

CHANGES IN THE ORGANIZATION OF BUSINESS ACTIVITY AND IMPLICATIONS FOR TAX REFORM

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We review the changing economic significance of various business entity types since the Tax Reform Act of 1986 (TRA86) and the implications of these changes for the design of tax policy. In particular, we focus on the increased role of pass-through entities and the declining significance of the taxable corporate form. Our analysis suggests that significant reductions in the corporate tax rate, absent changes in the personal tax rate, will likely reverse the organizational form incentives that have existed since TRA86. Further, if the loss in revenue from a rate reduction is offset by a broadening of the tax base, most business entities, comprising most business income, are likely to face an overall increase in their tax burden.

Keywords: corporate tax, organizational form, tax rates

JEL Codes: H25, K34

I. INTRODUCTION

In the 27 years since the passage of the Tax Reform Act of 1986 (TRA86) the significance that various types of organizational forms have played in business activity has changed dramatically. This evolution has taken place in response to changes in the rates of tax on various types of income, changes in the types of legal entities providing limited liability, and other changes in the economic and, more importantly, legal landscape governing the operation of business. As part of recent policy discussions broad changes are being contemplated for both the individual and corporate rate schedules, as well as many of the key structures and provisions that govern business taxation. One theme among these proposals is a reduction in the maximum statutory corporate income tax rate with the decrease in revenue offset by a broadening of the business tax base.

This paper surveys the trends in corporate and other business activity during these past 25 years. We begin with a review of the numerous legal changes that took place as a result of TRA86 and describe their effect on organizational form decisions by businesses. In the following two sections we examine federal corporate income tax

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receipts and provide an analysis of trends in corporate and non-corporate tax revenues. The fourth section provides data on the distribution of business income and taxes by organizational form, describes other changes that have taken place over time, and discusses the implications of these trends for legislative proposals. In Section V we present estimates of the possible effects of recently proposed legislation on organizational form decisions. We conclude with a discussion of our results in the context of proposals for changes in the corporate tax system.

II. CHANGES INFLUENCING BUSINESS ORGANIZATION SINCE TRA86

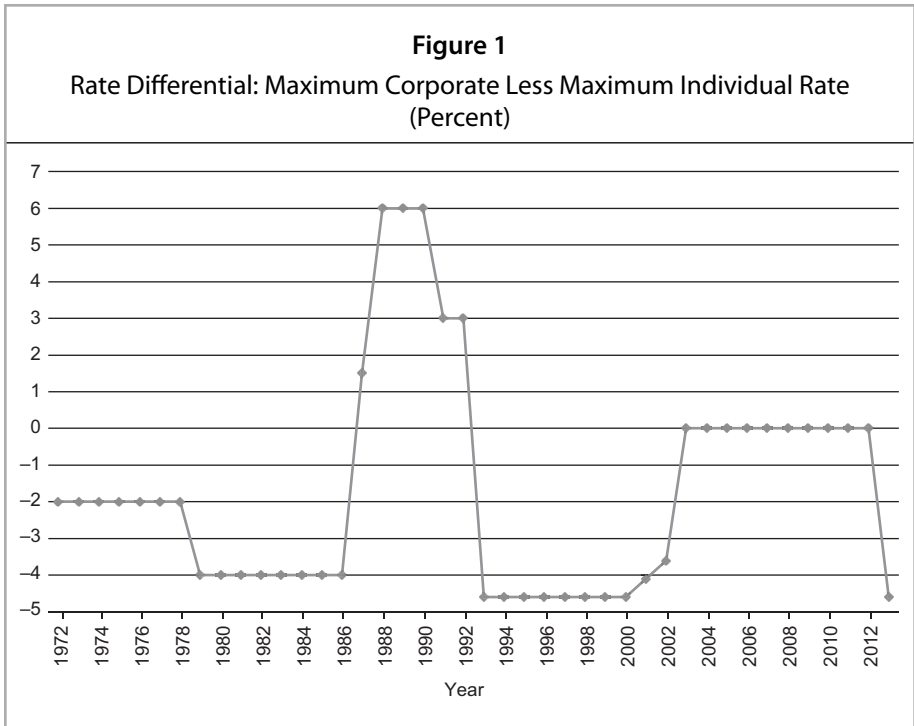
Businesses may operate in a variety of organizational forms, ranging from sole proprietorships to multinational corporations comprised of a variety of entities characterized by sole or shared ownership.¹ There are a number of factors that differentiate these entity types, the most significant (for purposes of this paper) being whether there is limited liability protecting the shareholders (or owners) and whether the income earned by the business is taxed only once, at the shareholder level, or twice, first with an entity-level tax and second at the shareholder level with the tax triggered by the payment of a dividend or the sale of shares.

