Limited Partnerships	Limited Liability Companies	Nonfarm Sole Proprietorships
Average, All Industries	62	38	20	2	4	7	5
Goods-Producing Industries	69	31	17	3	2	7	3
Agriculture ^a	36	64	39	2	3	10	10
Mining	66	34	9	5	7	9	3
Construction	29	71	46	3	3	9	11
Manufacturing	80	20	9	3	2	6	0
Service-Providing Industries	58	42	22	1	5	7	6
Utilities	82	18	1	1	10	6	0
Wholesale and retail trade	58	42	28	1	4	6	3
Transportation and warehousing	59	41	20	1	7	5	9
Information	74	26	6	5	5	8	1
Finance and insurance ^b	82	18	6	1	2	5	4
Real estate ^c	31	69	22	2	8	23	14
Professional services	38	62	28	2	12	9	11
Holding companies	84	16	5	0	4	6	0
Health care services	42	58	26	2	5	11	13
Accommodation and food services	40	60	30	2	5	15	8
All other services	36	64	35	2	3	8	16

Source: Congressional Budget Office based on Table 3 of the Internal Revenue Service's Integrated Business Dataset, www.irs.gov/uac/SOI-Tax-Stats---Integrated-Business-Data.

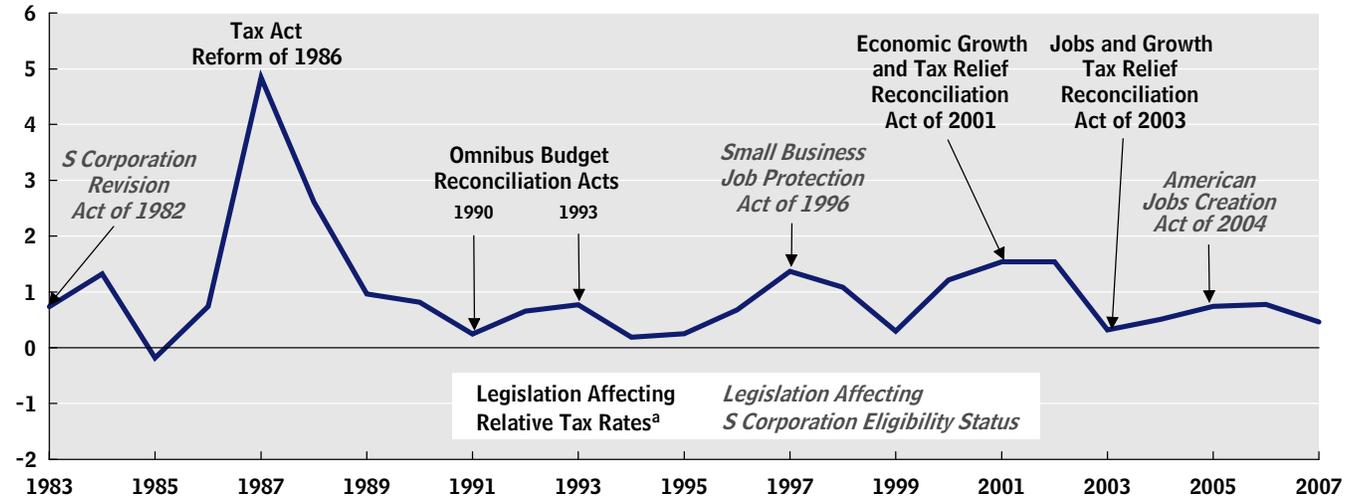
Notes: Business receipts are the revenues businesses receive from their sales of goods and services.

Table 1 summarizes the key characteristics of C corporations and the various pass-through entities.

- a. Excludes farm sole proprietorships.
- b. Excludes interest income.
- c. Excludes rental income.

Figure 2. **Return to Reference 1, 2**
Changes in the Share of Business Receipts Attributable to Pass-Through Entities

(Percent)



Source: Congressional Budget Office.

Notes: Business receipts are the revenues businesses receive from their sales of goods and services.

Table 1 summarizes the key characteristics of C corporations and the various pass-through entities.

