

Corporate Business Activity Before and After the Tax Reform Act of 1986

by Patrick J. Wilkie, James C. Young, and Sarah E. Nutter

The Tax Reform Act of 1986 (TRA 86) marked an important shift in Federal income tax policy. While previous tax acts provided incentives or disincentives for various business activities and industries, TRA 86 attempted to create a more "level playing field" by broadening the tax base and lowering tax rates. However, while TRA 86 reduced the direct effect of the Federal income tax on alternative economic activities, the repeal of the 50 percent net capital gains exclusion and the *General Utilities* doctrine, which had allowed corporations to distribute assets tax-free in liquidation in certain circumstances, increased the impact of the "double tax" on corporate earnings. These changes, coupled with the reduction of the maximum tax rate on individual taxpayers below the maximum tax rate on corporations, provided an incentive for taxable corporations to elect S-corporation status or to alter their financing decisions to limit the amount of income subject to the corporate-level tax.

Previous research indicates that the transition to the new tax regime under TRA 86 substantially affected business taxpayers, with an increase in the number, investments, and profits of S-corporations [1]. However, many corporations did not switch to S-corporation status. One likely explanation for companies retaining their taxable status is that the eligibility requirements to elect S-corporation status (such as having only 35 shareholders and one class of stock) prohibited them from qualifying for the election. Another explanation, however, may be that some corporations were able to achieve "homemade" S-corporation status (and avoid double taxation of earnings) by distributing income to shareholders in tax deductible form. The payment of such potential "deductible dividends" to shareholders, which we define to include interest, rent, and personal-service compensation, eliminates corporate income from the double tax. However, these payments may not be allowed as deductions under the Federal income tax. For example, the reasonableness restrictions on compensation in Section 162 of the Internal Revenue Code prohibit excessive payments to shareholder-employees. Further, if these distributions are made, how does the corporation maintain its investment base?

Data were collected from corporate income tax returns for tax years 1984 through 1990 to provide information on

Smaller corporations that did not convert to S-Corporation status reduced their income subject to corporate taxation by paying larger percentages of interest, rent, and officer's compensation.

four related taxable-corporation issues: (1) number of taxpayers and economic resources, (2) profits, (3) payment of potential deductible dividends, and (4) debt capital provided to the corporation from its

shareholders. These data are presented on an annual basis, and in terms of multi-year arithmetic means, for the pre- and post-TRA 86 periods.

Reflecting previous research, which documents the growth and profitability of S-corporations subsequent to TRA 86, our data show a decline in the number and profitability of the remaining smaller taxable corporations. In addition, we find that smaller corporations that did not convert to S-corporation status reduced the amount of their income subject to corporate taxation by paying larger percentages of interest expense, rent expense, and officer compensation payments. Given the limitations of the data, we cannot trace these deductible dividend payments directly to the owners of these taxable corporations. However, the corporations most likely to create "homemade" S-corporation status (via the payment of deductible dividends) are smaller in size, which is consistent with the notion that closely-held corporations are better able to consummate the necessary contractual arrangements that allow these payments to occur.

The Tax Reform Act of 1986

TRA 86 was a major event in the history of the U.S. Federal income tax, and sought to create a more neutral tax system that lessened the impact of the Federal income tax on business decisions. To achieve this goal, statutory tax rates generally were lowered and flattened, while taxable income was broadened so that business activities were treated more equally. Specific changes in the law that are important here are described in Figure A.

Interestingly, however, while TRA 86 strove to equalize the tax treatment of different business activities, it created a further disincentive to conduct profitable businesses in traditional, taxable corporate form. As discussed in the next section, the combined effect of changes in corporate and individual tax rates, along with the repeal of the 50 percent net capital gains exclusion for individuals and the *General Utilities* doctrine, placed investors in taxable-corporations at a distinct tax disadvantage relative to owners of S-corporations.

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Figure A

Major Changes in Investment Taxation Associated with TRA 86

Corporate Taxation

- The top marginal rate declined from 46 percent to 34 percent, though rates of 15 percent and 25 percent existed for taxable income less than \$100,000.
- The definition of business taxable income was broadened, with provisions that postponed the recognition of expenses (e.g., bad debt charge-off, uniform capitalization for inventories, lengthened depreciable lives for business assets, repeal of investment tax credit).
- The corporate alternative minimum tax was expanded by subjecting to immediate taxation a portion of economic income that was not otherwise included in the regular taxable income.
- The repeal of the General Utilities doctrine, which had allowed, in certain circumstances, a tax-free distribution of corporate assets in a liquidation.

Individual Taxation

- The top marginal tax rate declined from 50 percent to 28 percent (33 percent for some intermediate taxable income levels). This decline lowered the top individual rate below the top corporate tax rate.
- The long-term capital gains deduction (exclusion) was eliminated.
- Passive loss limitations, which gradually disallowed individual taxpayers' deductions from taxable income of business losses originating in "passive activities," were introduced.

The Taxation of Alternative Business Forms

There are two basic types of business entities for Federal income tax purposes: (1) "taxable" corporations (often referred to as C-corporations due to their taxation under Subchapter C of the Internal Revenue Code), and (2) flow-through entities, which include sole proprietorships, partnerships, and S-corporations. Income derived by a flow-through entity is reported by its owners for tax purposes and, thus, the income is taxed only once. Income earned by a taxable corporation, however, is subject to "double taxation," once at the corporate level and a

second time when the after-corporate-tax amount is distributed to shareholders as dividends, or as gain when shareholders sell their shares.

Figure B illustrates the hypothetical tax effects associated with the corporate and non-corporate business forms before and after TRA 86. These effects are shown for varying time horizons with the maximum tax rates in existence for the pre-TRA 86, post-TRA 86, and post-RRA 93 (Revenue Reconciliation Act of 1993) tax environments, assuming taxable corporations pay no dividends [2]. The hypothetical returns in Figure B illustrate

Figure B

Hypothetical After-Tax Percentage Rates of Return for Investors in S-Corporations and Taxable Corporations for Various Time Horizons

Type of corporation	Number of years					
	1	5	10	20	30	40
Pre-TRA 86 ¹						
S-Corporation.....	1.10	1.61	2.59	6.73	17.45	45.26
Taxable Corporation.....	1.09	1.54	2.43	6.42	17.55	48.58
Post-TRA 86 ²						
S-Corporation.....	1.14	1.96	3.84	14.74	56.60	217.29
Taxable Corporation.....	1.10	1.62	2.77	8.88	29.98	102.89
Post-RRA 93 ³						
S-Corporation.....	1.12	1.77	3.13	9.79	30.61	95.75
Taxable Corporation.....	1.09	1.61	2.72	8.58	28.44	95.88

Note: TRA 86 is the Tax Reform Act of 1986; RRA 93 is the Revenue Reconciliation Act of 1993.