Under Subchapter C of the Internal Revenue Code, income earned by a corporation is first taxed at the corporate level and then again at the shareholder level when the income is distributed, with transfers of shares resulting in a capital gain or loss for shareholders. Until the distribution or capital gains realization occurs, however, only the corporate tax is paid and the potential shareholder dividend tax or capital gains liability is deferred, with the retained income after corporate tax remaining at the disposal of the corporation. However, if the restrictions of Subchapter S of the Code are met, and the corporation elects Subchapter S status, the corporate level tax is eliminated and the income earned by the corporation is immediately taxed at the shareholder level regardless of any distribution. Partnerships, including Limited Liability Corporations (LLCs) and Limited Liability Partnerships (LLPs), are also pass-through entities, with the income and expenses of the business allocated among the owners. By contrast, sole proprietorships are not legally distinct from their owners and do not have limited liability, and their income and expenses are reported only on the owner's income tax return.

Individually and combined, a number of provisions in TRA86 increased the incentives for businesses to opt out of the corporate level tax and seek to be taxed as a pass-through,— primarily by converting to an S corporation because such a change had no other effect on the organizational structure or legal status of the entity other than the change in tax treatment.² Most importantly, TRA86 reduced the top individual tax rate below the corporate tax rate (Figure 1). Over a 2-year phase-in period, the maximum individual rate was reduced from 50 to 28 percent while the corporate rate declined

¹ See Dennis-Escoffier and Fortin (2011) for a description of the tax rules for various business entities.

² See Plesko (1995), Ayers, Cloyd, and Robinson (1996), Wittman and Gill (1998), Petska et al. (2005), and Congressional Budget Office (2012) for general descriptions of these incentives. Omer, Plesko, and Shelley (2000) and Hodder, McAnalley, and Weaver (2003) provide industry-specific analyses.



from 46 to 34 percent. As a result, the incentives under prior law to use a taxable corporation to lower current tax liabilities and defer (and possibly permanently avoid) the individual tax were reversed, with businesses organized as C corporations now subject to a higher tax burden than pass-through entities even if they did not distribute their profits. Other provisions of TRA86 created additional disincentives to remaining a C corporation. First, TRA86 introduced a new corporate Alternative Minimum Tax, which made it more difficult for a C corporation to reduce its taxes or avoid paying a corporate tax altogether. Second, TRA86 repealed the *General Utilities* doctrine, under which a C corporation that sold its assets to another corporation was able to distribute the proceeds of the sale to shareholders without having to pay a corporate level tax. The repeal of *General Utilities* meant any income on a subsequent sale would also be subject to two levels of tax instead of one. Intensifying the need for corporations to make these decisions quickly, TRA86 also modified the tax rules for built-in gains on S corporations that had existed while the company was a C corporation. For conversions that took place prior to 1987 there remained a three-year, rather than a newly-enacted 10-year, recognition period for these gains.

The inverted rate structure lasted until 1993 when the Omnibus Budget Reconciliation Act of 1993 increased the maximum individual rate to 36 percent with a 10 percent surtax on income in excess of \$250,000 (married filing jointly), and thus created a new maximum individual marginal tax rate of 39.6 percent. In addition, a new corporate

tax rate of 35 percent was introduced on taxable income in excess of \$10 million, and a new phase out of the 34 percent tax rate levied a 3 percent surcharge on income in the phase-out range. The 2001 Economic Growth and Tax Relief Reconciliation Act, along with the Jobs and Growth Tax Relief Reconciliation Act of 2003, reduced the top individual rate to 35 percent, the same as the top corporate rate, beginning in 2003, and those two equal maximum rates persisted through the end of 2012.

Other changes encouraged the expansion of pass-through entities during this period. The number of shareholders allowed in an S corporation rose from 35 to 100, and changes in state laws facilitated the growth of LLPs and LLCs. In 1997 the Internal Revenue Service issued its “check the box” rules, which make it easy for businesses to opt out of federal entity level taxation.

III. CORPORATE AND OTHER BUSINESS TAX RECEIPTS IN THE FEDERAL BUDGET

The combination of tax rates and tax bases determines revenues from business profits. As the profits of pass-through entities have increased as a share of total business income the shares of business tax revenues coming from owners of pass-through enterprises has increased relative to the share from the corporate income tax.

The Tax Policy Center (TPC) has estimated individual income tax revenues from the income of sole-proprietorships, partnerships, and subchapter S corporations going back to 2004 and projected forward to 2022 (Table 1 and Figure 2). CBO projects corporate taxes will increase to \$459 billion in 2022 from \$189 billion in 2004, an annual growth rate of 5.1 percent.³ TPC projects that individual income taxes on business income will increase from \$102 billion in 2004 to \$436 billion in 2022, for an annual growth rate of 8.4 percent. By the end of the projection period, individual revenues from business taxation will be almost as large (95 percent) as corporate tax receipts.⁴

IV. TRENDS IN BUSINESS ACTIVITY AND ORGANIZATIONAL FORM

Since 1980, the overall number of tax returns reporting business income has grown from 13 million to 31.6 million.⁵ Of these returns, the vast and increasing majority are nonfarm sole-proprietorships (with their income reported on the 1040 Schedule C),

³ For this table, we used the CBO baseline projections from January 2012 for corporate receipts (rather than the more recent 2013 projections) to be consistent with the latest available TPC estimates, which are based on CBO's 2012 economic forecasts and had not been updated before this paper was completed.

