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The Persistent Appeal of S Corporations: How Tax Cuts Might Not Help Small Corporations

Manas Kumar
University of Michigan Law School

THE PERSISTENT APPEAL OF S CORPORATIONS: HOW TAX CUTS MIGHT NOT HELP SMALL CORPORATIONS

Manas Kumar[*]

INTRODUCTION

In December 2017, President Donald Trump signed into law the Tax Cuts and Jobs Act ("the Act").[1] The Act provided the largest tax cuts since the Tax Reform Act of 1986.[2] Among the many reforms implemented, the Act imposed lower taxes for corporations and individuals. The top 35% corporate tax rate was reduced to 21%.[3] The Act also reduced the individual tax bracket rates, as seen below.[4]

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* J.D. Candidate, December 2018, University of Michigan Law School; B.A. (2015), University of Michigan; Executive Comments Editor, MICHIGAN BUSINESS & ENTREPRENEURIAL LAW REVIEW. I am grateful to all my colleagues on MBELR for providing support in writing this Note. All opinions expressed in this Note are my own.

1. *See* Eileen Sullivan & Michael Tackett, *In Signing Sweeping Tax Bill, Trump Questions Whether He Is Getting Enough Credit*, N.Y. TIMES (Dec. 22, 2017), https://www.nytimes.com/2017/12/22/us/politics/trump-tax-bill.html.

2. *See How the Republican Tax Bill Compares with Previous Reforms*, ECONOMIST (Dec. 9, 2017), https://www.economist.com/news/united-states/21732096-todays-bill-does-not-much-resemble-1986-tax-overhaul-how-republican-tax-bill.

3. *See* Jean Murray, *Corporate Tax Rates and What You Owe*, BALANCE (Aug. 27, 2018), https://www.thebalance.com/corporate-tax-rates-and-tax-calculation-397647.

4. *Compare* Kyle Pomerleau, *2017 Tax Brackets*, TAX FOUND. (Nov. 10, 2016), https://taxfoundation.org/2017-tax-brackets/, *with* Amir El-Sibaie, *2018 Tax Brackets*, TAX FOUND. (Jan. 2, 2018), https://taxfoundation.org/2018-tax-brackets/.

Single Taxable Income Tax Brackets and Rates, 2017	
10%	$0 to $9,325
15%	$9,325 to $37,950
25%	$37,950 to $91,900
28%	$91,900 to $191,650
33%	$191,650 to $416,700
35%	$416,700 to $418,400
39.60%	$418,400+

Tax Brackets and Rates, 2018	
Rate	Taxable Income Bracket
10%	0 to $9,525
12%	$9,525 to $38,700
22%	$38,700 to $82,500
24%	$82,500 to $157,500
32%	$157,500 to $200,000
35%	$200,000 to $500,000

While tax rates for both corporations and individuals decreased, the corporate tax rate dropped dramatically. Some high-earning corporations are now subject to a lower maximum income tax than some high-earning individuals. Currently, most U.S. corporations are classified as S corporations—corporations taxed as partnerships.[5] For tax purposes, S corporations pass through their total annual income to owners, who are subjected to their individual income brackets.[6] The Act's corporate tax cut suggests that some eligible corporations might reconsider whether to file as pass-through firms for federal income tax purposes or elect for corporate status.

While many high-earning partnerships and S corporations will certainly take advantage of the "qualified business income" deduction open to many businesses not classified as C corporations, these deductions will cease after 2025.[7] Assuming that Congress will not significantly extend this deduction, many high-earning partnerships and S corporations might convert to C corporations to exploit the lower corporate tax rates. This Note argues that while a

5. *See* Tim Worstall, *More Than 90% of US Businesses Don't Pay the Corporate Income Tax*, FORBES (Dec. 23, 2014, 12:34 PM), https://www.forbes.com/sites/timworstall/2014/12/23/more-than-90-of-us-businesses-dont-pay-the-corporate-income-tax/#507c27e65e48 (quoting Timothy Taylor, *Opting Out of the U.S. Corporate Income Tax*, CONVERSABLE ECONOMIST (Dec. 22, 2014, 7:00 AM), http://conversableeconomist.blogspot.pt/2014/12/opting-out-of-us-corporate-income-tax.html).