- a. The tax rates in question are the top rates in the individual and corporate income taxes. The Tax Reform Act of 1986 and the Economic Growth and Tax Relief Reconciliation Act of 2001 reduced the top rate in the individual income tax to a level less than or equal to the top rate in the corporate income tax. The other three acts changed the relationship between the top rates in the individual and corporate income taxes in the opposite direction.

Table 3.**Return to Reference 1, 2, 3****Income Tax Liability of S Corporations and Limited Liability Companies in 2007
If They Had Been Subject to Entity-Level Taxation**

(Billions of dollars)

	Amount of Income	Tax Liability If Businesses Had Been Subject to Corporate Tax Treatment
Profitable Businesses		
S Corporations		
Business and rental income	383	110
Ordinary portfolio income ^a	22	6
Dividends and long-term capital gains	78	22
Subtotal	484	138
Limited Liability Companies		
Income of owners subject to the individual income tax		
Business and rental income	50	16
Ordinary portfolio income ^a	50	16
Dividends and long-term capital gains	87	28
Subtotal	186	61
Income of tax-exempt owners ^b	60	20
Total	730	219
Unprofitable Businesses		
S Corporations		
Business and rental income	-88	-14
Ordinary portfolio income	3	1
Dividends and long-term capital gains	1	*
Subtotal	-83	-13
Limited Liability Companies		
Income of owners subject to the individual income tax		
Business and rental income	-67	-12
Ordinary portfolio income ^a	-6	-1
Dividends and long-term capital gains	-14	-2
Subtotal	-86	-15
Income of tax-exempt owners ^b	-22	-4
Total	-191	-32
All Businesses		
Total	539	187

Source: Congressional Budget Office based on the Internal Revenue Service's business tax statistics for 2007; see www.irs.gov/uac/SOI-Tax-Stats---Table-1---Returns-of-Active-Corporations,-Form-1120S; www.irs.gov/uac/SOI-Tax-Stats-Table-2>Returns-with-Net-Income,-Form-1120S; and www.irs.gov/uac/SOI-Tax-Stats-Partnership-Statistics-by-Sector-or-Industry.

Notes: Table 1 summarizes the key characteristics of S corporations and limited liability companies.

* = between zero and 0.5.

a. Includes interest income, short-term capital gains, and royalties.

b. Includes, for example, nonprofit organizations and individual retirement accounts.

Table 4. **Return to Reference 1, 2, 3**

Owner-Level Income Taxation of S Corporations and Limited Liability Companies in 2007

(Billions of dollars)

	Amount of Income	Income Tax Liability		Difference
		Pass-Through Treatment	Corporate Treatment	
Profitable Businesses				
S Corporations				
Business and rental income	383	123		
Ordinary portfolio income ^a	22	7		
Dividends and long-term capital gains	78	13		
Before-tax profits	484	143		
Applicable entity-level tax ^b	-138			
After-tax profits	345			
Distributed	173		28	
Retained	173		17	
Limited Liability Companies^c				
Business and rental income	50	16		
Ordinary portfolio income ^a	50	16		
Dividends and long-term capital gains	87	14		
Before-tax profits	186	46		
Applicable entity-level tax ^b	-61			
After-tax profits	125			
Distributed	63		10	
Retained	63		6	
Total		188	60	-128

Continued

Table 4.

Continued

Owner-Level Income Taxation of S Corporations and Limited Liability Companies in 2007

(Billions of dollars)

	Amount of Income	Income Tax Liability		Difference
		Pass-Through Treatment	Corporate Treatment	
Unprofitable Businesses				
S Corporations				
Business and rental income	-88	-10		
Ordinary portfolio income ^a	3	*		
Dividends and long-term capital gains	1	*		
Before-tax losses	-83	-10		
Applicable entity-level tax ^b	-13			
Undistributed after-tax losses	-70		-2	
Limited Liability Companies^c				
Business and rental income	-67	-8		
Ordinary portfolio income ^a	-6	-1		
Dividends and long-term capital gains	-14	-1		
Before-tax losses	-86	-9		
Applicable entity-level tax ^b	-15			
Undistributed after-tax losses	-71		-2	
Total		-19	-5	14
All Businesses				
Total		169	55	-114

