

Taxes and Organizational Choice: An Analysis of Trends, 1985-1992

by Tom Petska

Statistics compiled from business tax and information returns reveal some dramatic changes since the mid-1980's, particularly between businesses electing to be taxed at individual versus corporate rates. In the period between 1985-1992, a shift occurred among corporations, from those electing to be subject to the corporation income tax, to S Corporations, those electing to be subject to the individual income tax. This shift was initially observed in the statistics for Tax Year 1987, the first year for which the Tax Reform Act of 1986 (TRA86) was in effect, and is consistent with a response to the tax rate changes of the Act.

This shift to S Corporations, which is more apparent in the number of businesses than in economic activity, is consistent with a response by smaller-size corporations to the marginal tax rate reductions in TRA86. These tax rate reductions made the individual income tax rates, at which S Corporation profits were taxed, more attractive. The fact that this change primarily affected smaller corporations is also consistent with the restrictions affecting S Corporations.

This article is an extension of earlier works on trends in business activity based on statistics compiled from tax and information returns [1,2,3]. It includes the most recent year for which complete Statistics of Income (SOI) data are available for all business types, Tax Year 1992.

Taxation and Organizational Choice

Studies of business dynamics have generally focused on the activities or behaviors of one or more types of businesses. The motives for these studies have generally been: (1) to present and analyze data on one legal form of business, or (2) to examine the pros and cons of shifting from one organizational form to another based on various factors, including incentives (or disincentives) in the Internal Revenue Code. The Internal Revenue Service's Statistics of Income (SOI) studies, as well as others, have most often been of the first type, while many other studies (often from academia) have been of the second type [4,5].

While both approaches have contributed to the understanding of the effect of taxation of businesses, these approaches do not explicitly take into consideration the overall "zero sum" nature of business activity -- that businesses conduct their profit-seeking activities in a variety of legal modes, and that rational economic behavior requires that managers examine various alternative forms of organizational structure in much the same way that they consider the merits of other strategies.

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To address this issue, data from the major SOI business statistics programs have been compiled and are examined in this article. The advantage of this approach is primarily that organizational changes from one legal form could have offsetting changes in another legal form. By combining summary data for several organizational types, trends in the overall composition can be more readily ascertained.

This section summarizes some of the most significant features of various organizational forms. Since Federal taxation of business income is a complicated topic, these issues are summarized at only a very basic level [6]. In addition, some of the significant tax law changes in the 1985-1992 period are highlighted.

Business Organizational Forms

The major legal forms of economic organization that are examined in this article are corporations, partnerships, and nonfarm sole proprietorships [7]. Corporations, in this analysis, are subdivided into those taxed at corporate rates and those electing to be taxed through their shareholders at individual income tax rates (commonly referred to as Subchapter S Corporations or simply S Corporations).

The tax treatments of these organizational forms are briefly summarized below:

Corporations.--Corporation income is generally taxed directly at the business level, then again at the shareholder level, at the applicable rates on dividend income. However, certain provisions in the Internal Revenue Code lessen this effect. First, the corporate income potentially taxable at the shareholder level excludes the taxes paid by the corporation, so income distributed to shareholders is only taxable on the after-tax profits earned by the corporation. Second, the after-tax income of the corporation is not taxable at the shareholder level until it is paid to the latter as dividends or until the shareholder realizes capital gains by selling shares that have appreciated in value. Statistical compilations of corporation income based on tax returns are published annually [8,9].

Subchapter S Corporations are small, closely-held corporations that are not taxed directly. Their income is generally subject to tax only at the owner level, much like partnerships. Owners of S Corporations report their *pro rata* shares of income or loss on their own tax returns. Although S Corporations have attractive features, they do face restrictions, including limitations on the number and type of shareholders and on the classes of stock permitted, and prohibition of foreign or corporate ownership. S Corporation data are also compiled annually and are published in this issue of the *SOI Bulletin* [10].

Partnerships.--The partnership entity is not taxed

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directly; each partnership files an annual information return, which includes an income statement, balance sheet (in most cases), and a schedule of allocations or distributions made to each partner. Partners report their allocated shares of income and expenses on their own tax returns. Partners are predominately (though not exclusively) individuals.

Partnerships may be either general partnerships or limited partnerships. Limited partnerships include all partnerships for which the liability of any partner is limited to the amount invested in the business. General partnerships, and general partners as well, face personal liability limited only by their personal resources and the applicable bankruptcy laws. Limited partners are more like corporate shareholders, with liability limited to the amount invested and with no active participation in management of the business. Annual compilations of partnership data are published in the *SOI Bulletin* [11].

Sole proprietorships.--The profits of nonfarm sole proprietorships are taxed only at the personal (i.e., owner) level. The income statement of proprietorships, which summarizes the income and expenses of the business, is completed on Schedule C (or C-EZ) of the owner's individual tax return. The net income or loss from proprietorships is added to personal income from all other sources and taxed at the applicable individual income tax rates [12]. In effect, the proprietorship acts as a conduit through which the income of the business is passed through to the business owner. Data on nonfarm sole proprietorships are published annually in the *SOI Bulletin* [13].

Limited Liability Companies.--A relative newcomer among business types is the Limited Liability Company (LLC). These entities have the limited liability of corporations, but are taxed in the partnership model--income and expenses flow through the LLC to the owners, who are taxed on their *pro rata* shares. Unlike S Corporations, however, LLC's do not have nearly as extensive restrictions on the number and composition of owners.

Data on LLC's have not been collected in the past. However, LLC's are now required to report their financial activities on the partnership annual information return (Form 1065), and indicate that they are filing as a LLC. The SOI partnership program identified these entities for the first time for Tax Year 1993 [14]. To provide some perspective on their number and the scope of their financial activities, summary data on LLC's are included in the next section.

Tax Law Changes

Many provisions of tax legislation in the 1985-1992 period may have affected the choice of business organizational

Changes in the marginal tax rates for individuals or corporations may create incentive to switch organizational form to minimize tax liabilities.

form. Clearly, the Tax Reform Act of 1986 (TRA86), the most comprehensive revision of the Internal Revenue Code since 1954, had a major impact. Key provisions of TRA86 broadened the tax base of both individuals and

corporations, by curtailing or rescinding many provisions in the tax code which had previously eroded the base, while lowering overall tax rates [15]. Other provisions of TRA86 and other law changes may have also affected organizational structure, including repealing the "general utilities doctrine," tightening the corporation "alternative minimum tax," limiting losses from "passive activities," and repealing the long-term capital gains exclusion. However, the law changes that appear to have had the most significant effect (and are the focus of this article) are the changes in corporate and individual marginal tax rates.

Since business income is taxable either at the corporate or individual level (or both), changes in the individual income tax rates have an effect on the taxation of business income. In addition, changes in the marginal tax rates for individuals or corporations may create incentives to switch from a corporate to either a non-corporate or Subchapter S structure to minimize tax liabilities. Thus, not only is the applicable tax rate schedule (whether corporate or individual) for the entity significant, but so are the tax rates for other organizational forms. For example, in the period after TRA86, the tax rates for both individuals and corporations declined; however, the individual marginal rate reversed its pre-TRA position by becoming the lower of the two. This lower individual tax rate has been cited as the primary reason for the enormous growth in the number of S Corporations in the post-TRA period [16].