6. *Id.*

7. I.R.C. § 199A(i) (2017).

plethora of factors will continue to attract businesses to S corporation status, many *high-earning* entities will have an incentive to elect back to C corporation status. In contrast, *lower-earning* entities—the category into which most S corporations fall—will continue to elect pass-through status to avoid taxation of corporate dividends. This is due in large part to the fact that the Act did not significantly alter the federal tax law regarding S corporation election qualifications. This Note will first review the tax preferences for entity choice under the old tax regime for the sake of context. It will then compare the tax benefits of electing to C and S corporation status under the regime created by the Act. The Note will conclude with an analysis of the factors sustaining the tax appeal of pass-through firms for lower-earning businesses with special attention to the largely unaltered state of tax law and business entity choice. It proposes that the Act did not sufficiently reform the Internal Revenue Code to close up the tax advantage that high-earning corporations incur with a Subchapter S election.

I. THE OLD REGIME: THE MASS APPEAL OF PASS-THROUGH FIRMS.

The pre-2017 corporate tax brackets and tax rates motivated businesses to elect pass-through status. Individual tax brackets provided comparatively lower tax rates for business owners, and pass-through status also avoided dividend taxation on the shareholder level, commonly known as double taxation.[8]

For federal tax purposes, C corporations are all for-profit corporations that are subject to a separate corporate income tax before income is distributed to shareholders.[9] Under the applicable federal regulations, all business entities defined under state or foreign law as corporations are automatically classified as C corporations unless they elect for S corporation status.[10] In turn, a corporation must satisfy all the statutory requirements to qualify for S corporation status.[11]

S corporations are business entities that meet the statutory and regulatory requirements of Subchapter S and choose to be classified as such for tax purposes.[12] These requirements include: being a domestic corporation;[13] having only shareholders who are individuals or certain trusts and estates as opposed to partnerships or corporations; having no non-resident alien shareholders;[14] having no more than one hundred qualified shareholders;[15] having only one class of

8. *S Corporations*, INTERNAL REVENUE SERV., https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations (last visited Oct. 20, 2017).

9. *Id.*

10. *See* Treas. Reg. § 301.7701-2(b)(1); *see also* Treas. Reg. § 301.7701-2(b)(8); *see also* Treas. Reg. § 301.7701-3(c)(1)(v)(C).

11. *See* I.R.C. § 1361.

12. *Id.*

13. *See* I.R.C. §§ 1361(b)(1).

14. I.R.C. § 1361(b)(1)(B); *see also* I.R.C. § 1361(b)(1)(C).

15. I.R.C. § 1361(b)(1)(A).

stock;[16] and not being an ineligible corporation, such as certain financial enterprises or insurers.[17] These requirements preclude a large number of corporations from electing pass-through status. Many notable brand corporations are actually subsidiaries with more than one hundred shareholders, several different classes of stock, and corporate shareholders. For instance, Chrysler, as a subsidiary of Fiat Chrysler Automobiles,[18] could never elect S corporation status because it has corporate shareholders, more than one hundred total shareholders, and different classes of stock, such as voting common shares and preferred shares. Thus, the federal income tax law relies on the market rigors and complex needs of publicly owned corporations, widely owned corporations, and multinational corporations, to ensure that many corporations cannot escape the dividend tax by invoking Subchapter S. Given these strict requirements, the law seems to imagine most S corporations having a small pool of owners.[19]

The S corporation retains state and federal legal protections and obligations unique to corporations, such as limited liability.[20] The benefit of the election is avoiding the double taxation of income inherent in C corporations. The assumption is that an S corporation shareholder will be better off financially than he would be as a C corporation shareholder subject to double taxation.[21] The utility of this business entity choice will be analyzed in the next part.[22]

Partnerships are unincorporated, multimember business entities. They are subject to a single level of taxation.[23] A partnership can earn income or loss in the course of a tax year and though it must fill out tax returns reporting allocations of income, loss, deductions, and other items, partners do not necessarily pay a tax until distributions are made.[24]