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that under the pre-TRA 86 rules, after-tax returns for investors were similar for S-corporations and taxable corporations, with taxable corporation investors achieving superior results in the long-term. Under the post-TRA 86 rules, however, the after-tax returns to investors in S-corporations dominate their corporation counterparts for all time horizons, and the difference grows over time. These results suggest that TRA 86 further encouraged investors to conduct business in such a way as to avoid the double taxation of taxable corporations.

Avoiding the "Double Taxation" of Taxable Corporations

To avoid the corporate tax and achieve superior after-tax returns, investors could have chosen to: (1) elect S-corporation status, or (2) use the taxable corporate business form, but distribute corporate earnings to shareholders in tax deductible form. The option to elect S-corporation status is generally limited, however, to non-financial companies that do not own a controlling interest in another corporation and who have 35 or fewer U.S. citizens (or residents) as shareholders. Thus, larger corporations or those in the financial industries, are not likely to convert to S-corporation status.

Nonetheless, taxable corporations could effectively achieve "homemade" S-corporation status by distributing corporate earnings to their shareholders in tax deductible form. Such distributions include: (1) compensation (to shareholder-employees), (2) interest (to shareholder-creditors), or (3) rent (to shareholder-lessors). These distributions of what arguably should be profit are likely to be restricted to smaller companies whose management

and ownership groups are substantially identical. This observation is well known to the Internal Revenue Service, which closely reviews the validity of employee, creditor, and lessor relationships between shareholders and their corporations. To successfully avoid the corporate level tax, deductible payments must be ordinary, necessary, and reasonable (Section 162 of the Internal Revenue Code). For example, with regard to compensation, the U.S. Tax Court has established 12 factors to distinguish reasonable compensation from dividends [3]. Similarly, with respect to interest payments, the courts look to determine if the loans are *bona fide*. In this regard, Section 385 of the Internal Revenue Code provides guidance by listing the characteristics that distinguish between equity and debt investments [4].

As noted above, the factors involved in determining the deductibility of these payments to shareholders is complex and subject to interpretation. Thus, it is conceivable that many corporations that could not, or chose not to, convert to S-corporation status may have achieved the same tax benefits by altering their financial structure (renting assets and borrowing money from shareholders) to achieve similar tax savings.

Descriptive Analysis

Number of Taxpayers and Volume of Economic Activity

The share of economic activity conducted in S-corporation form increased substantially after TRA 86 [5]. Data on the number of returns, total assets, and business receipts in the taxable corporation sector of the economy are presented in Figures C, D, and E. The data in Figure C show an 11.6 percent decline in the total number of taxable

Figure C

U.S. Corporations: Number of Returns by Size of Total Assets, Tax Years 1984-1990

(All figures are estimates based on samples--number of returns is in thousands)

Tax year	All returns	Size of total assets						
		\$1 under \$100,000	\$100,000 under \$250,000	\$250,000 under \$500,000	\$500,000 under \$1,000,000	\$1,000,000 under \$5,000,000	\$5,000,000 under \$10,000,000	\$10,000,000 or more
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1984.....	2,274	1,162	454	265	179	170	22	23
1985.....	2,365	1,203	474	279	185	178	23	24
1986.....	2,370	1,204	476	278	184	180	24	25
1987.....	2,237	1,140	450	262	173	166	22	24
1988.....	2,080	1,043	411	247	169	164	21	24
1989.....	1,997	1,002	388	239	163	161	22	25
1990.....	1,946	974	373	234	161	156	21	26
1984-1986 average.....	2,336	1,190	468	274	183	176	23	24
1987-1990 average.....	2,065	1,040	406	246	167	162	22	25
Percentage increase.....	-11.60	-12.61	-13.25	-10.22	-8.74	-7.95	-4.35	4.17

NOTE: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

SOURCE: Data are based on a sample of corporation income tax returns for the selected tax years. For information about the sample, see Statistics of Income--Corporation Income Tax Returns, for the years concerned.

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Figure D

U.S. Corporations: Total Assets by Size, Tax Years 1984-1990

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

Tax year	All returns	Size of total assets						
		\$1 under \$100,000	\$100,000 under \$250,000	\$250,000 under \$500,000	\$500,000 under \$1,000,000	\$1,000,000 under \$5,000,000	\$5,000,000 under \$10,000,000	\$10,000,000 or more
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1984.....	5,202,620	41,438	73,372	93,844	124,788	347,805	152,042	4,369,331
1985.....	5,821,929	43,183	76,548	98,694	129,548	364,423	159,450	4,950,083
1986.....	6,268,494	42,193	76,938	98,736	128,925	367,359	162,779	5,391,564
1987.....	6,454,395	40,376	72,518	92,851	121,699	336,637	151,907	5,638,406
1988.....	6,941,633	36,548	66,908	87,493	119,188	335,021	147,849	6,148,626
1989.....	7,412,645	33,333	62,919	83,789	114,576	330,337	150,242	6,637,450
1990.....	7,677,948	32,065	60,948	83,405	114,333	319,906	149,113	6,918,177
1984-1986 average.....	5,764,348	42,271	75,619	97,091	127,754	359,862	158,090	4,903,659
1987-1990 average.....	7,121,655	35,581	65,823	86,885	117,449	330,475	149,778	6,335,665
Percentage increase.....	23.55	-15.83	-12.95	-10.51	-8.07	-8.17	-5.26	29.20

NOTE: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

SOURCE: Data are based on a sample of corporation income tax returns for the selected tax years. For information about the sample, see Statistics of Income—Corporation Income Tax Returns, for the years concerned.

corporations between 1984-86 (an average of 2.3 million) and 1987-90 (an average of 2.1 million). They also indicate that this decline is concentrated in the small-company categories, with the number of very-large taxable corporations increasing slightly. This finding is consistent with previous research, since small corporations are most likely to be able to elect S-corporation status.

The data in Figures D and E show that the total assets and business receipts in the taxable corporation sector as a whole rose substantially after TRA 86, with increases of 23.55 percent and 11.16 percent, respectively. However,

the small-corporation categories showed consistent declines along both dimensions, a result that agrees with the findings of previous research that companies converting to S-corporation status were small in size [6]. Figure F shows the percentage change in returns, total assets, and receipts for the periods before and after TRA 86.