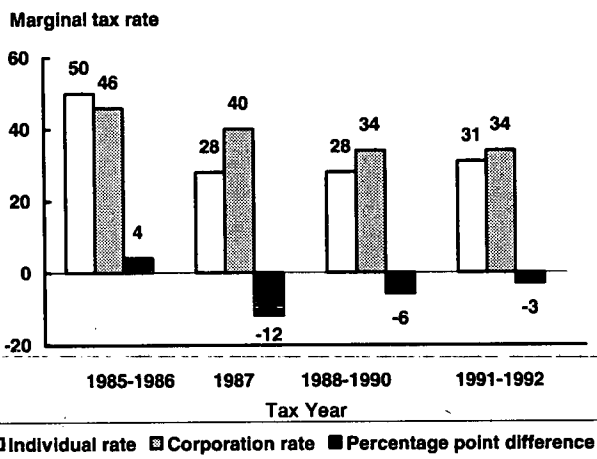
The tax rates applicable to corporate and individual taxable income are reflected in the tax computation schedules, usually with higher marginal rates applicable for larger amounts of taxable income. In this article, the top marginal tax rates are assumed to be the applicable tax rate business owners would consider in deciding which form of organization to adopt [17].

Figure A shows the top marginal corporate and individual marginal tax rates during the 1985-1992 period, as well as the difference between the two [18]. Three key inferences which may be drawn from Figure A are that:

- The top marginal tax rates for both individuals and corporations declined for 1987 as a result of TRA86.

Figure A

Individual and Corporation Marginal Tax Rates, Tax Years 1985-1992



■ The individual marginal rate replaced the corporate marginal tax rate as the lower of the two, thereby providing an incentive (after making an allowance for the double taxation of some corporate income) to shift either to an unincorporated or Subchapter S business structure.

■ The size of this differential between corporate and individual rates decreased for 1988 and again for 1991, the latter with the initiation of a 31 percent marginal tax rate for individual income. Thus, while the lower individual marginal tax rate continued to provide incentives for conducting business as an entity taxed at the individual level, the magnitude of this differential declined.

As a result of the change in the relative positions of the top corporate and individual marginal tax rates, certain taxable corporations might consider reorganizing as an S Corporation, a partnership, a sole proprietorship, or a Limited Liability Company in the period following TRA86. Considerations other than the marginal tax rate would also enter into this decision-making, however, since each of these organizational types has limitations and restrictions. Nevertheless, after the 1986 reform, a change from taxable corporation status to that of a business that would be taxed at the individual tax rates could have substantially reduced tax liability. Whether or not such a change did occur is a primary focus of the analysis in the next section.

Analysis of Business Data

The data in this article were compiled from SOI annual

cross-sectional studies of corporations (taxable and S Corporations), partnerships, and nonfarm sole proprietorships, for Tax Years 1985-1992. Data from the annual statistical studies are publicly available and are published in a variety of SOI reports [8-11,13]. They represent weighted estimates of U.S. totals by year for each legal form or organizational type. The data base used in this article combines data from these types of organizations for an 8-year period to examine changes in their overall composition.

This section is divided into three parts. First, the size and composition of the business sector is examined in detail for the most recent year for which complete data are available, Tax Year 1992. Next, trends in the data between 1985 and 1992 are examined to ascertain what transpired within this period. Finally, this 8-year period is divided into 4 sub-periods, and changes between the sub-periods are examined. These periods are: the pre-TRA period (1985-1986); the initial year of TRA86 (1987); the subsequent years of TRA86 (1988-1990); and the final years of TRA86 transition and the economic recession (1991-1992).

The Composition of Financial Activity in 1992

For a first look at the data, summary data on corporations (taxable and S), partnerships, and nonfarm sole proprietorships for Tax Year 1992 are displayed in Figure B. Nonfarm proprietorships accounted for 74 percent of the nearly 21 million entities for 1992, but only 6 percent of business receipts, and 26 percent of net income (less deficit). Corporations, on the other hand, accounted for only 19 percent of the total number of entities, but 90 percent of business receipts, and 67 percent of net income (less deficit).

Figures C and D graphically show this dominance in the number of entities and business receipts for all types of organizations. Clearly, two legal types are predominant -- the large number of relatively small proprietorships and the considerably smaller number of corporations that dominate the financial statistics.

These figures together show several other noteworthy phenomena. S Corporations, although accounting for relatively small portions of the overall financial statistics (14 percent of business receipts and 8 percent of net income (less deficit)), account for over 46 percent of all corporations. Partnerships account for relatively small portions of the overall number of entities (7 percent), business receipts (4 percent), and net income (less deficit) (7 percent). General partnerships are the dominant form of partnerships, both in number of entities and in net income (less deficit). Limited partnerships represent 18

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Figure B

Number of Entities, Business Receipts, Net Income (Less Deficit), Net Income, and Deficit by Type of Entity, 1992

[All figures are estimates based on samples--numbers of entities are in thousands and money amounts are in billions of dollars.]

Entity type	Number of entities	Business receipts	Net income (less deficit)	Net income	Deficit
	(1)	(2)	(3)	(4)	(5)
Total	20,849	12,542.3	598.9	865.7	266.8
Corporations	3,869	11,271.6	402.0	570.4	168.4
S Corporations.....	1,785	1,795.3	46.2	79.6	33.5
Taxable corporations.....	2,084	9,476.3	355.8	490.8	134.9
Unincorporated businesses.....	16,980	1,270.7	196.9	295.3	98.4
Partnerships ¹	1,485	533.6	42.9	121.8	78.9
Limited partnerships.....	271	n.a.	-3.3	50.3	39.9
General partnerships.....	1,214	n.a.	46.2	86.1	30.1
Nonfarm sole proprietorships.....	15,495	737.1	154.0	173.5	19.5

¹ Data are available for Limited Liability Companies only for Tax Year 1993. However, for comparison purposes, there were 17,000 such companies, with \$7.1 billion in business receipts, \$0.3 billion net income (less deficit), \$1.1 billion net income, and \$0.8 billion deficit.
n.a.--not available.

Figure C

Entities by Type, Tax Year 1992

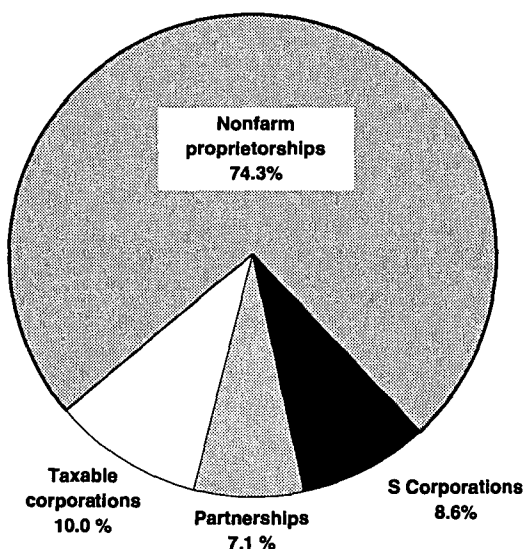
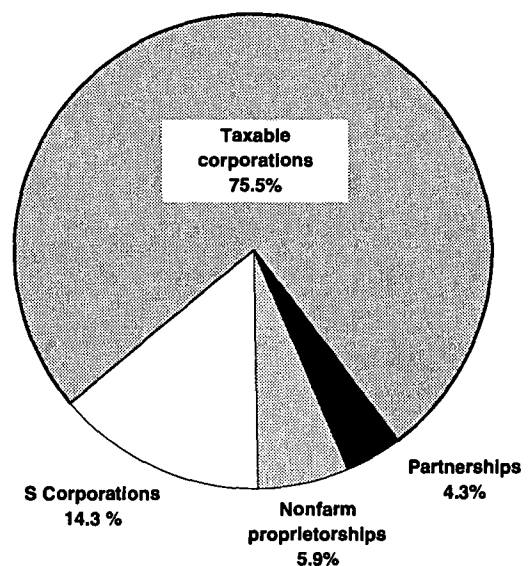


Figure D

Business Receipts by Type of Entity, Tax Year 1992



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percent of all partnerships and show an overall loss, as they have annually since the 1970's.