A. *Limits to the Choice of Business Entity Under the Law*

Before reviewing the merits of electing pass-through status under the old regime, it must be established how these elections were made. Under the old tax regime, the corporate tax rate varied, and tax brackets reached up to 39%. Wanting a lesser tax burden, a business would seek pass-through status wherever and whenever possible. Under Treas. Reg. §§ 301.7701-1, 301.7701-2, and

16. I.R.C. § 1361(b)(1)(D).

17. I.R.C. § 1361(b)(2).

18. *Fiat Completes Chrysler Acquisition in $4.35 Billion Deal*, AUTO. NEWS (Jan. 21, 2014, 10:43 AM), http://www.autonews.com/article/20140121/OEM/140129980/fiat-completes-chrysler-acquisition-in-4-35-billion-deal#axzz2r8024er1.

19. *See* I.R.C.§ 1361(b)(1)(A).

20. *See Compare LLC vs. S Corporation*, BIZFILINGS, https://www.bizfilings.com/toolkit/research-topics/incorporating-your-business/s-corp-vs-llc (last visited Mar. 1, 2018).

21. *See* INTERNAL REVENUE SERV., *supra* note 8.

22. *See Infra,* Part II: The New Regime.

23. *E.g.*, Jean Murray, *Your Partnership Income Tax Questions Answered*, BALANCE, (Oct. 28, 2016), https://www.thebalance.com/your-partnership-income-tax-questions-answered-398993.

24. *Id.*

301.7701-3, federal income tax law provides a "Check the Box" regime for opting into pass-through status.[25]

The federal tax law first asks whether there is a business entity.[26] A business entity can either result from an action performed by an entity or a transaction between two or more actors.[27] If there is no separate business entity, then two or more business actors (other than separate juridical entities) merely co-own a common pool of assets or have performed a transaction. If there is a business entity, then federal tax law asks whether the entity is organized under a state corporation law or a recognized foreign jurisdiction; that is, it asks whether the entity is a *per se* corporation.[28] If a U.S. or recognized foreign jurisdiction provides a corporation law and the entity meets the requisite statutory conditions, then it is treated as a corporation for federal tax purposes. If not, further analysis is required.

Federal tax law then asks if there is a single owner.[29] If there is a single owner, then the entity is a disregarded for tax purposes.[30] The disregarded entity's separate existence is then ignored, and all incomes, losses, and other tax items attributable to it are added to the owner's individual tax return.[31] If there are multiple owners, then it is a default partnership for federal tax purposes.[32]

In either case, however, the owner(s) retain the option of electing corporate status. This system—known as the "Check the Box Regime"—allows taxpayer-entities to choose how they will be taxed. As stated above, the options open to a taxpayer depend on how many owners there are and whether it is a corporation under the laws of its home jurisdiction.[33]

A business entity classified and taxed as a noncorporate limited liability company under the State of Delaware could still be taxed federally as a partnership so long as the entity meets certain statutory qualifications, or "checks" the boxes on the IRS form necessary for such an election. State law corporations cannot elect to be taxed as partnerships. Instead, they can elect for S corporation treatment.[34]

While the "Check the Box" regime makes it easier for a corporation to elect single-level taxation, the fact that § 301.7701-2 identifies state-law and other statutorily organized corporations as corporations by default for tax purposes suggests that the federal tax law desires to subject corporations to double taxation. Although high-earning partnerships can provide large tax receipts, the de-

25. Treas. Reg. §§ 301.7701-1, 301.7701-2, 301.7701-3 (2017).
26. Treas. Reg. §§ 301.7701-2(a) (2017).
27. Treas. Reg. §§ 301.7701-3(a) (2017).
28. Treas. Reg. §§ 301.7701-2(b) (2017).
29. Treas. Reg. §§ 301.7701-3(b)(1)–(2) (2017).
30. Treas. Reg. §§ 301.7701-3(b) (2017).
31. *Id.*
32. Treas. Reg. §§ 301.7701-3(a) (2017).
33. *Id.*
34. Treas. Reg. §§ 301.7701-3(c)(v)(C) (2017).

fault double taxation paid by corporate taxpayers ultimately provides more revenue opportunities for the U.S. Treasury. The Treasury wants more corporate taxpayers and seeks eligible volunteers who elect corporate status for their own reasons. The question of interest is why corporations would elect for S corporation status.