Source: Congressional Budget Office based on the Internal Revenue Service's business tax statistics for 2007; see www.irs.gov/uac/SOI-Tax-Stats---Table-1---Returns-of-Active-Corporations,-Form-1120S; www.irs.gov/uac/SOI-Tax-Stats-Table-2>Returns-with-Net-Income,-Form-1120S; and www.irs.gov/uac/SOI-Tax-Stats---Partnership-Statistics-by-Sector-or-Industry.

Notes: Table 1 summarizes the key characteristics of S corporations and limited liability companies.

Values appear in the table where applicable. Shaded cells are excluded from the calculation in the corresponding column.

* = between zero and 0.5.

- Includes interest income, short-term capital gains, and royalties.
- See the last column of Table 3.
- Includes only the income of owners that is subject to the individual income tax.

Table 5. **Return to Reference 1, 2**
Payroll Taxation of Limited Liability Company Members in 2007

(Billions of dollars)

	Amount of Tax Liability		Difference
	SECA Treatment	FICA Treatment	
Profitable LLCs			
Owners' compensation	5	5	0
Business income	3	0	-3
Unprofitable LLCs			
Owners' compensation	1	1	0
Business income	-6	0	6
Total	2	5	3

Source: Congressional Budget Office based on the Internal Revenue Service's business tax statistics for 2007; see www.irs.gov/uac/SOI-Tax-Stats-Partnership-Statistics-by-Sector-or-Industry.

Notes: Table 1 summarizes the key characteristics of limited liability companies.

SECA = Self-Employment Contributions Act; FICA = Federal Insurance Contributions Act; LLCs = limited liability companies.

Table 6.**Return to Reference**

Summary of Effects on Federal Revenues in 2007 of Taxing S Corporations and Limited Liability Companies as C Corporations

(Billions of dollars)

	Effects on Revenues		Difference
	Pass-Through Treatment	Corporate Treatment	
Entity-Level Income Taxation			
Business profits ^a	0	219	219
Business losses ^a	0	-32	-32
Owner-Level Income Taxation			
Business profits ^b	188	60	-128
Business losses ^b	-19	-5	14
Owners' compensation	86	86	0
Payroll Taxation			
S corporation owners	19	19	0
Limited liability company members ^c	2	5	3
Total	275	352	76

Source: Congressional Budget Office based on the Internal Revenue Service's business tax statistics for 2007; see [www.irs.gov/uac/SOI-Tax-Stats---Table-1---Returns of Active Corporations,-Form-1120S](http://www.irs.gov/uac/SOI-Tax-Stats---Table-1---Returns%20of%20Active%20Corporations,-Form-1120S); www.irs.gov/uac/SOI-Tax-Stats-Table-2>Returns-with-Net-Income,-Form-1120S; and www.irs.gov/uac/SOI-Tax-Stats-Partnership-Statistics-by-Sector-or-Industry.

Note: Table 1 summarizes the key characteristics of S and C corporations and of limited liability companies.

- a. Data were drawn from Table 3.
- b. Data were drawn from Table 4.
- c. Data were drawn from Table 5.

Table A-1.**Return to Reference****Data Used to Construct Regression Variables in CBO's Analysis**