Profits

Figure B showed the hypothetical after-tax returns to investors in S-corporations and taxable corporations when those businesses and investors experienced the highest

Figure E

U.S. Corporations: Business Receipts by Size of Total Assets, Tax Years 1984-1990

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

Tax year	All returns	Size of total assets						
		\$1 under \$100,000	\$100,000 under \$250,000	\$250,000 under \$500,000	\$500,000 under \$1,000,000	\$1,000,000 under \$5,000,000	\$5,000,000 under \$10,000,000	\$10,000,000 or more
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1984.....	6,121,638	191,681	208,604	227,345	287,643	776,400	301,124	4,128,840
1985.....	6,447,749	206,390	226,196	238,879	297,646	811,578	313,504	4,353,557
1986.....	6,419,944	210,052	233,145	252,337	296,267	815,696	322,630	4,289,817
1987.....	6,658,858	205,179	229,518	234,876	285,812	732,211	289,358	4,681,903
1988.....	6,890,206	198,953	209,840	224,434	269,093	730,280	282,406	4,975,200
1989.....	7,173,210	178,868	204,647	217,541	265,917	711,274	285,317	5,309,647
1990.....	7,422,151	179,097	194,615	215,055	272,099	679,725	283,285	5,598,274
1984-1986 average.....	6,329,777	202,708	222,648	239,520	293,852	801,225	312,419	4,257,405
1987-1990 average.....	7,036,106	190,524	209,655	222,977	273,230	713,373	285,092	5,141,256
Percentage increase.....	11.16	-6.01	-5.84	-6.91	-7.02	-10.96	-8.75	20.76

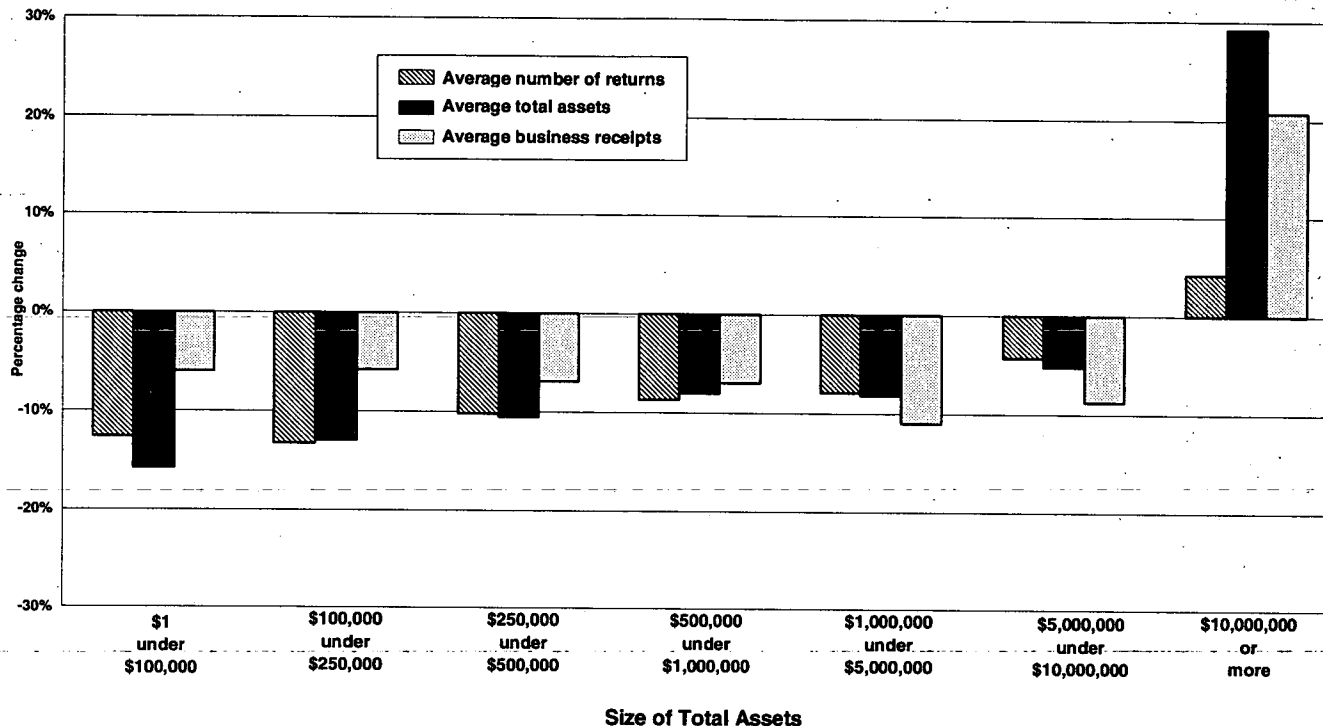
NOTE: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

SOURCE: Data are based on a sample of corporation income tax returns for the selected tax years. For information about the sample, see Statistics of Income—Corporation Income Tax Returns, for the years concerned.

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Figure F

Taxable Corporations: Percentage Changes in the Average Number of Returns, Total Assets, and Receipts by Size of Total Assets, Tax Years 1984-1986 to 1987-1990



Notes: The graph depicts the percentage change in the average number of returns, total assets, and business receipts shown in Figures C, D, and E. The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

marginal tax rates. These equations showed that TRA 86 provided a strong tax incentive for *profitable* corporations to elect S-corporation status or to create "homemade" S-corporation status by distributing corporate earnings in tax deductible form. The data in Figures G and H show the taxable income of corporations in the pre- and post-TRA 86 periods. In presenting these data, differences in company size are controlled by scaling taxable income by total assets (Figure G) and business receipts (Figure H). Finally, these figures include the annual values for taxable income, their annual mean values during the pre- and post-TRA 86 periods, and the amount of change between the two periods.

The data presented in Figures G and H reveal three consistent trends, which are shown graphically in Figures I and J. First, profitability generally increases with asset size. Second, all taxable corporations, except the very largest, showed strong decreases in taxable income after

TRA 86. Third, the amount of decrease in taxable income is inversely related to asset size. These results can be explained in three ways. First, some evidence indicating that profitable corporations elected S-corporation status subsequent to TRA 86 exists [7]. Second, the corporations that were unable to elect S-corporation status, may have reduced the amount of corporate earnings subject to the corporate tax by distributing deductible dividends. Third, the ability to elect S-corporation status or pay deductible dividends appears to be inversely related to asset size, perhaps because the owners' and managers' interests are closely connected in small companies.

Deductible Dividends

For a variety of reasons, many corporations did not convert to S-corporation status. For example, as discussed earlier, corporations with more than one class of stock are prohibited from making this election.

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Figure G

U.S. Corporations: Net Income (less Deficit) as a Percentage of Total Assets, by Size of Total Assets, Tax Years 1984-1990

[All figures are estimates based on samples]

Tax year	All returns	Size of total assets						
		\$1 under \$100,000	\$100,000 under \$250,000	\$250,000 under \$500,000	\$500,000 under \$1,000,000	\$1,000,000 under \$5,000,000	\$5,000,000 under \$10,000,000	\$10,000,000 or more
		(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Percentages							
1984.....	3.11	-5.17	2.02	2.16	2.19	2.12	2.20	3.37
1985.....	2.59	-5.76	1.67	1.80	1.49	1.63	1.43	2.83
1986.....	2.19	-5.66	1.74	1.93	1.49	1.72	1.54	2.33
1987.....	2.91	-7.60	1.23	1.88	1.28	1.48	1.47	3.19
1988.....	3.62	-10.96	-0.43	0.55	1.12	1.21	1.39	4.02
1989.....	2.88	-10.68	-1.32	-0.78	0.84	0.50	0.95	3.24
1990.....	2.60	-14.10	-1.99	-0.42	0.05	-0.07	0.27	2.97
1984-1986 average.....	2.63	-5.53	1.81	1.96	1.72	1.82	1.72	2.84
1987-1990 average.....	3.00	-10.84	-0.63	0.31	0.82	0.78	1.02	3.36
Increase.....	0.37	-5.31	-2.44	-1.65	-0.90	-1.04	-0.70	0.52

NOTE: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

SOURCE: Data are based on a sample of corporation income tax returns for the selected tax years. For information about the sample, see Statistics of Income—Corporation Income Tax Returns, for the years concerned.