B. *The Appeal of Passing Through Income as an S Corporation*

Under the federal income tax laws, a per se corporation's only option for pass-through taxation is with S corporation status. Under the old regime, a taxpayer would generally seek S corporation status to avoid double taxation. Despite this favorable treatment, there were benefits specific to retaining C corporation status.

Many corporations retained C corporation status for business reasons. Basic C corporations allow for other corporations, non-individual entities like investment funds, and foreign investors to buy shares in the enterprise, as opposed to S corporations who must limit their shareholders to domestic non-corporate persons.[35] These corporate investors receive 50–100% deductions on their dividends because their own corporate earnings and profits drop down to their individual investors as taxable dividends.[36] Also, C corporations are free to issue multiple classes of stock, unlike the limitation to one class of stock for S corporations.[37] This means, for instance, that C corporations can generate additional revenue by offering less risky preferred shares to passive investors with the right to elect common status if the investor wishes to become more involved in the company.

A C corporation's ability to flexibly offer different stock classes to different investors raises its overall power to generate capital. C corporations can issue stock to more than one hundred shareholders.[38] Therefore, a C corporation can offer voting common shares to active investors, such as managers and employees, while also soliciting funds from a large volume of investors. A C corporation can also issue preferred stock to cautious investors looking only for a return while offering incentives and means of control for insiders with common stock—effectively balancing capital flow and corporate governance interests.[39] Thus, C corporation status remains attractive because it provides corporations with the flexibility they need to meet their capital requirements.[40]

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35. *See* INTERNAL REVENUE SERV., *supra* note 8.

36. I.R.C. § 243(a)(1) (2017).

37. *See* INTERNAL REVENUE SERV., *supra* note 8.

38. *See id.*

39. *See* Amy Fontinelle, *Keeping Control of Your Business After the IPO*, INVESTOPEDIA (Oct. 14, 2018, 9:28 AM), https://www.investopedia.com/articles/personal-finance/102715/keeping-control-your-business-after-ipo.asp.

40. *See* Barbara Weltman, *5 Reasons to Be a C Corporation*, U.S. SMALL BUS. ASSOC., (May 23, 2012), https://www.sba.gov/blogs/5-reasons-be-c-corporation.

On the other hand, the appeal of S corporation status for smaller businesses is apparent. S corporations make up a significant number of U.S. business entities and have steadily grown in volume since Congress enacted Subchapter S of the Internal Revenue Code. The Tax Foundation estimated that there were 4.2 million filed S corporations in 2011, which dwarfed the 800,000 filed in 1986.[41] A 2017 Tax Foundation report claimed that of the 30.8 million private U.S. businesses in 2014, 13.6% identified as S corporations.[42] The IRS estimates that there were 4.6 million S corporation owners in 2014.[43] *Forbes* examined S corporations and other pass-through firms and noted "more than 90 percent of businesses, representing more than one-third of all business activity, in the United States are structured as flow-through entities—businesses that do not pay the corporate income tax, but rather pass profits through to owners who pay tax under the individual income tax."[44] It also asserted that 80% of U.S. business income came from C corporations in 1980 while they now only yield 30% of business income.[45] It is uncertain whether this increase in S corporation volume is due to there being more corporations of all sizes electing S corporation status or there simply being more small businesses; however, the 2017 Tax Foundation report asserted that the Tax Reform Act of 1986 was one factor motivating the shift from C corporations to S corporations.[46] The report commented that lowering the top individual income tax made pass-through business structures more profitable to operate.[47]

The appeal of S corporation status to small businesses under the old regime was logical. A single level of individual taxation with brackets applying to smaller amounts of income would be preferential to double taxation. The previous federal corporate income tax regime set brackets at a minimum of 15% for income amounts between $0 and $50,000 to a maximum of 35% for any income above $18,333,333.[48] In contrast, the individual federal income tax rates started at 10% for income below $9,325 for single taxpayers and $18,650 for married taxpayers filing jointly and climbed to 39.6% for income above $418,400 for single taxpayers and $470,700 for married taxpayers filing jointly.[49] Aside from a single level of taxation and a lesser tax rate, taxpayers could also exploit a series of personal deductions, such as for having dependents, debt,

41. William McBride, *America's Shrinking Corporate Sector*, TAX FOUND., (Jan. 6, 2015), https://taxfoundation.org/america-s-shrinking-corporate-sector/.