For comparison purposes, Limited Liability Company data are shown in the footnote to Figure B even though these data are for Tax Year 1993, the first year of their availability. Despite the overall interest and anecdotal information on this relatively new "hybrid" organizational type, these organizations are still small in number and in financial activity, accounting for only about 0.1 percent of entities, business receipts, and net income (less deficit).

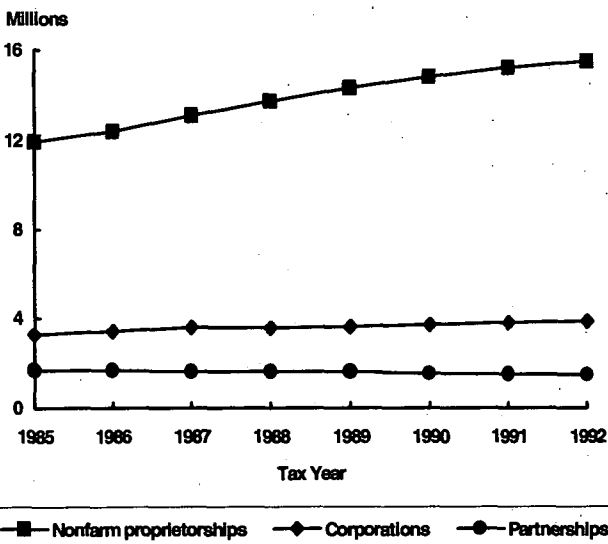
Trends in the Number of Businesses

This section focuses on trends in the number of entities and financial data for the various organizational types for the period 1985-1992. These data are presented in Tables 1-4.

Number of entities.-- In terms of number of entities, Figure E provides some perspective on the composition by organizational types over time. Nonfarm proprietorships dominate the numbers of entities throughout the 1985-1992 period, and their dominance in numbers appears to

Figure E

Number of Entities by Type, Tax Years 1985-1992

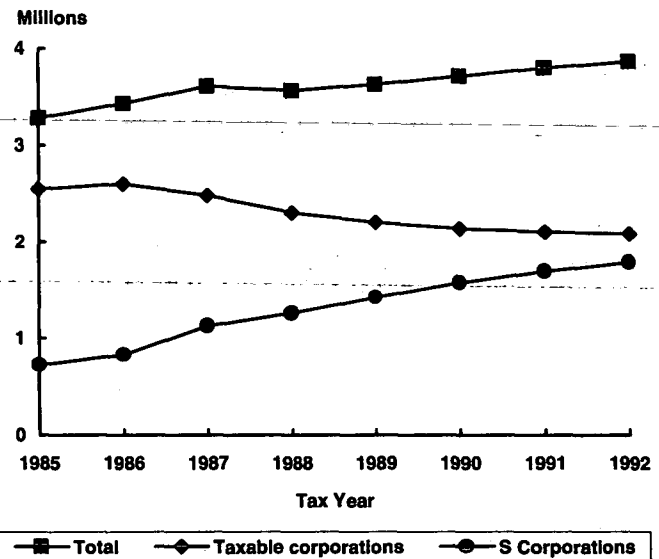


be increasing. Corporations are a distant second, followed by partnerships. Growth in the number of corporations was relatively modest for this period. The number of partnerships declined after the passage of TRA86, which is consistent with an anticipated response to the passive loss limitations.

In Figure F, the total number of corporations is shown again along with separate plots of the numbers of S and taxable corporations. Overall, the number of corporations grew very little in this period. However, what happened within the corporate sector is most striking, where changes in the numbers of S Corporations and taxable corporations began with the passage of TRA86. Starting with 1987, the first year for which TRA86 was in effect, the number of S Corporations grew dramatically. For 1987 alone, they increased in number by nearly 37 percent [19]. The

Figure F

Number of Corporations by Type, Tax Years 1985-1992



number of taxable corporations declined annually since the passage of TRA86, complementing the growth of S Corporations. As a result, the numbers of these two types seem to be converging--for 1992, S Corporations account for 46 percent of all corporations and taxable corporations the remaining 54 percent.

As previously noted, the partnership population declined over this time frame. Somewhat surprisingly, this decline occurred for both general as well as limited partnerships. Since the passive loss limitations of TRA86 were intended to address the losses generated by limited partnerships, their decline in numbers was expected. If anything, it is surprising that they have not declined more rapidly. However, the steady decline in the number of general partnerships was less anticipated, even though many general partnerships are in real estate (the industry group most affected by the passive loss limitations).

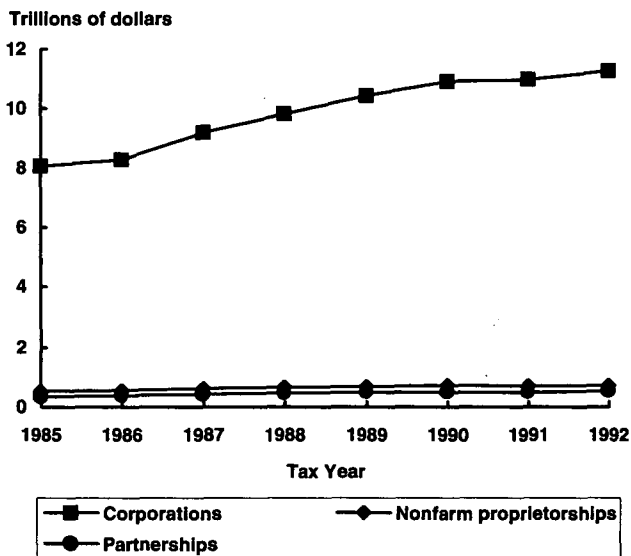
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General partnerships declined in every year in this period [20]. Why owners seem to be avoiding the partnership organizational form is not clear. Roll-ups, roll-outs, and other "consolidation strategies" may have reduced the numbers, but these have generally been for limited partnerships.

Business receipts.-- Data plotted in Figure G for business receipts show a very different picture than trends for the number of entities [21]. Corporations clearly

Figure G

Business Receipts by Type of Entity, Tax Years 1985-1992

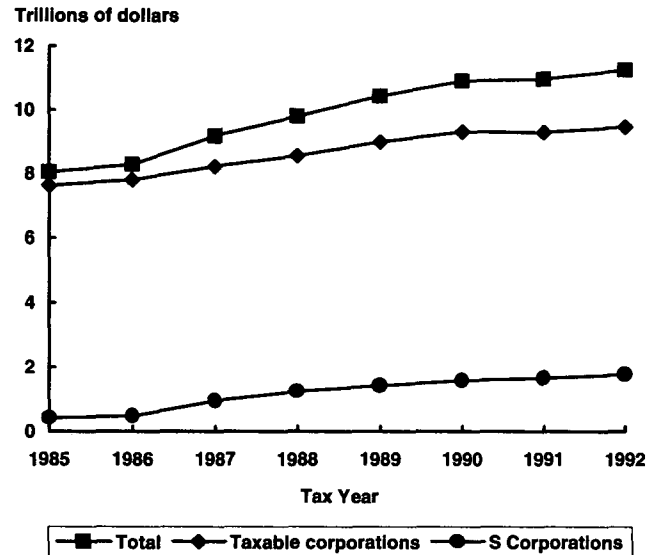


dominate this measure of gross financial activity. Throughout the 1985-1992 period, corporations accounted for approximately 90 percent of overall business receipts. Partnerships and proprietorships both show small and relatively stable portions of business receipts during this period.