⁴ Individual receipts from business taxes were temporarily higher than corporate receipts in 2009 and 2011, reflecting the sharp drop in corporate taxes in the recession in 2009 and the additional temporary drop due to the enactment of full expensing for business equipment for tax year 2011 only. But for most years, corporate receipts have been significantly higher than individual receipts attributable to business income.

⁵ Data for this and the remaining figures are drawn from *SOI Tax Stats – Integrated Business Data*, IRS, <http://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data> A description of the database is provided by Luttrell, Treubert, and Parisi (2006). Plesko and Henry (2012) provide a broader analysis of these data in the context of proposed corporate rate reductions.

Table 1
Comparison of Corporate and Pass-Through Taxes, 2004–2022
 (\$Billions)

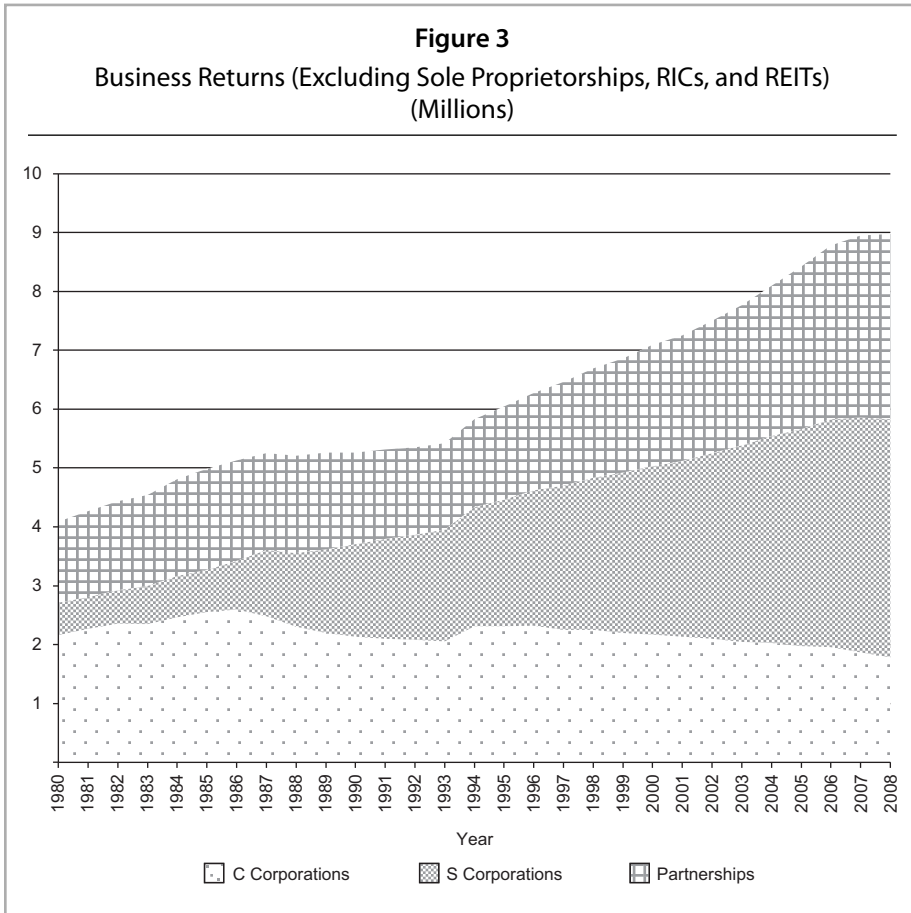
Year	Corporate Taxes	Non-corporate Taxes
2004	189.4	102.1
2005	278.3	159.6
2006	353.9	177.1
2007	370.2	179.4
2008	304.3	174.8
2009	138.2	160.9
2010	191.4	168.3
2011	181.0	185.8
2012	251.0	208.0
2013	320.0	249.9
2014	427.0	276.5
2015	442.0	300.0
2016	436.0	320.5
2017	465.0	336.0
2018	461.0	352.0
2019	454.0	371.5
2020	444.0	388.7
2021	452.0	410.6
2022	459.0	435.8

Figure 2
Revenue from Corporate and Non-Corporate Taxes



which at 8.9 million comprised 68.6 percent of all business returns in 1980. By 2008, the number of returns reporting sole-proprietor income had increased to 22.6 million, 71.5 percent of the total number of business returns. Even if one excludes sole proprietors, the differences in the growth rates among the various return types between 1980 and 2008 are striking. As shown in Figure 3 and looking at the composition of corporate returns, even though the number of corporation returns grew 215 percent overall, C corporation returns have actually declined by 18 percent, offset by a 742 percent increase in the number of S corporations. Of partnership returns (including LLCs), which grew 228 percent, LLCs comprised more than 60 percent of the total, growing from 17,335 returns in 1993 to nearly 1.9 million in 2008.