42. *See* Scott Greenberg, *Pass-Through Businesses: Data and Policy*, TAX FOUND., (Jan. 17, 2017), https://taxfoundation.org/pass-through-businesses-data-and-policy/.

43. *See The History and Challenges of America's Dominant Business Structure*, S-CORP.ORG, http://s-corp.org/?page_id=121 (last visited Nov. 29, 2018).

44. *See* Worstall, *supra* note 5.

45. *Id.*

46. *See* Greenberg, *supra* note 42.

47. *Id.*

48. *See* Murray, *supra* note 3.

49. *See* Pomerleau, *supra* note 4.

mortgages, charitable contributions, and retirement plans.[50] For a local business making $200,000 with only two shareholders, the owners would prefer S corporation status over paying high rates on two levels. As such, the growth of S corporations in the U.S. economy matches the incentives that the tax code has provided it.

Given the narrow requirements for successfully filing for S corporation status, fears that large conglomerates would attempt to claim pass-through status in order to dodge taxes were insubstantial. Of the corporations eligible for S corporation election, proponents point out that tax bills simply shift from corporations to individual shareholders. [51] Applying the statutory and regulatory qualifications for S corporations, corporate subsidiaries, and foreign corporations cannot make the election. The real concern was the number of high-earning firms that could claim S corporation status in a new tax schedule with reduced income taxes. S corporation filing does not include income requirements.[52] Therefore, any number of corporations that would normally be taxed at the maximum 39.6% corporate tax rate could still be treated as pass-through firms.

Of course, there are statutory and judicial protections against abuse. The statutory requirements explicitly prohibit "ineligible corporations" from filing for S corporation status, including financial institutions that use the reserve method of accounting for bad debts, insurance companies taxed under Subchapter L, and domestic international sales corporations.[53] Under, Subchapter S, pass-through status terminates when a business entity operates profitably for three consecutive years while deriving more than 25% of its gross receipts for each year from passive investment income.[54] However, these statutory regulations are minimal at best given that "passive investment income" is largely income accumulated from "royalties, rents, dividends, interest, and annuities."[55] If a small construction company with a $2 million annual income fulfills all S corporation requirements and its passive investment income is below 25% every year, it could successfully claim S corporation status and continue to do so as long as it remains closely held and compliant to the tax regulations. Meanwhile, shareholders can pass the corporation's income to themselves as carefully calculated distributions based on ownership stakes and "reasonable compensation" for employees. Also, not all S corporations are small businesses. Hobby

50. *See* INTERNAL REVENUE SERV., *Credits & Deductions for Individuals*, IRS.gov, https://www.irs.gov/credits-deductions-for-individuals (last visited Mar. 1, 2018).

51. *See* Tim Worstall, *Dear New York Times – The S Corporation Is Not A Corporate Tax Dodge Nor Loophole*, FORBES (Apr. 17, 2017, 9:24 AM), https://www.forbes.com/sites/timworstall/2017/04/27/dear-new-york-times-the-s-corporation-is-not-a-corporate-tax-dodge-nor-loophole/#68190c60353d.

52. I.R.C. § 1361 (2007).

53. *Id.*

54. I.R.C. § 1362(d)(3).

55. I.R.C. § 1362(c)(1).

Lobby is organized as an S corporation.[56] According to Forbes, Hobby Lobby employed 32,000 people and earned $4.6 billion in revenue in 2017.[57] Its status as a pass-through firm risks a substantial amount of lost tax revenue that the Treasury would otherwise collect if Hobby Lobby were subjected to double taxation as a C corporation. Allowing high-earning entities to elect S corporation status risks losing tax revenue and contradicts the legislative intent behind Subchapter S.