Corporation business receipts are the focus of Figure H, which displays time series data for taxable, S, as well as total corporations. Despite the enormous growth in the number of S Corporations, taxable corporations still clearly dominate corporate receipts. Not that S Corporation receipts have not grown; they clearly have in this period. However, for 1985, they only accounted for 5 percent of total corporate receipts. Even though S Corporation receipts exhibited substantial growth in the post-TRA period (for example, they more than doubled in 1987 alone), their share of corporate receipts rose only to 16 percent by 1992. This reflects the facts that S Corpora-

Figure H

Corporation Business Receipts by Type of Corporation, Tax Years 1985-1992

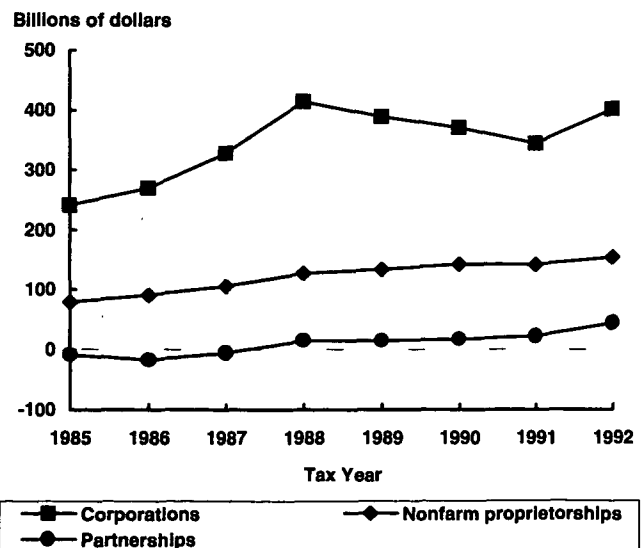


tions are generally small in size and that taxable corporations include the nation's largest corporations.

Net income (less deficit).--Profits or net income (less deficit) for all three organizational types are plotted in Figure I [22]. As in the case of business receipts, corpora-

Figure I

Profits by Type of Entity, Tax Years 1985-1992



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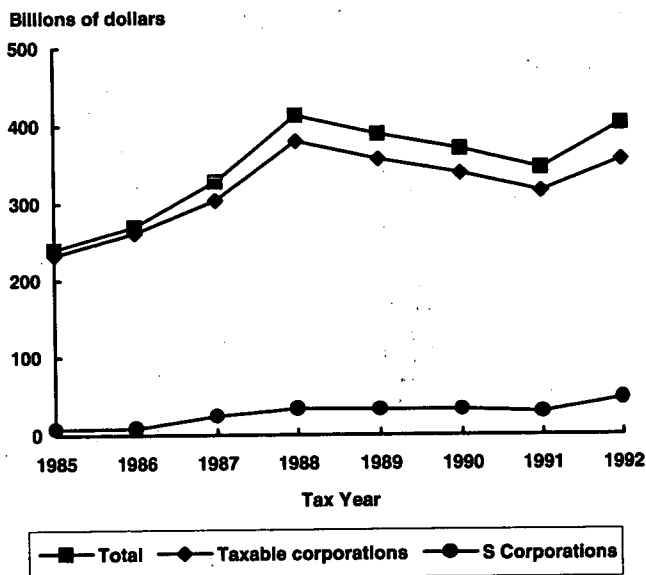
tions again dominate the statistics on profits (even after allowing for definitional differences), but with two caveats. First, their dominance of profit statistics is not to the same degree as business receipts. For example, for 1992, corporations accounted for 90 percent of business receipts, but only 67 percent of profits. Second, unlike business receipts, corporate profits are volatile and actually declined in 3 of the 4 years since 1988.

Profits of nonfarm proprietorships show modest growth throughout this period, amounting to \$154 billion for 1992 (26 percent of the total). Partnerships, on the other hand, had deficits through 1987, but began a steady stream of (positive) profits thereafter.

Figure J focuses on corporate profits by type of corporation. As expected, taxable corporations very much dominate corporate profits, and, as a result, their pattern of volatility is very much the same as that for all corporations. Although S Corporation profits increased following the passage of the 1986 tax reform, they still are a relatively small component of total corporate profits, accounting for only 11 percent for 1992. Thus, despite an annual growth rate of 26 percent between 1985 and 1992 by S

Figure J

Profits of Corporations by Type of Corporation, Tax Years 1985-1992

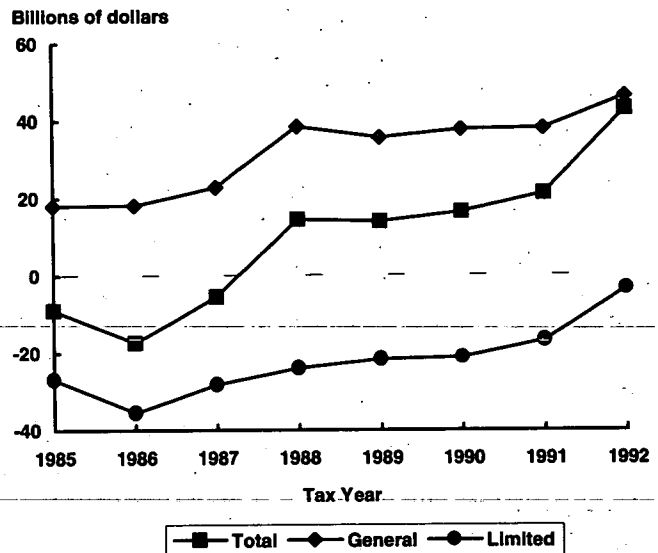


Corporations, overall corporate profits are still dominated by those of taxable corporations.

The profits of partnerships, by type of partnership, (Figure K) show similar trends, but at considerably different levels. Limited partnerships had losses for every year,

Figure K

Profits of Partnerships by Type of Partnership, Tax Years 1985-1992



bottoming out at nearly \$36 billion for 1986, the last pre-TRA year. However, since that year, losses have steadily declined to only \$3 billion for 1992. General partnerships show a similar pattern of growth throughout the period, however at a much higher level. Unlike limited partnerships that had deep losses for 1985, general partnerships had \$18 billion in net income (less deficit) for 1985 and registered increases in 6 of 7 years thereafter.