Figure H

U.S. Corporations: Net Income (less Deficit) as a Percentage of Business Receipts, by Size of Total Assets, Tax Years 1984-1990

[All figures are estimates based on samples]

Tax year	All returns	Size of total assets						
		\$1 under \$100,000	\$100,000 under \$250,000	\$250,000 under \$500,000	\$500,000 under \$1,000,000	\$1,000,000 under \$5,000,000	\$5,000,000 under \$10,000,000	\$10,000,000 or more
		(1)	(2)	(3)	(4)	(5)	(6)	(7)
		Percentages						
1984.....	2.65	-1.12	0.71	0.89	0.95	0.95	1.11	3.57
1985.....	2.34	-1.21	0.56	0.74	0.65	0.73	0.73	3.22
1986.....	2.14	-1.14	0.58	0.75	0.65	0.77	0.77	2.93
1987.....	2.82	-1.50	0.39	0.74	0.54	0.68	0.77	3.84
1988.....	3.64	-2.01	-0.14	0.21	0.50	0.55	0.73	4.97
1989.....	2.98	-1.99	-0.40	-0.30	0.28	0.23	0.50	4.05
1990.....	2.69	-2.52	-0.62	-0.16	0.02	-0.03	0.14	3.67
1984-1986 average.....	2.38	-1.16	0.62	0.79	0.75	0.82	0.87	3.24
1987-1990 average.....	3.03	-2.00	-0.19	0.12	0.34	0.36	0.54	4.13
Increase.....	0.65	-0.84	-0.81	-0.67	-0.41	-0.46	-0.33	0.89

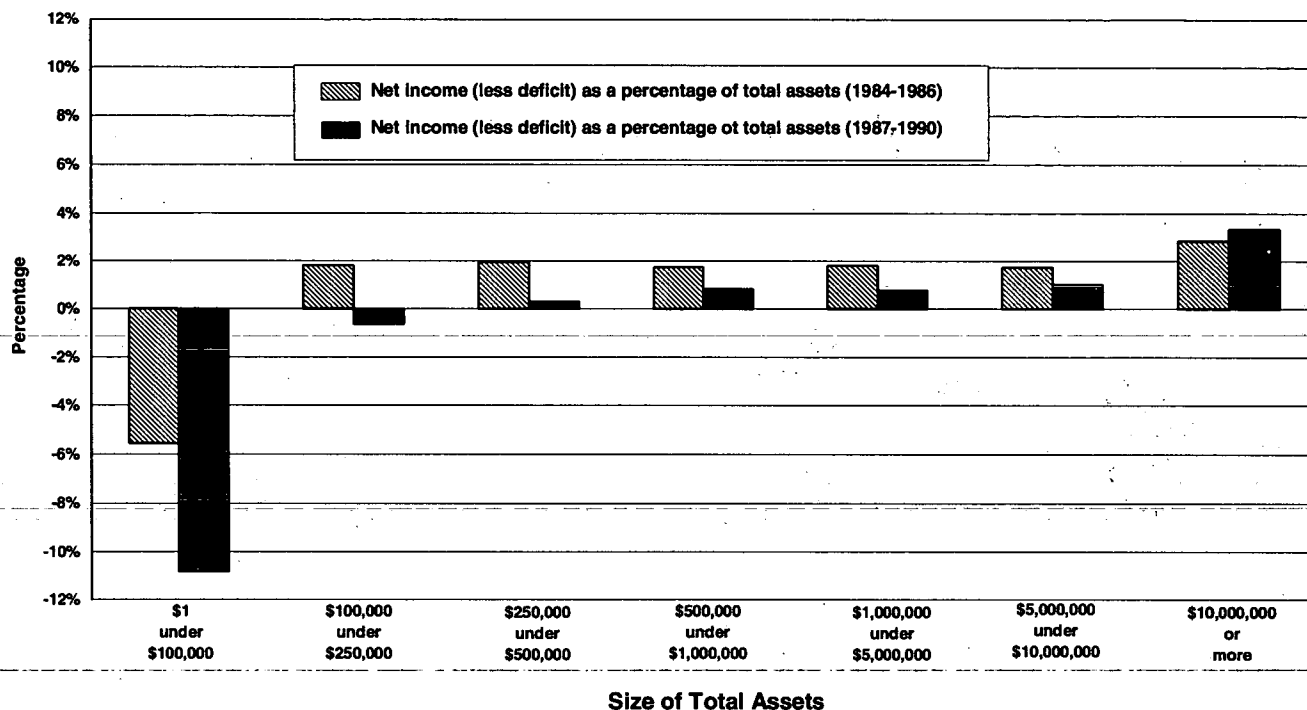
NOTE: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

SOURCE: Data are based on a sample of corporation income tax returns for the selected tax years. For information about the sample, see Statistics of Income—Corporation Income Tax Returns, for the years concerned.

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Figure I

Taxable Corporations: Net Income (less Deficit) as a Percentage of Total Assets, by Size of Total Assets, Tax Years 1984-1986 and 1987-1990



Note: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

Nonetheless, these taxable corporations could achieve homemade S-corporation status by distributing corporate earnings to shareholders in tax deductible form. Such payments, whether in the form of interest, rents, or employee compensation, are deductible by the corporation (and thus, they avoid the corporate tax), assuming the contractual relationships are bona fide and the amounts are ordinary, necessary, and reasonable (Section 162 of the Internal Revenue Code).

Data on the amount of potential deductible dividends are shown in Figure K, where "distributable income" is used to control for differences in company size. Distributable income is the sum of four items: (1) net income (less deficit), (2) rental expense, (3) interest expense, and (4) officer's compensation. The ratio of these potential deductible dividends (rental expense, interest expense, and officer's compensation) to distributable income shows the portion of distributable income that escapes corporate taxation. The amounts included in Figure K include annual data and the annual means for the pre- and post-