While the number of returns may be indicative of how business operations are organized, the trends in returns outlined above do not necessarily provide useful insights on the amount of economic activity taking place in each business form. To better understand the economic significance of these changes in business demographics we



examine aggregate net income less deficit, which is an intermediate measure of taxable income that is calculated prior to taking special deductions (it can be either positive or negative). As we show in Figure 4, even though the vast majority of returns are sole-proprietorships, corporations and partnerships are responsible for approximately 85 percent of net income less deficits. The dramatic change in the role of organizational form and economic activity is seen in the sharp decline of the C corporation share. While C corporations reported 78.2 percent of net income less deficit in 1980, by 2008 that share had declined to only 27.2 percent of the total.⁶

A slightly different pattern emerges for the subset of returns reporting positive net income (Figure 5). While the nominal net income of all types of business entities grew during this period, it is also clear, and consistent with Figure 4, that their relative contributions to overall profitability are different, with partnerships and S corporations, which essentially reported zero net income less deficit in 1980, reporting increased profitability. When the same data are displayed as percentages of the total (Figure 6), the change in the relative economic significance of taxable versus pass-through entities becomes stark. Of total business net income, C corporations, which accounted for nearly 70 percent in 1980, accounted for only 40 percent in 2008, with sole-proprietorships also showing a decline in relative importance (from 16 to 12 percent). By contrast, partnerships (including LLCs) accounted for just under 11 percent of net income in 1980, but accounted for 34 percent in 2008. S corporation shares rose similarly, from 3.5 percent to 13.6 percent. In short, the percentage of business income that is no longer subject to the corporate level tax grew from 30.7 percent to 60.0 percent over this 29-year period.

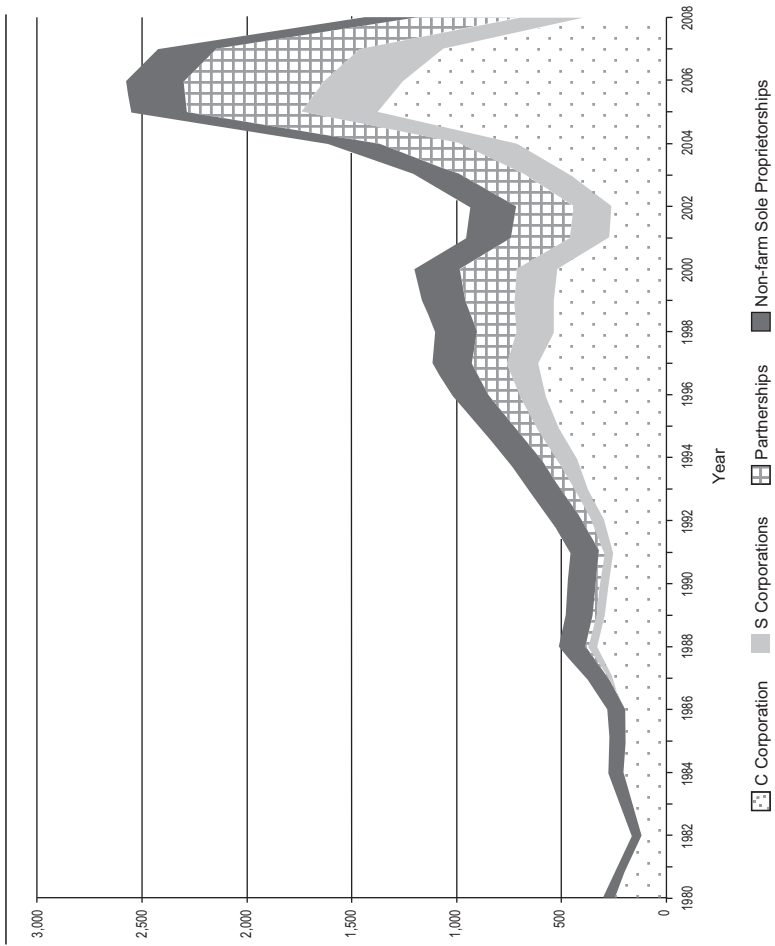
While the structure of the tax system influences organizational form and business operations, the ultimate purpose of the tax system is to raise revenue. The composition of total revenue is affected both by policy, which defines the base and sets the rates on various income sources, and economic conditions. Over the past 60 years, corporate revenues as a percentage of GDP have declined, as has their share of total receipts. During the 1950s, corporate receipts averaged 4.7 percent of GDP and 27.4 percent of total federal revenues (Figure 7). Over the next three decades, corporate receipts declined as both a share of GDP and within the overall mix of federal revenue. During the 1980s, corporate receipts averaged less than two percent of GDP, and their share of total federal revenues declined to 10.6 percent. These percentages have remained fairly stable since, and — absent a change in law — are expected to remain at these levels through the first quarter of the 21st century.