Growth Rates

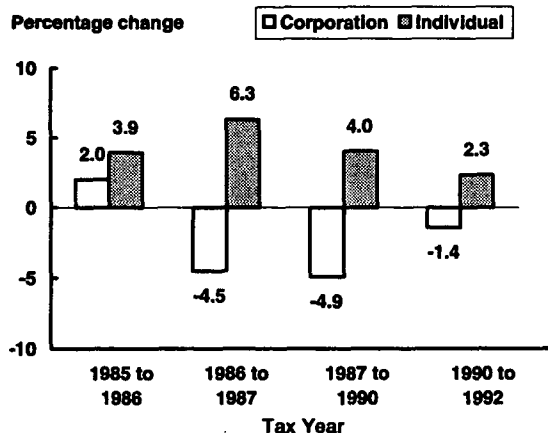
Growth rates were computed from the database to further examine trends in the 1985-1992 period. However, clearer patterns emerge by compiling the data into 4 distinct periods, based on tax law provisions. The periods are: the pre-TRA period (1985 to 1986); the initial year of TRA (1986 to 1987); the subsequent years of TRA (1988 to 1990); and the final years of TRA transition, which were also accompanied by individual tax increases and a recession (1990 to 1992). The percentage changes are "annualized" rates of growth, so that periods of different duration can more readily be compared [23].

Number of entities.--Table 1 shows data and percentage changes for the number of entities for the four periods, which are summarized graphically in Figure L. In the latter, a re-aggregation was made to focus on the effects of taxation. S Corporation data have been combined with partnership and proprietorship data to create an aggregate of entities taxed as individuals. The corporate data that remain are the non-S or taxable corporations.

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Figure L

Annual Percentage Change in Number of Entities by Type of Taxation, Tax Years 1985-1992

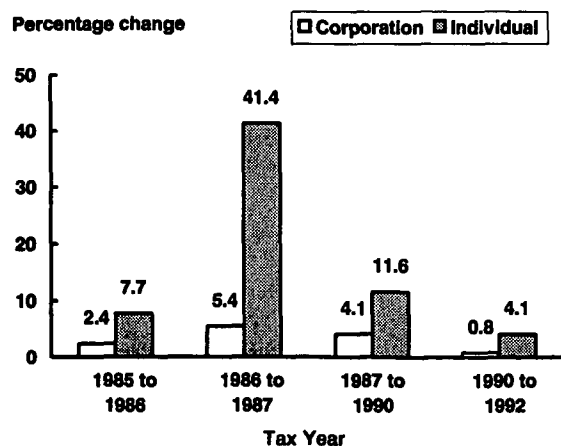


For entities taxed as corporations, a modest 2 percent gain for 1986 was followed by nearly 5 percent annual declines for 1986-1990. This pattern of change is consistent with the shift to S Corporations in the post-TRA period. Conversely, for entities taxed as individuals, nearly 4 percent growth in the pre-TRA period was followed by 6 percent growth for 1987, and declining, though positive, growth rates through 1992. Most of this increase for 1987 was a result of a 37 percent increase for S Corporations, which continued to show strong, albeit declining, rates of growth through 1992.

Business receipts.-- Data and percentage changes for

Figure M

Annual Percentage Change in Receipts by Type of Taxation, Tax Years 1985-1992



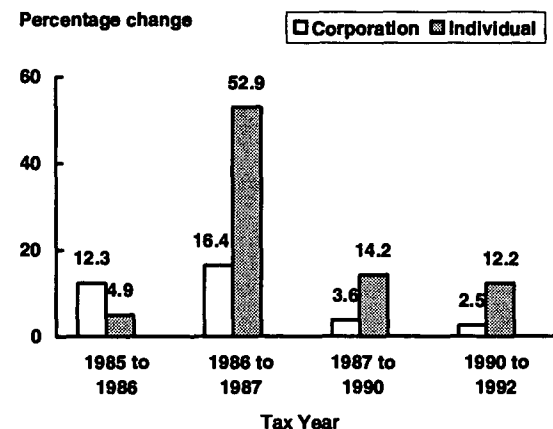
business receipts are shown in Table 2 and summarized in Figure M. These data exhibit some similarities and some differences to data on entity changes. In both instances, the rate of growth for those taxed as corporations was approximately 2 percent for 1986. However, between 1987-1990, differences emerge. The annual declines in growth rates for the number of corporations for the 1987-1990 period were in contrast to the 4 to 5 percent annual increases for corporate business receipts in this period. This is consistent with the earlier findings, which showed that taxable corporations, despite declines in number, still registered steady growth in receipts in the post-TRA period.

In spite of the continued growth of corporation receipts, the receipts of organizations taxed as individuals show substantial growth in all periods, peaking at 41 percent for 1987. Although the receipts of all entities taxed as individuals grew in all periods, S Corporations registered by far the largest increases, more than doubling for 1987, followed by a 17 percent annual rate of increase for 1988-1990.

Net income (less deficit).--Data and year-to-year changes in net income (less deficit) are in Table 3 and a

Figure N

Annual Percentage Change in Profits by Type of Taxation, Tax Years 1985-1992



graphical summary of percentage changes appears in Figure N. These data clearly show some of the most pronounced swings. Taxable corporation profits increased in the 12 to 16 percent range from 1985-1987, but their rate of growth declined to 3 to 4 percent after 1987. This is mainly due to the fact that corporate profits declined in 3 of the 4 years since 1988. The profits of entities taxed as individuals increased by nearly 53 percent for 1987

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alone and continued to increase at rates between 12 to 14 percent through 1992.

Summary and Conclusions

So what do the time series data and growth rates tell us about the most significant developments in organizational choice dynamics in the 1985-1992 period? Here are some conclusions.

- Businesses taxed as individuals grew substantially in the post-TRA86 period, both in overall numbers and in financial activity. This rate of growth peaked with 1987, the first post-TRA year, but continued even despite the 1991-1992 recession.

- The number of S Corporations accounted for much of the overall increase in the number of businesses and financial activities of businesses taxed as individuals. Their large increase in number for 1987 was partly attributable to conversions from taxable corporations [24]. The growth in the number of S Corporations in the post-TRA period appears to have been primarily at the expense of taxable corporations. This is also consistent with a response to the incentives provided by the marginal tax rate changes.

- Despite declining numbers, taxable corporations still generally increased in terms of receipts and profits, thereby maintaining their dominance of overall business financial activity. This was because many of the businesses that shifted to S Corporation status were relatively small, thereby causing a larger change in the number of businesses than in financial activity.

- Partnerships grew in number until 1986, then declined after the passage of TRA86. This is also consistent with the expected response to the passive loss limitations in TRA86.

- Nonfarm proprietorships exhibited the most stable patterns of growth throughout the period.

The changes in the number of corporations are affected by the increase in the number of consolidated returns filed for affiliated groups [25]. These affiliated groups would have included established companies that formerly filed separate returns whose ownership changed, as well as new companies. The increase in merger activity that occurred in the 1980's would have reduced the number of corporation returns, and, to a lesser extent, reduced the corporate financial data since intra-company transfers among affili-

ates would be netted out in the reported statistics. However, the extent of this latter effect is not clear [26].

The data and analysis in this paper can best be characterized as "the tip of the iceberg," since each study for each year is a statistical compilation of data from literally thousands of tax and information returns. Clearly, additional detail in the time series, such as more financial data, or industry or financial size delineations, would improve the data base [27]. An even further improvement would be to build a multi-year, multi-legal form micro-data base, to include panel studies of identical entities for each legal type and a means to track entity changes. However, all of these exceed the scope of this article. Still, the analysis of trends in the business data can provide a framework for assessing the relative size and changes over time of the various types of entities. For example, the data show a strong correlation between changes in the tax law, particularly the marginal tax rate changes associated with TRA86 and the choice of organizational structure. While this does not demonstrate causality, it can provide a framework for insight into the underlying dynamics.