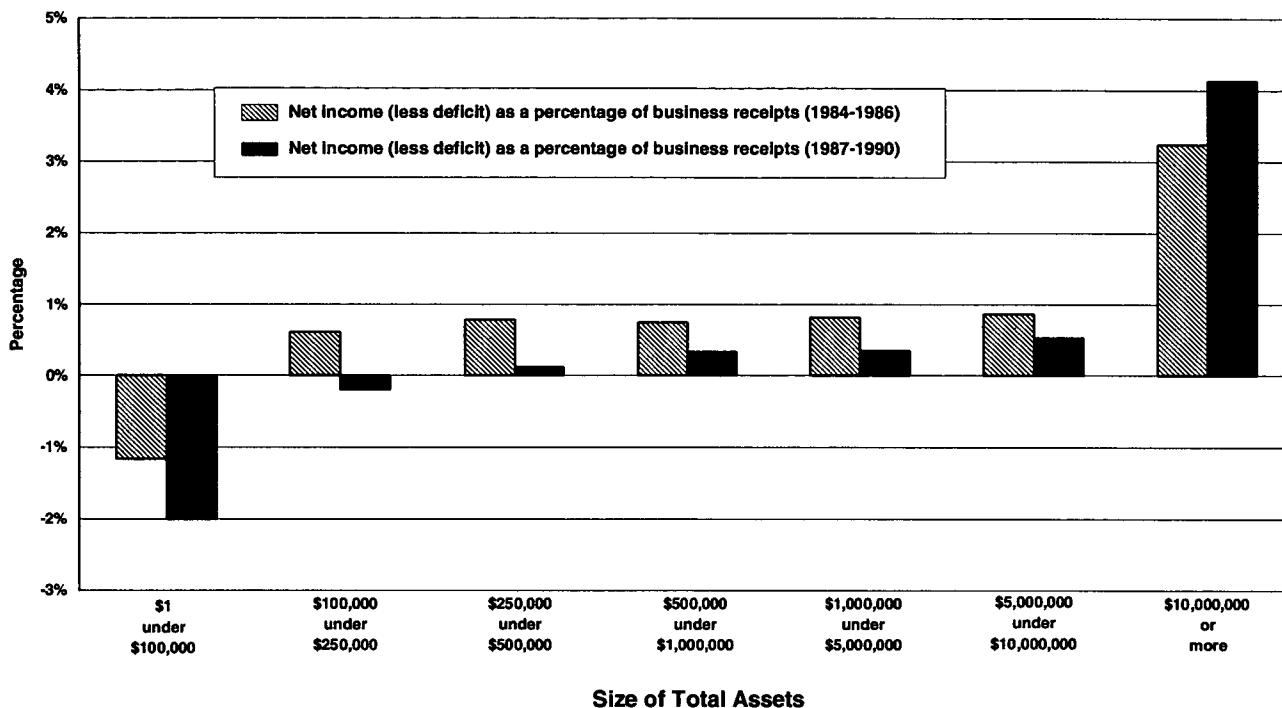
TRA 86 periods.

Three trends appear in the data presented in Figure K and shown graphically in Figure L. First, the payment of deductible dividends is inversely related to company size. This is consistent with the idea that smaller and more closely-held corporations are better able to create the necessary contractual arrangements that allow these payments to occur. Second, the amount of potential deductible dividends increased substantially for each company-size category, with the exception of the largest corporations. This too is consistent with the notion that taxable corporations achieved homemade S-corporation status by distributing corporate earnings to shareholders in tax deductible forms (i.e., interest, rent, and compensation payments to shareholders). Third, the amount of potential deductible dividends approaches 100 percent of distributable income for all but the largest corporations (and exceeds 100 percent for the smallest corporations, which indicates that the payment of these potential deductible dividends created a net operating loss). Thus, for all but

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Figure J

Taxable Corporations: Net Income (less Deficit) as a Percentage of Business Receipts, by Size of Total Assets, Tax Years 1984-1986 and 1987-1990



Note: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

Figure K

U.S. Corporations: "Deductible Dividends" as a Percentage of "Distributable Income," by Size of Total Assets, Tax Years 1984-1990

[All figures are estimates based on samples]

Tax year	All returns	Size of total assets						
		\$1 under \$100,000	\$100,000 under \$250,000	\$250,000 under \$500,000	\$500,000 under \$1,000,000	\$1,000,000 under \$5,000,000	\$5,000,000 under \$10,000,000	\$10,000,000 or more
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Percentages								
1984.....	72.11	105.47	85.39	92.01	89.69	85.96	81.81	61.95
1985.....	75.20	106.21	86.33	93.53	92.85	88.81	87.38	65.61
1986.....	77.98	105.76	86.39	93.16	93.09	88.74	86.52	69.58
1987.....	71.93	107.60	87.30	93.99	94.19	90.10	86.60	61.95
1988.....	66.70	112.52	101.00	98.18	94.69	91.88	87.83	56.97
1989.....	71.78	113.68	103.29	103.01	96.96	96.58	91.56	63.89
1990.....	73.77	118.87	105.21	101.59	99.75	100.48	97.45	66.10
1984-1986 average.....	75.04	106.52	86.67	93.56	93.38	89.22	86.83	65.71
1987-1990 average.....	70.75	115.02	103.17	100.93	97.13	96.31	92.28	62.32
Percentage increase.....	-5.72	7.98	19.04	7.88	4.02	7.95	6.28	-5.16

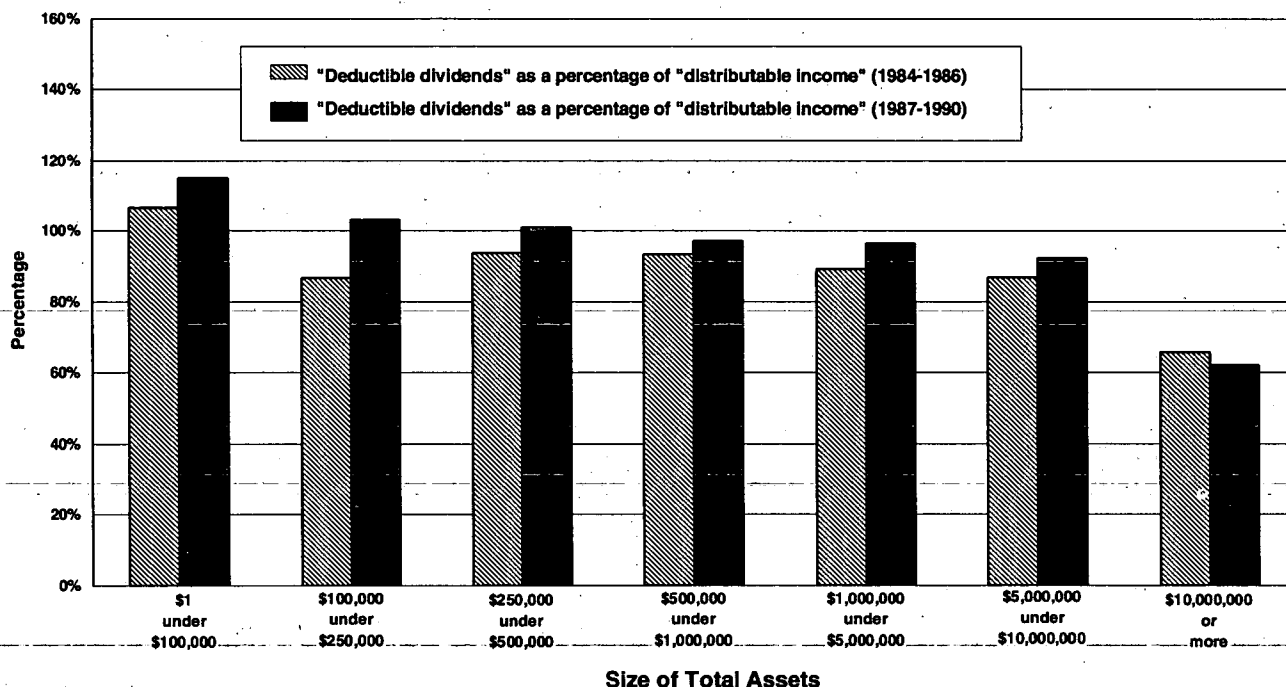
NOTE: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

SOURCE: Data are based on a sample of corporation income tax returns for the selected tax years. For information about the sample, see Statistics of Income—Corporation Income Tax Returns, for the years concerned.