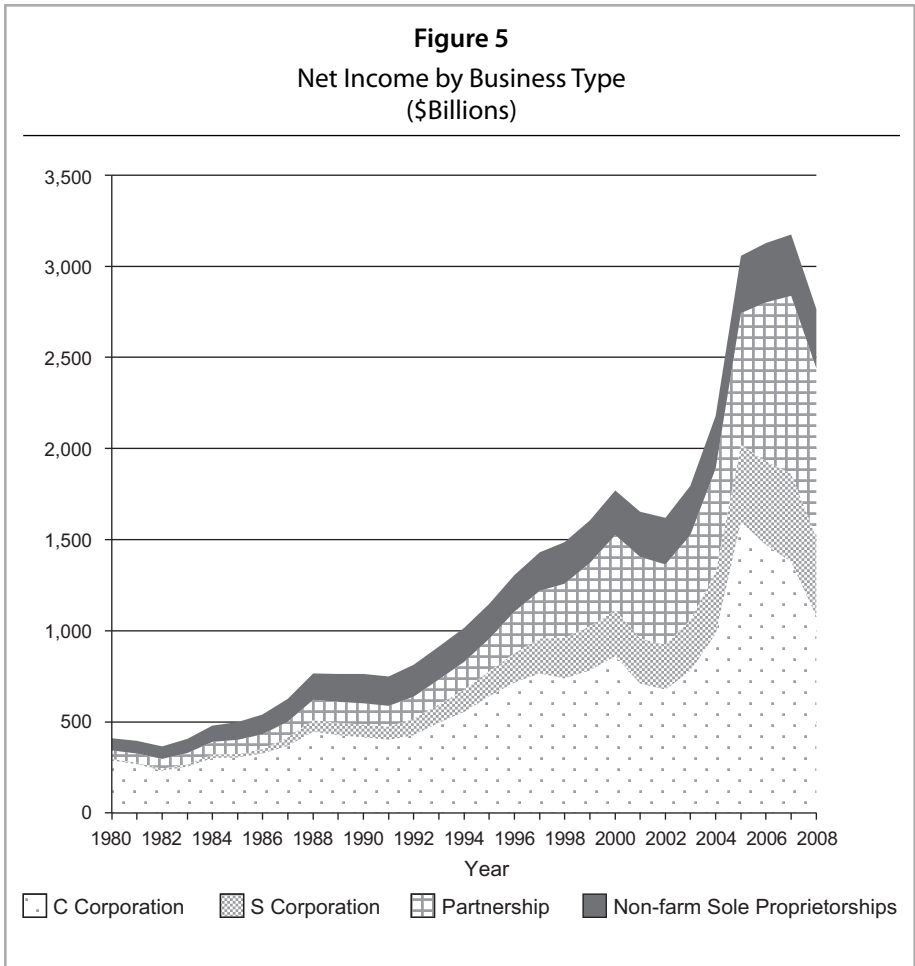
V. TAX RATES ON BUSINESS INCOME: 1980, 2013, AND BEYOND

Investors in C corporation equity pay tax on the corporate profits attributable to them at both the corporate and individual level. The corporate level tax is paid annually on profits earned and reported to the IRS, with the individual level tax deferred

⁶ These percentages and the figure exclude income or loss attributable to Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs), both of which are pass-through entities; these entities accounted for 4.6 percent of business net income less deficit in 1980 and 20 percent in 2008.

Figure 4
Net Income Less Deficit (\$Billions)