In conclusion, this analysis of trends in aggregate statistics indicates there were some substantial changes in the overall structure of U.S. business activity in the 1985-1992 period. The most substantial change was the shift to S Corporations beginning with 1987, the first full year for which the Tax Reform Act of 1986 was in effect, although this was more apparent in the number of businesses than in the financial activity. This shift is consistent with a response by smaller-size corporations to the provisions of TRA86, particularly the relative lowering of the individual marginal tax rates. Also, the fact that this change primarily affected smaller corporations is consistent with the restrictions affecting the size of S Corporations.

Data Sources and Limitations

The data in this paper were compiled from Statistics of Income (SOI) annual studies of corporations, partnerships, and nonfarm sole proprietorships for Tax Years 1985-1992. These data are publicly available and are published in a variety of SOI reports [8-11,13]. They represent weighted estimates of U.S. totals based on samples, by year for each legal form. This data base combines data from these types of organizations for an 8-year period to examine overall changes in their overall composition.

The SOI studies for each of these forms of business are conducted independently and are affected by changes in the Internal Revenue Code, IRS administrative processing, and the tax forms themselves, as well as the effects of

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resource constraints and changes in statistical processing methodology. Sometimes these changes result in discontinuities in the time series. While efforts have been made to minimize these discontinuities, several remain, some of which have been mentioned already:

- Proprietorship farms, a major portion of farming businesses, are not included in the data because the annual SOI studies were discontinued after Tax Year 1980 in response to resource constraints.

- It is difficult, if not impossible, to track an individual entity legal change which results in the issuance of a new Employer Identification Number (EIN).

- A significant activity has been made to derive data that are comparable among legal types, particularly for business receipts and net income. Although this often succeeded, some problems remain [28].

The corporate data include all filers of the Form 1120 series, *U.S. Corporation Income Tax Return*. The data on S Corporations, which have been extracted from Form 1120S, *U.S. Income Tax Return for an S Corporation*, are also included in the overall corporation data, but have been deducted to compute amounts for corporations other than S Corporations (i.e., taxable corporations).

Data for partnerships have been separated into those for general partnerships and limited partnerships. Partnership data have been aggregated with those for nonfarm sole proprietorships to compute an "unincorporated business total," and the corporate and unincorporated data have been aggregated into a grand total for all businesses.

Although partnership income is subject to tax at the applicable rates of the partners, who can be individuals, corporations, tax-exempt organizations, or virtually any other legal type, most partners are individuals. In this analysis, it is assumed that all partnership income is subject to individual taxation. Partnership data were aggregated with data for nonfarm proprietorships and S Corporations to produce data for entities taxed as individuals.

Explanation of Terms

The analysis in this article is dependent on data that are both consistent over time for one organizational type, as well as consistent between organizational types. Efforts were made to construct time series that were as consistent as possible, even though some inconsistencies remain. This section provides basic definitions of terms used [29].

Number of entities.--This includes the estimated number of active tax or information returns filed by each

legal or form type. For corporations, the numbers represent the number of income tax returns of active corporations, rather than the number of active corporations. The number includes consolidated returns of parent corporations, but not the number of affiliated companies or subsidiaries. The number of partnerships represent the total number of returns of active partnerships that were engaged in a U.S. business or that had income from U.S. sources. Nonfarm proprietorships represent the number of nonfarm sole proprietors, rather than the number of nonfarm businesses owned by sole proprietorships. In all instances, part-year returns are included.

Total and business receipts.--Business receipts include the gross operating receipts of the business. Total receipts include business receipts plus income from investments. In this article, the business receipts of corporations and partnerships classified under finance, insurance, and real estate were made equal to total receipts in recognition of the fact that investment income is often the principal operating income of these businesses, even though such income is reported separately on the tax returns. For sole proprietorships, business receipts were made equal total receipts.

Net income (less deficit).--This amount represents the taxable profit, before income tax, computed under definitions in the Internal Revenue Code. However, because the definitions of receipts and deductions used to compute net income, as well as for conceptual reasons applicable to net income itself, net income (less deficit) is not always defined the same for all legal forms for all years.

Notes and References

- [1] Petska, Tom, "Do Taxes Affect Business Legal Structure? An Analysis of IRS Data," presented at the Allied Social Science Association Meetings, January 7, 1996, in San Francisco, California.
- [2] Petska, Tom, and Wilson, Robert, "Trends in Business Structure and Activity, 1980-1990," *Statistics of Income Bulletin*, Spring 1994, Volume 13, Number 4.
- [3] Petska, Tom, "The Effects of Tax Reform on the Structure of U.S. Business," *1993 Proceedings of the American Statistical Association, Section on Business and Economic Statistics*, 1994.
- [4] Most of the articles that appear periodically in the *SOI Bulletin* are analyses of one organizational type, for example, Gill, Amy M. and Wittman, Susan M., "S Corporation Elections after TRA86," a paper presented at the 1996 Allied Social Science Association Meetings, San Francisco, California, January,

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1996; Nelson, Susan C., "S Corporations: The Record of Growth After Tax Reform," *Journal of S Corporation Taxation*, Fall 1993, Volume 5, Number 2; Nutter, Sarah E., Young, Jim, and Wilkie, Patrick, "Tax Legislation and Business Form Choice: C Corporation Behavior Before and After TRA86," a paper presented at the 1996 Allied Social Science Association Meetings, San Francisco, California, January 1996 and published in the Winter 1995-96 *SOI Bulletin*; and Petska, Tom and Nelson, Susan, "Partnerships and Tax Shelters: An Analysis of the Impact of the 1986 Tax Reform," *1990 Proceedings of the American Statistical Association, Section on Survey Research Methods*, 1991.

- [5] Studies addressing multi-organizational types include, Gordon, Roger H. and MacKie-Mason, Jeffrey K., "Tax Distortions to the Choice of Organizational Form," Working Paper No. 4227, National Bureau of Economic Research, 1992; Gordon, Roger H. and MacKie-Mason, Jeffrey K., "Effects of the Tax Reform Act of 1986 on Corporate Financial Policy and Organizational Form," Department of Economics, University of Michigan, 1989; MacKie-Mason, Jeffrey K. and Gordon, Roger H., "Taxes and the Choice of Organizational Form," University of Michigan, National Bureau of Economic Research, and the Hoover Institution, 1991; and Plesko, George A., "Corporation Taxation and the Financial Characteristics of Firms," *Public Finance Quarterly*, July 1994.
- [6] For more details on changes to the Internal Revenue Code, see Steuerle, C. Eugene, *The Tax Decade: How Taxes Came to Dominate the Public Agenda*, The Urban Institute, 1991; Pechman, Joseph A., *Federal Tax Policy*, The Brookings Institute, 1987; and Scholes, Myron S., and Wolfson, Mark A., *Taxes and Business Strategy: A Planning Approach*, Prentice-Hall, 1991.
- [7] Data from Schedule F, *Farm Income and Expenses*, were excluded from the annual SOI study of sole proprietorships beginning with Tax Year 1981, so the data base is deficient in this respect.
- [8] Internal Revenue Service, *Source Book of Statistics of Income, Corporation Income Tax Returns*, 1993.
- [9] Internal Revenue Service, *Statistics of Income—Corporation Income Tax Returns*, 1992.
- [10] See Gill, Amy M. and Wittman, Susan M., "S Corporation Returns, 1993," in this issue.