	Pass-Through Share of Business Receipts (Percent) ^a	Top Marginal Corporate Tax Rate (Percent)	Top Marginal Tax Rate on Passed- Through Profits (Percent)	Total Marginal Tax Rate on Corporate Profits (Percent) ^b	Maximum Number of S-Corporation Shareholders
1982	13.5	46.0	50.0	73.0	25
1983	14.2	46.0	50.0	73.0	35
1984	15.5	46.0	50.0	73.0	35
1985	15.3	46.0	50.0	73.0	35
1986	16.1	46.0	50.0	73.0	35
1987	20.9	40.0	38.5	63.1	35
1988	23.5	34.0	28.0	52.5	35
1989	24.5	34.0	28.0	52.5	35
1990	25.3	34.0	28.0	52.5	35
1991	25.5	34.0	31.0	54.5	35
1992	26.2	34.0	31.0	54.5	35
1993	27.0	35.0	39.6	60.7	35
1994	27.2	35.0	39.6	60.7	35
1995	27.4	35.0	39.6	60.7	35
1996	28.1	35.0	39.6	60.7	35
1997	29.5	35.0	39.6	60.7	75
1998	30.5	35.0	39.6	60.7	75
1999	30.8	35.0	39.6	60.7	75
2000	32.0	35.0	39.6	60.7	75
2001	33.6	35.0	39.1	60.4	75
2002	35.1	35.0	38.6	60.1	75
2003	35.4	35.0	35.0	44.8 ^c	75
2004	35.9	35.0	35.0	44.8	75
2005	36.7	35.0	35.0	44.8	100
2006	37.5	35.0	35.0	44.8	100
2007	37.9	35.0	35.0	44.8	100

Source: Congressional Budget Office.

Note: [Table 1](#) summarizes the key characteristics of C corporations, whose profits are taxed through the corporate income tax, and the various pass-through entities, whose profits are taxed under the individual income tax.

- Business receipts are the revenues businesses receive from their sales of goods and services.
- The total marginal tax rate on corporate profits shown here incorporates the assumption that all profits are distributed in the form of dividends at the end of each year.
- Because the Jobs and Growth Tax Relief Reconciliation Act of 2003 decoupled the tax rate on dividends from the tax rate on passed-through profits, the fully phased-in total marginal tax rate on corporate profits associated with the Economic Growth and Tax Relief Reconciliation Act of 2001 is not reflected in this table. The rate was 57.8 percent and would have been realized in 2006.

Table A-2.**Return to Reference****Statistical Information About the Causes of the Expansion in Pass-Through Entities and the Implied Share of Each Cause**

	Coefficient	Standard Error	t-Statistic	Share of <i>PTshrchg</i> Accounted for (Percent)
No Dividend Tax, Fully Phased-In Tax Rates, One-Year Lags				
Constant	0.0055	0.0008	6.76**	56
<i>PosTchg</i>				25
Contemporaneous	0.2157	0.0742	2.91**	
Lagged one year	0.2080	0.0317	6.57**	
<i>Smaxchg</i>				10
Contemporaneous	0.0068	0.0028	2.44**	
Lagged one year	0.0063	0.0028	2.25**	
<i>TRA-86</i>				9
Contemporaneous	0.0214	0.0080	2.67**	
Lagged one year	^a	^a	^a	
Dividend Tax, Fully Phased-In Tax Rates, One-Year Lags				
Constant	0.0055	0.0008	6.52**	56
<i>PosTchg</i>				16
Contemporaneous	0.6168	0.2178	2.83**	
Lagged one year	0.6148	0.2178	2.82**	
<i>Smaxchg</i>				10
Contemporaneous	0.0069	0.0029	2.37**	
Lagged one year	0.0063	0.0029	2.19**	
<i>TRA-86</i>				19
Contemporaneous	0.0338	0.0046	7.32**	
Lagged one year	0.0116	0.0046	2.50**	
Dividend Tax, Current-Year Tax Rates, No Lags				
Constant	0.0073	0.0012	6.33**	75
<i>PosTchg</i>	0.2314	0.0973	2.37**	14
<i>Smaxchg</i>	^a	^a	^a	^a
<i>TRA-86</i>	0.0284	0.0074	3.84**	12

Source: Congressional Budget Office.

Note: *PTshrchg* = change in the share of business receipts (the revenues businesses receive from their sales of goods and services) attributable to pass-through entities; *PosTchg* = positive change in the amount by which the difference between the corporate and individual tax rates increased; *Smaxchg* = percentage increase in the maximum number of S corporation shareholders; *TRA-86* = dummy variable for 1987—the first year after enactment of the Tax Reform Act of 1986; and ** = statistically significant at the 95 percent level of confidence.

a. Omitted from the equation because it was not statistically significant.