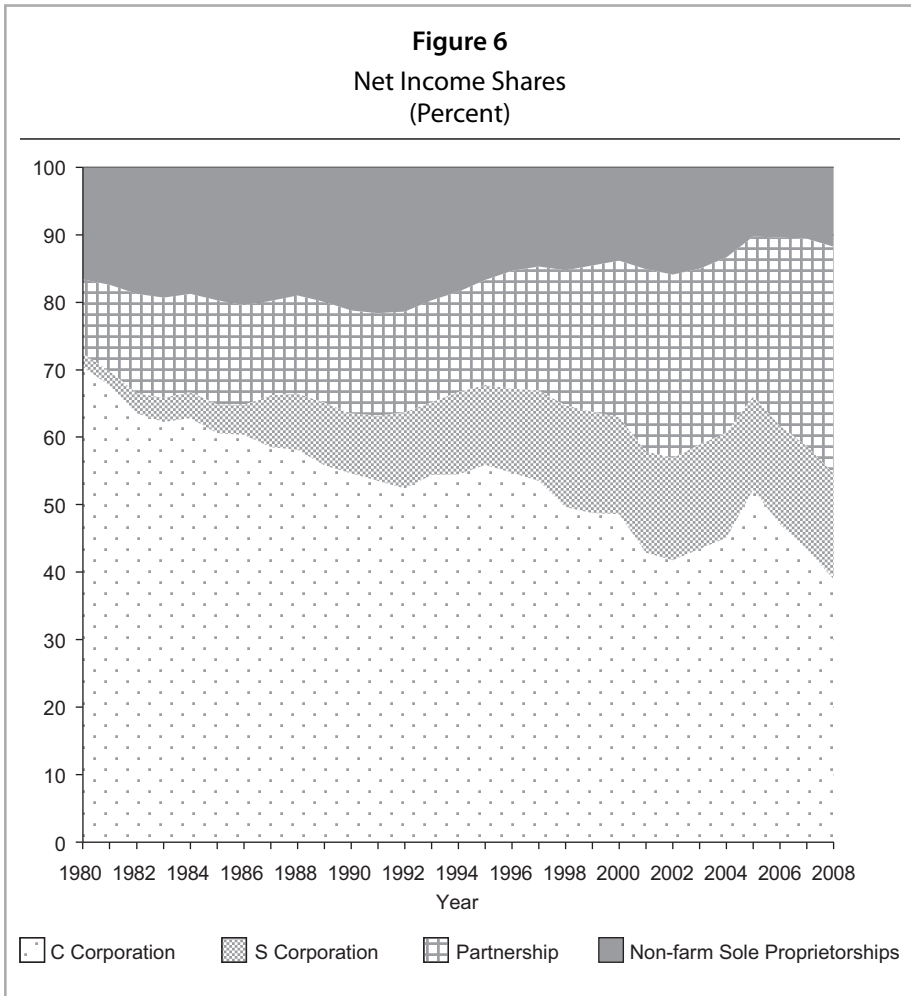




until the corporation pays out dividends to the shareholder or the shareholder realizes any appreciation in the value of the shares upon sale.⁷ The tax rates on realizations of long-term capital gains and, in recent years, on corporate dividends have been lower than tax rates on ordinary income. By contrast, owners of businesses that are taxed as pass-through enterprises pay the individual income tax at ordinary rates on their shares of business profits. Therefore, the comparative tax treatment for an investor in

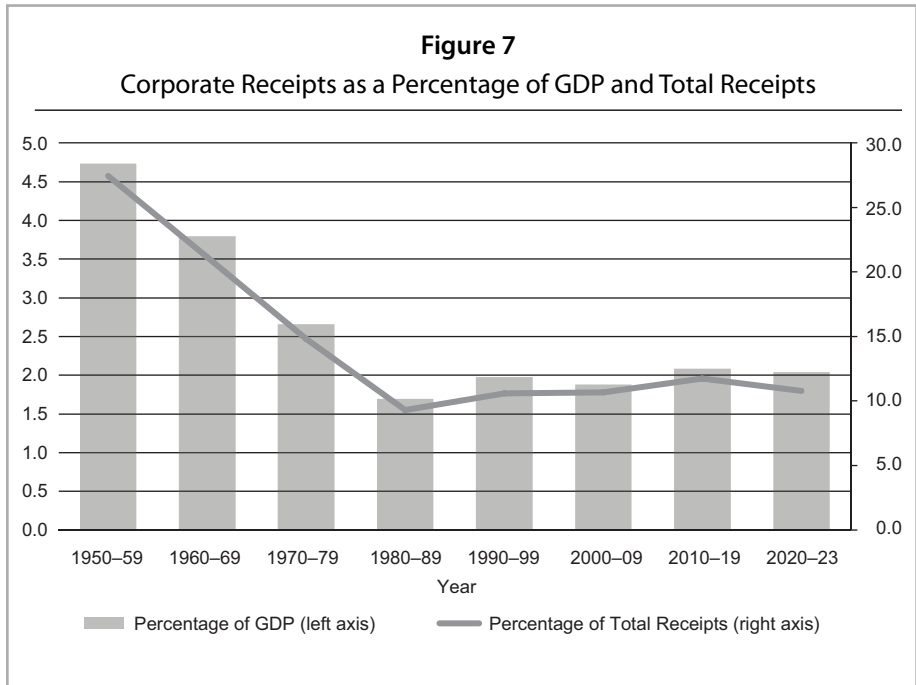
⁷ While the capital gains tax is paid by a shareholder upon sale of appreciated shares, the amount of capital gain is determined not only by the amount of earnings retained by the corporation, but also by investors' expectations of the value of future income. Only the tax on the portion of the gain that is attributable to retained earnings represents a second level of tax on current corporate profits.

Figure 6
Net Income Shares
(Percent)



a taxable corporation and an investor in a pass-through entity depends on four factors: (1) the statutory tax rates applied to corporate and individual income, (2) the tax rates individuals pay on dividends and capital gains, (3) the percentage of corporate profits that is paid out to shareholders as dividends, and (4) the percentage of accrued capital gains that shareholders realize.

The relative tax rates applied to C corporations that retain profits and to the owners of pass-through businesses in the highest tax bracket have changed dramatically over the past 30 years, as shown in lines 1 through 4 of Table 2. Prior to the tax cuts of 1981, the top rate on individual income (line 4) was 70 percent, compared with a rate of 46 percent for corporations (line 1). The Economic Recovery and Tax Act of 1981



(ERTA) reduced the top individual rate to 50 percent, while leaving the corporate rate unchanged.⁸ TRA86 sharply reduced the top individual and corporate rates, but reversed their ranking, leaving the corporate rate (at 34 percent) 6 percentage points higher than the top individual rate (28 percent). The tax increases in 1990 and 1993 again made the top individual rate slightly higher than the top corporate rate (39.6 percent versus 35 percent). The two rates were equalized by the 2001 tax cuts, but recently the top individual rate increased again to 39.6 percent for taxpayers with incomes over \$450,000 (married filing jointly) or \$400,000 (single).