Subchapter S's legislative history indicates that Congress imagined S corporations as small businesses.[58] [59] In 1958, the United States had a different tax structure and economic landscape. The federal income tax collected a maximum 91% on individual ordinary income and a maximum 52% on corporate income.[60] Based on IRS tax return statistics, there were 990,381 active corporations in the 1958–59 year.[61] According to popular understanding, the intent behind Subchapter S was to provide small businesses with the liability benefits of a large corporation along with the tax benefits of a partnership.[62] According to a 1958 Senate Finance Committee Report, the proposal that eventually became the basis for Subchapter S remarked that: "It will be primarily beneficial to those individuals who have marginal tax rates below the 52-percent corporate rate (or 30-percent rate in the case of the smaller corporations) where the earnings are left in the business" and that "the provision will also be of substantial benefit to small corporations realizing losses for a period of years where there is no way of offsetting these losses against taxable income at the corporate level,

56. Drew DeSilver, *What Is a "Closely Held Corporation," Anyway, and How Many Are There?*, PEW RES. CTR., (July 7, 2014), http://www.pewresearch.org/fact-tank/2014/07/07/what-is-a-closely-held-corporation-anyway-and-how-many-are-there/.

57. *#91 Hobby Lobby Stores*, FORBES (Oct. 22, 2018), https://www.forbes.com/companies/hobby-lobby-stores/.

58. S. Report No. 85-1983, at 87 (1958) (According to a 1958 Senate Finance Committee Report, the basis for Subchapter S was that: "It will be primarily beneficial to those individuals who have marginal tax rates below the 52-percent corporate rate (or 30-percent rate in the case of the *smaller corporations*) where the earnings are left in the business" and that "[t]he provision will also be of substantial benefit to small corporations realizing losses for a period of years where there is no way of offsetting these losses against taxable income at the corporate level, but the shareholders involved have other income which can be offset against these losses.. . .") (emphasis added).

59. S. Report No. 2350, at 69, https://www.finance.senate.gov/imo/media/doc/Hrg97-119.pdf (1982). A report accompanying the 1982 amendments also affirmed that Congress enacted Subchapter S in order to offer businesses, particularly small businesses, with the option to be taxed as noncorporate entities in order to avoid the dividend tax despite then-higher individual taxes for some brackets or to pass through losses to offset shareholders' other income.

60. *1958 Top Federal Tax Rates*, GRAPHIQ (Sep. 22, 2017), https://web.archive.org/web/20170922160351.

61. INTERNAL REVENUE SERV., Pub. No. 16 (1-61), STATISTICS OF INCOME FOR 1958–59, at 3 (1961), https://www.irs.gov/pub/irs-soi/58cocrar.pdf.

62. David Branham, *Has the S-Corp Run Its Course? The Past Successes and Future Possibilities of the S Corporation*, 42 J. LEGIS. 89, 95 (2016), https://scholarship.law.nd.edu/cgi/viewcontent.cgi?article=1650&context=jleg.

but the shareholders involved have other income which can be offset against these losses.. . ."[63]

A Senate Report accompanying the 1982 amendments to Subchapter S also affirmed that Congress enacted Subchapter S in order to offer businesses—particularly small businesses—the option to be taxed as noncorporate entities or to pass through losses to offset shareholders' other income. The Report mentioned that taxing small businesses as noncorporate entities would allow them to avoid the dividend tax despite then-higher individual taxes for some brackets.[64] The intent appears, at least in part, to be developmental in nature. In fact, the 1958 Senate Finance Committee Report ends with a tact summation that, "Section 1361 and the proposed section 68 are presumably intended to provide tax relief for small businesses. Small-business enterprises, both incorporated and unincorporated, have fared poorly in the last 4 or 5 years and surely we must be concerned with equitable tax revision to mitigate tax biases against them."[65] Thus, there appeared to be substantial policy concern regarding the sustainability of small business in 1958, which culminated in providing a lower tax burden to small businesses in the form of Subchapter S. There is no indication that Congress either planned or desired such protection to extend to a large and successful corporation like Hobby Lobby.