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Figure L

Taxable Corporations: "Deductible Dividends" as a Percentage of "Distributable Income," by Size of Total Assets, Tax Years 1984-1986 and 1987-1990



Note: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

the largest corporations, the double taxation of corporate earnings was reduced via these payments of interest, rent, and officer's compensation.

Debt Capital Provided by Shareholders

To the extent that corporations responded to TRA 86 by increasing their payments of deductible dividends, smaller amounts of earnings were subject to the corporate tax, but less income remained within the corporation for reinvestment. To offset this reduction in retained earnings and maintain its investment capital, corporations might be expected to obtain additional debt capital, especially from shareholders. Loans to and from shareholders are reported as part of the corporation's income tax return. The data in Figures M and N show the amount of loans received by corporations from their shareholders and the loans made to shareholders by their

corporations, respectively. The data are shown as a percentage of total assets to control for company size, and are shown both annually and by annual means during the pre- and post-TRA 86 periods. The data are also shown graphically in Figures O and P. For larger corporations, these loans include loans to and from corporate affiliates.

The data in Figure M indicate that loans received by corporations from their shareholders are inversely related to asset size. However, these data also show that loans from shareholders increased substantially following the enactment of TRA 86, especially for corporations in the smallest size categories. No similar effect appears for loans to shareholders (Figure N). This finding is further evidence in support of the notion that taxable corporations attempted to achieve homemade S-corporation status by obtaining loans from their shareholders (and, thus, making deductible interest payments).

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Figure M

U.S. Corporations: Loans from Shareholders as a Percentage of Total Assets, by Size of Total Assets, Tax Years 1984-1990

[All figures are estimates based on samples]

Tax year	All returns	Size of total assets						
		\$1 under \$100,000	\$100,000 under \$250,000	\$250,000 under \$500,000	\$500,000 under \$1,000,000	\$1,000,000 under \$5,000,000	\$5,000,000 under \$10,000,000	\$10,000,000 or more
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Percentages								
1984.....	1.72	21.12	11.01	7.47	5.29	3.36	1.91	1.02
1985.....	1.84	21.38	10.12	7.39	5.27	3.38	2.15	1.22
1986.....	1.93	22.76	11.06	7.65	5.78	3.72	2.12	1.31
1987.....	2.12	23.12	11.46	7.89	6.26	4.15	2.61	1.54
1988.....	2.22	25.03	12.51	8.56	6.59	4.58	2.87	1.66
1989.....	1.96	26.60	13.28	8.74	7.33	5.23	2.85	1.37
1990.....	1.98	32.58	13.39	8.97	7.18	5.59	3.32	1.37
1984-1986 average.....	1.83	21.75	10.73	7.50	5.45	3.49	2.06	1.18
1987-1990 average.....	2.07	26.83	12.66	8.54	6.84	4.89	2.91	1.49
Percentage increase.....	13.11	23.36	17.99	13.87	25.50	40.11	41.26	26.27

NOTE: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

SOURCE: Data are based on a sample of corporation income tax returns for the selected tax years. For information about the sample, see Statistics of Income—Corporation Income Tax Returns, for the years concerned.

Figure N

U.S. Corporations: Loans to Shareholders as a Percentage of Total Assets, by Size of Total Assets, Tax Years 1984-1990

[All figures are estimates based on samples]

Tax year	All returns	Size of total assets						
		\$1 under \$100,000	\$100,000 under \$250,000	\$250,000 under \$500,000	\$500,000 under \$1,000,000	\$1,000,000 under \$5,000,000	\$5,000,000 under \$10,000,000	\$10,000,000 or more
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Percentages								
1984.....	0.81	7.83	5.56	3.44	2.14	1.31	0.78	0.53
1985.....	0.74	8.52	5.76	3.71	2.30	1.39	0.86	0.44
1986.....	0.77	8.71	5.89	3.84	2.35	1.40	0.93	0.50
1987.....	0.76	8.74	6.56	3.92	2.43	1.38	0.98	0.49
1988.....	0.82	8.83	5.50	3.97	2.32	1.32	0.92	0.82
1989.....	0.63	7.95	5.58	3.95	2.14	1.29	0.80	0.44
1990.....	0.66	7.62	5.56	3.69	2.40	1.30	0.84	0.49
1984-1986 average.....	0.77	8.35	5.74	3.66	2.26	1.37	0.86	0.49
1987-1990 average.....	0.72	8.29	5.80	3.88	2.32	1.32	0.89	0.56
Percentage increase.....	-6.49	-0.72	1.05	6.01	2.65	-3.65	3.49	14.29

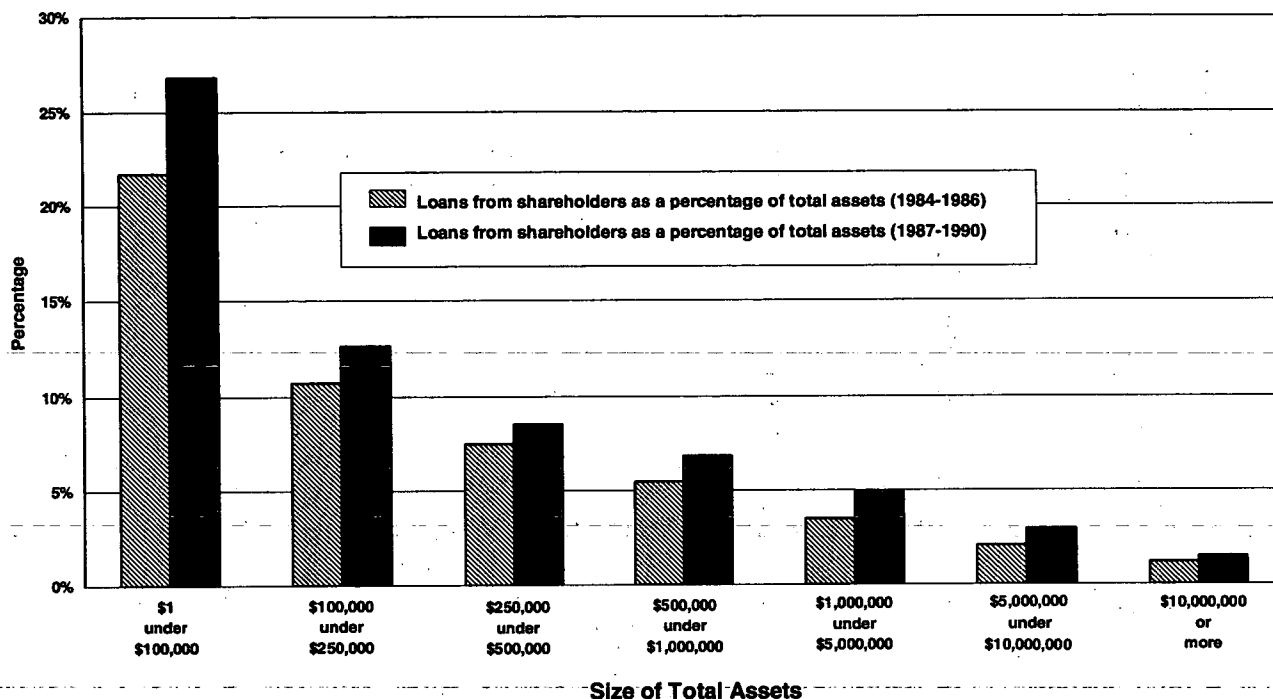
NOTE: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