The effects of these rates depend on the shareholder-level taxation of dividends and capital gains on corporate shares. For our calculation we assume as a base case that 50 percent of C corporation earnings are distributed and 25 of earnings are realized as capital gains.⁹ Even with the large gap between corporate and individual rates in 1980, the combined top rate on corporate dividends of 83.8 percent (shown in line 7) remained

⁸ ERTA also drastically reduced effective corporate tax rates due to the expansion of accelerated depreciation and other preferences, but these tax benefits also reduced the effective rate (relative to the statutory rate) on income from businesses taxed as pass-through entities.

⁹ The initial value of 25 percent follows Feldstein, Poterba, and Dicks-Mireaux (1983) in the estimate of the present-value of the capital gains deferral. Our alternative calculations reflect the possibility of individuals changing their realization behavior in response to changes in the tax rate.

Table 2
Combined Tax Rates on C and S Corporation Income
 (Percent)

	1980	1985	1988	1993	2000	2004	2013	Proposed
Tax Rates by Income Type								
1 Maximum corporate statutory rate	46.0	46.0	34.0	35.0	35.0	35.0	35.0	28.0
2 Maximum rate on capital gains	28.0	20.0	28.0	28.0	20.0	15.0	23.8	23.8
3 Maximum rate on dividends	70.0	50.0	28.0	39.6	39.6	15.0	23.8	23.8
4 Maximum rate on S corporation profits	70.0	50.0	28.0	39.6	39.6	35.0	39.6	39.6
Combined Tax Rates								
5 Undistributed Corporate Income	46.0	46.0	34.0	35.0	35.0	35.0	35.0	28.0
6 Realized capital gain ¹	61.1	56.8	52.5	53.2	48.0	44.8	50.5	45.1
7 Dividends ¹	83.8	73.0	52.5	60.7	60.7	44.8	50.5	45.1
8 Weighted average corporate ²	68.7	62.2	47.9	52.4	51.1	42.3	46.6	40.9
9 Unincorporated businesses	70.0	50.0	28.0	39.6	39.6	35.0	39.6	39.6
Effective Rate Differential: Weighted Average Corporate Less Unincorporated Business Tax Under Alternative Assumptions								
10 0 percent distributed, 0 percent capital gain	-24.0	-4.0	6.0	-4.6	-4.6	0.0	-4.6	-11.6
11 0 percent distributed, 25 percent capital gain	-20.2	-1.3	10.6	-0.1	-1.4	2.4	-0.7	-7.3
12 50 percent distributed, 0 percent capital gain	-5.1	9.5	15.2	8.3	8.3	4.9	3.1	-3.0
13 50 percent distributed, 25 percent capital gain	-1.3	12.2	19.9	12.8	11.5	7.3	7.0	1.3
14 100 percent distributed, 0 capital gain	13.8	23.0	24.5	21.1	21.1	9.8	10.9	5.5

¹Combined tax rate at corporate and individual levels.

²Combined tax rate at corporate and individual levels assuming a 50 percent dividend payout rate and that 50 percent of capital gains are realized.

higher than the top rate on unincorporated businesses (70 percent, line 9). However, the preferential capital gains rate mitigated this effect, lowering the weighted average tax on C corporation earnings under this payout and capital gains scenario to 68.7 percent (line 8). Lines 10 through 14 show the difference between the weighted average corporate rate and the tax on unincorporated businesses under a variety of alternative assumptions. Our base case, which shows the difference between the weighted average corporate tax rate (line 8) and the tax rate on unincorporated businesses (line 9), is reported on line 13.

For our base case assumption in 1980, the difference of -1.3 percent represents a slight advantage to being a taxable corporation compared to an unincorporated business, a gap that was reversed by 1985 to a 12.2 percentage point disadvantage following the individual rate cuts in ERTA (see line 13 for 1985). TRA86 left dividend paying corporations at a 19.9 percentage point disadvantage (47.9 percent for the weighted average corporate rate compared with 28 percent for flow-through business income). But the tax cuts enacted in 2001 and 2003 reduced this gap substantially by cutting the top tax rate on dividends to 15 percent. In 2004, after enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the top combined corporate/individual rate was down to 42.3 percent, just 7.3 percentage points above the tax rate applied to businesses taxed as pass-through entities.

The gap between the corporate rate on dividends and the rate on pass-through entities widened again in 2013, with the increase in the top rate on dividends from 15 to 23.8 percent due to a 5 percentage point rate increase for the capital gains and dividends earned by high income individuals under the American Tax Relief Act of 2012 (ATRA) and the additional 3.8 percent high income surcharge on investment income enacted in the Affordable Care Act of 2010 (ACA). Although the top individual rate also went up, the gap between the weighted average corporate and pass-through rates fell to 7.0 percentage points. As shown in the last column, a reduction of the corporate rate to 28 percent would still leave the weighted average corporate rate higher than the pass-through rate, but the difference would decrease to only 1.3 percentage points.