- [11] See Wheeler, Timothy D., "Partnership Returns, 1993," *Statistics of Income Bulletin*, Fall 1995, Volume 15, Number 2.
- [12] See footnote 7.
- [13] See Cruciano, Therese, "Sole Proprietorships, 1993," *Statistics of Income Bulletin*, Fall 1995, Volume 15, Number 2.
- [14] See footnote 11.
- [15] There are many sources that discuss the changes in the tax code resulting from TRA86. See, for example, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*; Internal Revenue Service, *Explanation of the Tax Reform Act of 1986 for Individuals*, Publication 920; and Nelson, Susan and Petska, Tom, "Partnerships, Passive Losses, and Tax Reform," *1989 Proceedings of the American Statistical Association, Section on Survey Research Methods*, 1990.
- [16] See sources in footnotes 2-5.
- [17] Ideally, not only should the full tax rate schedules for corporations and individuals be used, but also other provisions, such as the maximum tax rate on capital gains and the alternative minimum tax, should be taken into consideration.
- [18] Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, Volume 1, Budget Processes and Tax Systems*, Tables 9-10, 1993.
- [19] Beginning with 1987, S Corporations were required to use accounting periods identical to those of their owners. Since owners are mostly individuals with calendar year accounting periods, many S Corporations with other accounting periods had to file two part-year returns in order to convert to calendar year accounting periods and were double counted in the 1987 statistics for the number of S Corporations (there was no such duplication in the financial data, however). This double counting is estimated to have added approximately 100,000 returns to 1987. Taxable corporations also may be understated in the statistics because of an omission of Personal Service Corporations.
- [20] In retrospect, it appears that in processing the 1987 SOI partnership data, too many sampled records were rejected. If an appropriate adjustment were to

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be made, it would involve increasing the overall population estimate by 6,000 to 50,000 returns, which would result in a steady decline in the partnership population since 1987.

[21] One general issue on receipts data is that of "grossing up" business receipts. The multi-year and multi-type analysis in this article is dependent on data that are both consistent over time for one organizational type, as well as consistent among organizational types. However, in constructing the annual SOI statistical compilations, insuring such consistency, even within an organizational type, is a challenging, if not impossible, task. Potential changes (and discontinuities) can originate from changes in tax law, changes in tax forms, changes in the IRS master file system, and statistical processing changes. One example of a tax form change is the initiation of a new schedule for certain activities, such as rental income and expenses, which results in the inclusion of only rental net income in the income statement (instead of gross income and expense, separately). Such a change would cause an understatement in "gross" financial activities.

[22] As with business receipts, efforts were made to construct time series data that were consistent over time. However, some inconsistencies remain. For example, from 1987-1991, net income (less deficit) for S Corporations excludes taxable income (less deficit) from investments. For a more detailed discussion of these issues, see the footnote 2 to Table 1 in [2].

[23] Annual growth rates for periods of more than 1 year in this article were computed as follows:

$$G_t = (\ln X_t - \ln X_{t-n}) 100 / n$$

where

G_t = the annual growth rate in the value of X between periods t and n,

$\ln X_t$ = the natural logarithm of the value of X for period t,

$\ln X_{t-n}$ = the natural logarithm of the value of X for period t-n, and

n = the number of years on which the computation is based.

[24] See footnote 19.

[25] See source in footnote 2 for a discussion of the potential affects of mergers and consolidation.

[26] *Ibid.*

[27] A logical extension would be to add industrial detail to this analysis, particularly in such cases where certain industries show substantial differences. One such example is for real estate partnerships. While many of these losses are from limited partnerships, use of the industry delineation would probably have been more effective.

[28] Deriving consistent aggregates was made considerably more difficult beginning with 1987, when "portfolio income" distributed directly to partners and net income or loss from partnership rental and other real estate activities were excluded from net income (less deficit) on the Form 1065, *U.S. Partnership Return of Income*. However, efforts were made to recoup these income types to preserve a consistent time series. For S Corporations, a similar circumstance exists, but a similar adjustment was not made for the 1987-1991 data on net income (less deficit), so they are understated by the amounts of these types of income. In addition, since the taxable corporation data were computed by subtracting the S Corporation data from the corporation total, the taxable corporation data are consequently overstated by these amounts.

[29] For additional information, see the source in the "Notes and References" section, particularly notes to Table 1 in the article cited in footnote 2.

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Table 1.--Numbers of Corporations, Partnerships, and Nonfarm Sole Proprietorships for Selected Tax Years, 1985-1992

[All figures are estimates based on samples--numbers of entities are in thousands.]

Organizational type	1985	1986	Annual percentage increase, 1985-86	1987	Annual percentage increase, 1986-87	1990	Annual percentage increase, 1987-90	1992	Annual percentage increase, 1990-92
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Total.....	16,919	17,525	3.6	18,351	4.7	20,053	3.0	20,849	1.9
Corporations.....	3,277	3,429	4.6	3,612	5.3	3,717	1.0	3,869	2.0
S Corporations.....	725	826	13.9	1,128	36.6	1,575	11.1	1,785	6.3
Taxable corporations.....	2,552	2,602	2.0	2,484	-4.5	2,142	-4.9	2,084	-1.4
Partnerships.....	1,714	1,703	-0.6	1,648	-3.2	1,554	-2.0	1,485	-2.3
Limited partnerships.....	280	273	-2.5	262	-4.0	286	2.9	271	-2.7
General partnerships.....	1,434	1,430	-0.3	1,386	-3.1	1,268	-3.0	1,214	-2.2
Nonfarm sole proprietorships.....	11,929	12,394	3.9	13,091	5.6	14,783	4.1	15,495	2.4

Table 2.--Business Receipts for Corporations, Partnerships, and Nonfarm Sole Proprietorships for Selected Tax Years, 1985-1992

[All figures are estimates based on samples--money amounts are in billions of dollars.]

Organizational type	1985	1986	Annual percentage increase, 1985-86	1987	Annual percentage increase, 1986-87	1990	Annual percentage increase, 1987-90	1992	Annual percentage increase, 1990-92
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Total.....	8,938.8	9,220.0	3.1	10,224.4	10.9	12,146.4	5.7	12,542.3	1.6
Corporations.....	8,049.6	8,281.9	2.9	9,185.5	10.9	10,914.2	5.7	11,271.6	1.6
S Corporations.....	420.5	472.8	12.4	955.7	102.1	1,593.4	17.0	1,795.3	6.0
Taxable corporations.....	7,629.1	7,809.1	2.4	8,229.8	5.4	9,320.8	4.1	9,476.3	0.8
Partnerships.....	349.2	378.7	8.4	428.1	13.0	501.6	5.3	533.6	3.1
Nonfarm sole proprietorships.....	540.0	559.4	3.6	610.8	9.2	730.6	6.0	737.1	0.4

Table 3.--Net Income (Less Deficit) for Corporations, Partnerships, and Nonfarm Sole Proprietorships for Selected Tax Years, 1985-1992

[All figures are estimates based on samples--money amounts are in thousands of dollars.]