SOURCE: Data are based on a sample of corporation income tax returns for the selected tax years. For information about the sample, see Statistics of Income—Corporation Income Tax Returns, for the years concerned.

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Figure 0

Taxable Corporations: Loans from Shareholders as a Percentage of Total Assets, by Size of Total Assets, Tax Years 1984-1986 and 1987-1990



Note: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

Summary and Conclusion

In this paper we reviewed some of the major tax changes associated with the Tax Reform Act of 1986 and calculated that under some assumptions, after TRA 86, investors in S-corporations earned higher after-tax returns than investors in taxable corporations, all other things being equal. These higher returns undoubtedly led to the large increases in the number of non-corporate businesses that occurred after passage of TRA 86.

Corporations that did not convert to S-corporations nonetheless could effectively achieve homemade S-corporation status by distributing corporate earnings in tax deductible form. These distributions, whether described as interest payments, rental fees, or compensation, reduced the amount of distributable income subject to the corporate tax, as long as the contractual arrangements

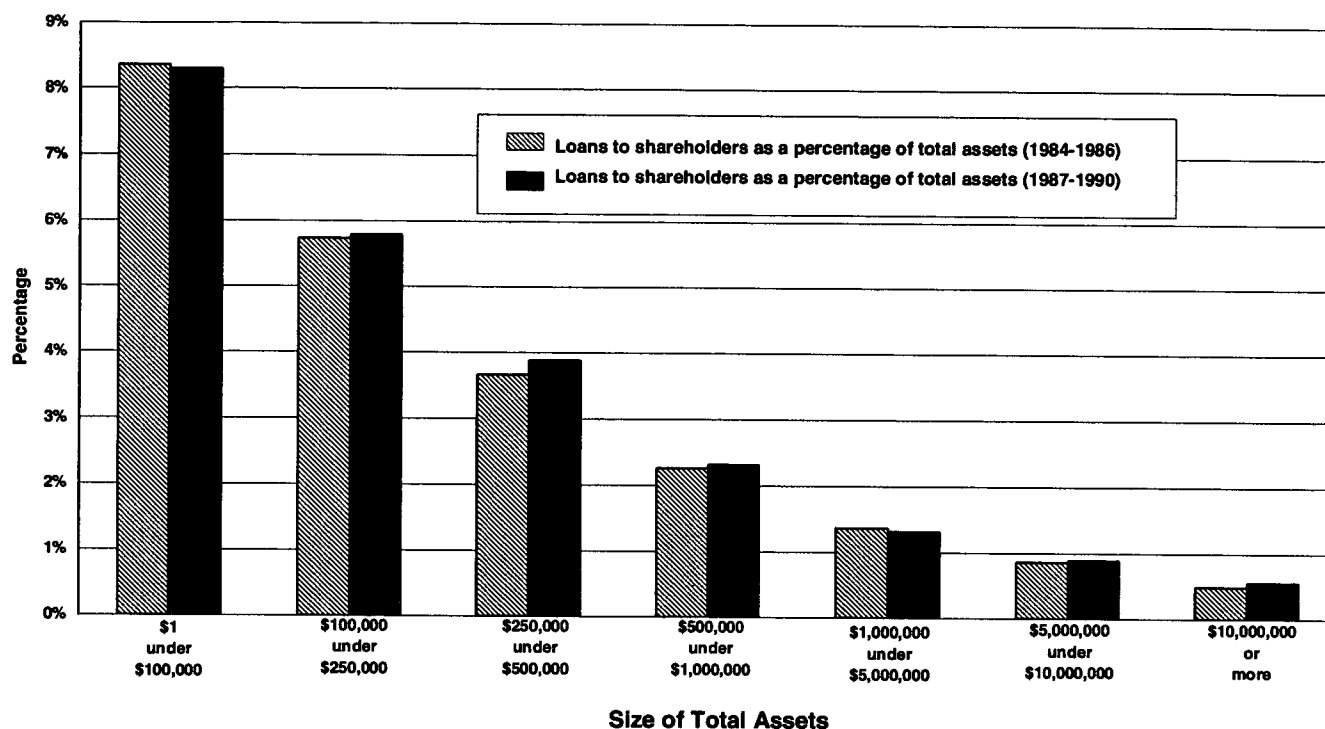
were bona fide and the amounts paid were ordinary, necessary, and reasonable, as specified in Section 162 of the Internal Revenue Code.

The data presented here show a dramatic decline in the number and profitability of smaller taxable corporations, which mirrors the increase in the number and profitability of S-corporations after TRA 86. In addition, corporations that did not convert to S-corporation status reduced the amount of their distributable income that was subject to the corporate level tax by paying-out various types of potential deductible dividends. Finally, the data show that these corporations increased the amount of loans received from their shareholders, which is also consistent with the notion of that such corporations increased the level of their deductible distributions or potential deductible dividends.

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Figure P

Taxable Corporations: Loans to Shareholders as a Percentage of Total Assets, by Size of Total Assets, Tax Years 1984-1986 and 1987-1990



Note: The data include all corporations with assets greater than zero, except those filing Forms 1120S (U.S. Income Tax Return for an S-Corporation), 1120F (U.S. Income Tax Return of a Foreign Corporation), and returns of corporations classified in finance, insurance, and real estate (excluding insurance agents, brokers, or service).

Explanation of Selected Terms

Business receipts.--Business receipts were, in general, the gross operating receipts of the corporation reduced by the cost of returned goods and allowances. For additional information on business receipts, see *Statistics of Income -- Corporation Income Tax Returns* for the selected Tax Year.