This conclusion depends on the assumptions for dividend and capital gains behavior, both of which are endogenous decisions of the firm. Lines 10 through 14 of Table 2 show the difference between the weighted average corporate rate and the tax on unincorporated businesses under a variety of alternative assumptions for the same time periods.

When we examine different assumptions about corporate payout behavior and capital gains realizations, the results change. Line 10 (calculated as line 5 minus line 9) in Table 2 uses an extreme set of values, assuming that businesses retain 100 percent of their earnings and that shareholders realize no capital gains. Under these assumptions, the advantage of the taxable corporate form prior to TRA86 is more pronounced, with a 24 percent rate advantage in 1980, falling to 4 percent in 1985 prior to TRA86, followed by a clear disincentive in 1988 (6.0 percent). From 1993 through 2000 the weighted average corporate rate was 4.6 percent lower than the pass-through rate, an advantage reintroduced in 2013 with the increase in the maximum tax rate on ordinary income.

If the corporate tax rate were cut to 28 percent, however, the relative advantage of investing in a closely held corporation would significantly increase; at 11.6 percentage points, the advantage to organizing a closely held business as a C corporation with control over the form of payouts instead of as a pass-through entity would become the largest it has been since before the 1981 tax cuts. This conclusion holds for three of the five sets of calculations that we perform. Only in the cases where the payout and realization rates are the highest do we observe a continuing incentive to operate as a pass-through corporation; again note that these policies are endogenous to the firm, and that firms can change their distribution policies in response to changes in the tax rates.

The bottom line is that the relative advantage of organizing as a C corporation instead of a pass-through depends on whether the company needs to pay dividends to shareholders and on the fraction of accrued capital gains that shareholders realize and pay tax on annually. If it is a closely held business in which the owners want mainly to accrue wealth in the business and from which they can get sufficient cash from compensation and bonuses, then current law slightly favors the C corporate form and the benefit to organizing as a C corporation will increase substantially if the corporate rate is reduced to 28 percent. If the C corporation instead pays out all its profits in dividends, then the effective tax rate on C corporate owners has always been higher than the rate on owners of pass-through businesses. But the introduction of a lower rate for dividends compared to ordinary income in JGTRRA reduced the relative advantage to pass-through status considerably, and this advantage will decline further to the lowest amount over the entire period if the corporate rate is cut to 28 percent.¹⁰

VI. CONCLUSION

The decline in the relative significance of subchapter C corporations has several implications for current policy discussions surrounding broad-based tax reform. In contrast to the demographics of the business environment in 1986, far more businesses (in both total and percentages) are organized as pass-through entities, and they account for a far larger percentage of economic activity. A key objective of corporate tax reform proposals is to reduce the top corporate rate with the revenue loss offset by broadening the business tax base. Given the data presented above, in the absence of an offsetting reduction in the individual tax, the corporate tax rate reductions for the 5.6 percent of business returns that potentially pay corporate income tax would be financed by the broadening of a base for which 94.4 percent of business returns are only subject to the individual rate. Evaluated on an income share basis (Figure 6), any corporate rate reduction would potentially benefit entities with at most 40 percent of business income,

¹⁰ In addition to payout policy, firms have other mechanisms to make payments to owner-shareholders that can avoid the corporate level tax, such as deductible wages and other compensation. Kleinbard (2013) provides an extensive review of these incentives and concludes that a return of a corporate rate below the individual rate will create incentives to use taxable corporations as tax shelters, similar to their use prior to 1986.

leaving businesses with up to 60 percent of net income potentially affected only by the broader tax base.

If, after a corporate rate reduction, the individual tax rate again exceeds the rate on corporate income, there will be a strong incentive to reverse the organizational choice decisions that have taken place since 1986, with the taxable corporate form once again becoming a mechanism to shelter income. The incentive to become a C corporation may well be further increased to the extent that other preferential rates on shareholder income are preserved. Lower individual tax rates on dividends and capital gains relative to wage rates, for example, combined with a graduated corporate rate structure can create incentives for C corporations to undertake tax planning to minimize the overall tax burden on the owner. Outlining the issues can identify the characteristics of changes to the tax system that could mitigate these incentives.

The simple objective of “broadening the base, lowering the rate” provides a way to frame certain objectives of corporate tax reform. Any tax system with a broader base and lower rate that raises the same amount of revenue as the current system should be more efficient and equitable by reducing the role taxes play in influencing decision making. However, the business structures we observe today have been guided by the tax policies of the past decades, and changes in one part of the tax system can easily affect incentives, behavior, and tax burdens in another. In the context of broad-based tax reform, attention to the current landscape of organizational form — and the effects that past tax and regulatory changes have had on the structure of business operations — are critical to designing an efficient reform.

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DISCLAIMERS

The views expressed in this paper are not necessarily those of the Tax Policy Center or the Urban Institute, its trustees, or its funders. All errors are our own.

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