Organizational type	1985	1986	Change, 1985-86	1987	Change, 1986-87	1990	Average annual change, 1987-90	1992	Average annual change, 1990-92
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Total.....	310.0	342.5	32.5	428.3	85.8	528.6	33.4	598.9	35.2
Corporations.....	240.1	269.5	29.4	328.2	58.7	370.6	14.1	402.0	15.7
S Corporations.....	7.6	8.3	0.7	24.2	15.9	32.3	2.7	46.2	7.0
Taxable corporations.....	232.5	261.2	28.7	304.0	42.8	338.3	11.4	355.8	8.8
Partnerships.....	-8.9	-17.4	-8.5	-5.4	12.0	16.6	7.3	42.9	13.2
Limited partnerships.....	-26.9	-35.5	-8.6	-28.2	7.3	-21.2	2.3	-3.3	9.0
General partnerships.....	18.0	18.1	0.1	22.8	4.7	37.8	5.0	46.2	4.2
Nonfarm sole proprietorships.....	78.8	90.4	11.6	105.5	15.1	141.4	12.0	154.0	6.3

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Table 4.—Number of Entities, Receipts, and Net Income by Type of Entity, Tax Years 1985-1992

[All figures are estimates based on samples—money amounts are in billions of dollars.]

Item	Tax year							
	1985	1986	1987	1988	1989	1990	1991	1992
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Grand total								
Number of entities.....	16,919,395	17,525,167	18,351,300	18,896,336	19,560,585	20,052,917	20,498,855	20,849,194
Total receipts	9,305.4	9,626.1	10,665.7	11,477.6	12,178.6	12,706.3	12,711.7	13,075.9
Business receipts.....	8,938.8	9,220.0	10,224.4	10,956.5	11,618.2	12,146.4	12,173.5	12,542.3
Net income (less deficit)	310.0	342.5	428.3	553.8	535.8	528.6	507.8	598.9
Net income.....	539.7	655.9	767.4	812.8	822.6	830.5	811.6	865.7
Deficit.....	229.6	257.0	248.4	259.0	286.8	301.8	303.9	266.8
Corporations, total								
Number of entities.....	3,277,219	3,428,515	3,612,133	3,562,789	3,627,863	3,716,650	3,802,788	3,869,023
Total receipts	8,398.3	8,669.4	9,580.7	10,264.9	10,935.0	11,409.5	11,436.5	11,742.1
Business receipts	8,049.6	8,281.9	9,185.5	9,803.8	10,439.5	10,914.2	10,961.9	11,271.6
Net income (less deficit)	240.1	269.5	328.2	413.0	389.0	370.6	344.9	402.0
Net income.....	363.9	408.9	465.2	555.9	556.3	552.5	535.8	570.4
Deficit.....	123.7	139.3	137.0	142.9	167.3	181.9	191.0	168.4
S Corporations								
Number of entities.....	724,749	826,214	1,127,905	1,257,191	1,422,967	1,575,092	1,698,271	1,785,371
Total receipts	430.6	484.0	972.2	1,264.0	1,464.0	1,620.7	1,683.0	1,821.9
Business receipts	420.5	472.8	955.7	1,242.1	1,439.8	1,593.4	1,660.1	1,795.3
Net income (less deficit)	7.6	8.3	24.2	33.4	32.5	32.3	29.1	46.2
Net income.....	21.2	23.9	45.0	58.1	63.3	67.9	66.0	79.6
Deficit.....	13.6	15.6	20.8	24.7	30.9	35.7	37.0	33.5
Taxable corporations								
Number of entities.....	2,552,470	2,602,301	2,484,228	2,305,598	2,204,896	2,141,558	2,104,517	2,083,652
Total receipts	7,967.7	8,185.4	8,608.5	9,000.9	9,471.0	9,788.8	9,753.5	9,920.2
Business receipts	7,629.1	7,809.1	8,229.8	8,561.7	8,999.7	9,320.8	9,301.8	9,476.3
Net income (less deficit)	232.5	261.2	304.0	379.6	356.5	338.3	315.8	355.8
Net income.....	342.7	441.3	420.2	497.8	493.0	484.6	469.8	490.8
Deficit.....	110.1	123.7	116.2	118.2	136.4	146.2	154.0	134.9
Unincorporated entities, total								
Number of entities.....	13,642,176	14,096,652	14,739,167	15,333,547	15,932,722	16,336,267	16,696,067	16,980,171
Total receipts	907.1	956.7	1,085.0	1,212.7	1,243.6	1,296.0	1,275.2	1,333.8
Business receipts	889.2	938.1	1,038.9	1,152.7	1,178.7	1,232.2	1,211.6	1,270.7
Net income (less deficit)	69.9	73.0	100.1	140.8	146.8	158.0	162.9	186.9
Net income.....	175.8	190.7	211.5	256.9	266.3	278.0	275.8	295.3
Deficit.....	105.9	117.7	111.4	116.1	119.5	119.9	112.9	98.4
Partnerships								
Number of entities.....	1,713,603	1,702,952	1,648,035	1,654,245	1,635,164	1,553,529	1,515,345	1,484,752
Total receipts	367.1	397.3	474.2	540.7	550.8	566.2	562.6	596.7
Business receipts	349.2	378.7	428.1	480.7	485.9	501.6	499.0	533.6
Net income (less deficit)	-8.9	-17.4	-5.4	14.5	14.1	16.6	21.4	42.9
Net income.....	77.0	80.2	87.7	111.4	113.9	116.3	113.4	121.8
Deficit.....	85.9	97.6	93.1	96.9	99.8	99.7	92.0	78.9
Limited partnerships								
Number of entities.....	279,878	273,076	262,210	285,000	293,637	285,769	270,681	270,748
Net income (less deficit)	-26.9	-35.5	-28.2	-24.0	-21.6	-21.2	-16.7	-3.3
General partnerships								
Number of entities.....	1,433,725	1,429,876	1,385,825	1,369,245	1,341,527	1,267,760	1,244,664	1,214,004
Net income (less deficit)	18.0	18.1	22.8	38.5	35.7	37.8	38.1	46.2
Nonfarm sole proprietorships								
Number of entities.....	11,928,573	12,393,700	13,091,132	13,679,302	14,297,558	14,782,738	15,180,722	15,495,419
Total receipts	540.0	559.4	610.8	672.0	692.8	730.6	712.6	737.1
Business receipts	540.0	559.4	610.8	672.0	692.8	730.6	712.6	737.1
Net income (less deficit)	78.8	90.4	105.5	126.3	132.7	141.4	141.5	154.0
Net income.....	98.8	110.5	123.8	145.5	152.4	161.7	162.4	173.5
Deficit.....	20.0	20.1	18.3	19.2	19.7	20.2	20.9	19.5
Addendum:								
Entities taxed at individual rates ¹								
Number of entities.....	14,366,925	14,922,866	15,867,072	16,590,738	17,355,689	17,911,359	18,394,338	18,765,542
Total receipts	1,337.7	1,440.7	2,057.2	2,476.7	2,707.6	2,917.4	2,958.2	3,155.7
Business receipts	1,309.7	1,410.9	1,994.6	2,394.8	2,618.5	2,825.6	2,871.1	3,066.0
Net income (less deficit)	77.5	81.3	124.3	174.2	179.3	190.3	192.0	243.1
Net income.....	197.0	214.6	256.5	315.0	329.6	345.9	341.8	374.9
Deficit.....	119.5	133.3	132.2	140.8	150.4	155.6	149.9	131.9

¹ This includes data for unincorporated businesses and S Corporations.