Deductible dividends.--For purposes of this article, deductible dividends are defined as the sum of the deductions for compensation to officers, interest, and rent. The definition of deductible dividends is subject to measurement error. The measure is limited in that, due to data limitations, the payments cannot be traced directly to the shareholders nor can their deductibility under Internal Revenue Code section 162 be assessed.

Taxable corporation.--For purposes of this article, a taxable corporation is subject to taxation under Subchapter C of the Internal Revenue Code. These

taxable corporations are treated as a separate taxpaying entity for Federal income tax purposes. S-corporations generally are not directly subject to Federal income taxation. S-corporations do, however, pay Federal income taxes directly in limited circumstances for items such as the "built-in gains" tax on the disposal of net appreciated property.

Data Sources and Limitations

The data used in this analysis were collected from Statistics of Income annual samples of corporate income tax returns. The analysis used data from all corporate income tax returns for Tax Years 1984 through 1990 with the exception of corporations filing Form 1120S, Form 1120F, those corporations in the finance and insurance industries (except insurance agents) and returns with zero assets. These excluded returns were filed by corporations that are uniquely taxed, subject to special provisions of the

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Internal Revenue Code, or report gross income in a way that makes inclusion in our analysis difficult. The corporations are then partitioned into seven size categories, based on their reported total assets.

Notes and References

[1] See, for example, Gordon, R. G. and MacKie-Mason, J., "Effects of the Tax Reform Act of 1986 on Corporate Financial Policy and Organizational Form," in J. B. Slemrod, ed., *Do Taxes Matter? The Impact of the Tax Reform Act of 1986*, Cambridge: MIT Press. (1991): 91-131; Nelson, S., "S Corporations Since the Tax Reform Act of 1986," *Proceedings of the National Tax Association Meetings* (November 1991): 18-24; Nelson, S., "S Corporations: The Record of Growth After Tax Reform," *Journal of S Corporation Taxation* 5 (Fall 1993): 138-161; Petska, T. B. and Wilson, R. A., "Trends in Business Structure and Activity, 1980-1990," *SOI Bulletin* 13 (Spring 1994): 27-72; and Plesko, G. A., "Entity Choice: Financial Characteristics of S and C Corporations," *Public Finance Quarterly* 22 (July 1994): 311-334.

[2] The data in Figure B are derived from the assumptions and equations herein. First, assume that a business earns a pre-tax rate of return of 20 percent regardless of business form. Second, the Internal Revenue Code specifies corporate and individual tax rates and the amount of capital gain income that must be included in gross income. In the pre-TRA 86 period (1984-1986), the maximum corporate tax rate was 46 percent, the maximum individual tax rate was 50 percent, and the capital gains income inclusion was 50 percent. In the post-TRA 86 period, the maximum corporate tax rate was 34 percent, the maximum individual tax rate was 28 percent (ignoring the 5 percent surtax to phase-out exemptions), and the capital gains income inclusion was 100 percent. Third, assume that the C-corporation does not distribute dividends, but is liquidated at some future point in time (and any funds retained in the C-corporation are distributed to owners and capital gains recognized). Fourth, assume that the S-corporation makes annual cash distributions that are sufficient to enable its owners to pay the tax that pertains to the business income. The equations below do not take into account inflation.

An investor in an S-corporation earns an after-tax rate of return for n periods as described below in equation (1):

$$[1 + R(1 - t_c)]^n$$

In words, the S-corporation earns a pre-tax rate of return, R , on an investment of \$1.00 that is subject to tax at the individual investor's tax rate of t_i . This after-tax amount is then reinvested for n periods. For the corporate investor, however, the after-tax rate of return over n periods is described below by equation (2),

$$[1 + R(1 - t_c)]^n - g_t ([1 + R(1 - t_c)]^n - 1).$$

The first term in equation (2), $[1 + R(1 - t_c)]^n$, states that the C-corporation earns a pre-tax return, R , on a \$1.00 investment, which is then subject to the corporate tax rate of t_c . The after-corporate-tax amount is then reinvested for n periods. The second term in equation (2), $g_t ([1 + R(1 - t_c)]^n - 1)$, states that upon liquidation of the C-corporation (or the sale of shares by the shareholders), the after-corporate-tax assets in the corporation, less the initial investment of \$1.00, $([1 + R(1 - t_c)]^n - 1)$, are subject to tax at the shareholder level. The amount of tax paid by the shareholder, g_t , depends upon t_i , the tax on ordinary income, and g , the portion of the gain subject to taxation. Equation (2) assumes that the corporation does not distribute dividends to its shareholders. If such dividends are paid, the after-tax return to investors falls because such dividends do not benefit from the capital gains deduction and fewer assets are available for reinvestment within the corporation. For additional information, see Scholes, M. S., and Wolfson, M. K., *Taxes and Business Strategy: A Planning Approach*, New Jersey: Prentice-Hall (1991).

[3] The twelve factors identified by the U. S. Tax Court are as follows: (1) the employee's qualifications; (2) the nature, extent, and scope of the employee's work; (3) the size and complexity of the business; (4) a comparison of salaries paid with sales, gross income, and capital value; (5) general economic conditions; (6) a comparison of salaries to distributions to shareholders and retained earnings; (7) employer's salary policy for all employees; (8) employer's financial condition; (9) the prevailing rates of compensation for comparable positions and companies; (10) the compensation paid in prior years; (11) whether the employee and employer dealt with each other at arm's length; and (12) whether the employee guaranteed the employer's debt. For additional information see, *Acme Construction Co., Inc.* (69 TCM 1596), *BOCA Construction Inc.* (69 TCM 1589), and *Comtec Systems, Inc.* (69 TCM 1581).

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[4] These characteristics include: (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth and to pay a fixed rate of interest; (2) whether there is subordination to or preference over any indebtedness of the corporation; (3) the ratio of debt to equity of the corporation; (4) whether there is convertibility into the stock of the corporation; and (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

[5] See note 1 above.

[6] See, for example, Gill, A.M. "S Corporation Returns, 1992," *SOI Bulletin* 14 (Spring 1995): 73-100; Nelson, S., "S Corporations Since the Tax Reform Act of 1986," *Proceedings of the National Tax*

Association Meetings (November 1991): 18-24; Nelson, S., "S Corporations: The Record of Growth After Tax Reform," *Journal of S Corporation Taxation* 5 (Fall 1993): 138-161; Petska, T. B. and Wilson, R. A., "Trends in Business Structure and Activity, 1980-1990," *SOI Bulletin* 13 (Spring 1994): 27-72; Plesko, G. A., "Entity Choice: Financial Characteristics of S and C Corporations," *Public Finance Quarterly* 22 (July 1994): 311-334; and Plesko, G. A., "The Role of Taxes in Organizational Choice: S Conversions After the Tax Reform Act of 1986," working paper (1995).

[7] See Carroll, R., and Joulfaian, D., "Taxes and Corporate Choice of Organizational Form," working paper (1995), and Plesko, G. A., "The Role of Taxes in Organizational Choice: S Conversions After the Tax Reform Act of 1986," working paper (1995).