The Internal Revenue Service heavily scrutinizes S corporations, especially single-employee corporations, which attempt to avoid payroll taxes by compensating workers with distributions.[66] *Spicer Accounting, Inc. v. United States* held that a corporation's sole full-time employee must be treated as an employee.[67] Therefore, shareholder-employees providing substantial services to the business cannot use distributions in lieu of compensation. Similarly, a United States Tax Court found that a single employee collecting only independent contractor fees from his S corporation accounting firm was still liable to pay the payroll tax.[68]

Courts scrutinize S corporation distributions to shareholders based on "reasonable compensation." The Service states that amounts of compensation "will never exceed the amount received by the shareholder either directly or indirectly. However, if cash or property or the right to receive cash and property did go [sic] the shareholder, a salary amount must be determined and the level of salary must be reasonable and appropriate."[69] However, shareholder-employees of

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63. S. REP. NO. 85-1983, at 87 (1958).

64. S. REP. NO. 2350, at 69 (1982).

65. S. REP. NO. 85-1983, at 265 (1958).

66. *See* Tony Nitti, *Tax Geek Tuesday: Reasonable Compensation in the S Corporation Arena*, FORBES (Feb. 4, 2014, 9:04 AM), https://www.forbes.com/sites/anthonynitti/2014/02/04/tax-geek-tuesday-reasonable-compensation-in-the-s-corporation-arena/2/#3121244c3610.

67. *See* Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990).

68. Joseph M. Gray Pub. Accountant, P.C. v. Comm'r, 119 T.C. 121 (2002).

69. *See* INTERNAL REVENUE SERV., WAGE COMPENSATION FOR S CORPORATION OFFICERS (Aug. 2008), https://www.irs.gov/newsroom/wage-compensation-for-s-corporation-officers.

S corporations receiving both distributions and compensation only face nine court-recommended factors to show reasonable compensation: (1) employee qualifications, (2) nature, extent, and scope of the employee's work, (3) business size and complexity, (4) prevailing economic conditions, (5) employee's compensation as percentage of gross gain and net income, (6) employee-shareholder's compensation compared to shareholders' distributions, (7) the employee-shareholder's compensation compared to non-shareholder employees or paid in prior years, (8) prevailing rates of compensation for comparable positions in comparable concerns, and (9) comparison of compensation paid to a particular shareholder-employee in previous years by a corporation that has a limited number of officers.[70] It should be noted that there are no definitive regulations or caselaw regarding "reasonable compensation" for S corporations.[71] According to the Service, various courts have ruled on whether there was reasonable compensation based on facts and circumstances of the arrangement.[72] While judicial tests offer protections against some S corporations attempting tax avoidance through larger-than-normal salaries, a lack of uniform standards could risk some corporate taxpayers successfully defending their compensation schedules in a more relaxed court. There is also the worrisome fact that the Service only has a list of court-suggested factors to scrutinize S corporation shareholders rather than utilizing a binding judicial test or authoritative regulations. Under such a regime, a large or lucrative S corporation like Hobby Lobby could be in a position to pass through large amounts of money that a C corporation would not be able to when contending with double taxation.

There was—and still is—a plausible concern that small, high-income firms could abuse S corporation status to avoid certain tax costs. The Act did not address reforming the requirements of S corporation status. While C corporations face a lower corporate tax, large S corporations never had to face the corporate tax at all. However, the Act might affect the motives of taxpayers electing for S corporation status.

II. THE NEW REGIME: THE SUSTAINED APPEAL OF S CORPORATIONS

The Act reduced both the corporate and individual tax rates.[73] The top corporate tax bracket was reduced from 39.6% to 21%. The dramatically decreased tax rate for corporations might motivate many C corporations contemplating pass-through status under the old regime to remain or return to C corporation status. However, the other factors contemplated by eligible S Corporation applicants must be considered before determining whether pass-through status remains a rational option for corporate taxpayers.

70. *Id.*

71. *Id.*

72. *Id.*

73. Kimberly Amadeo, *Trump's Tax Plan and How It Affects You*, BALANCE, https://www.thebalance.com/trump-s-tax-plan-how-it-affects-you-4113968 (last updated Nov. 27, 2018).

The lower corporate tax rate is a strong incentive for eligible corporations to elect for C corporate status for federal income tax purposes. However, the lower corporate tax rate does not guarantee more after-tax income to individual taxpayers. Imagine, for example, that an S corporation makes $700,000 in profits for its two owners, both of whom are single filer taxpayers. The S corporation passes through $350,000 in income to each owner. Under the new individual income tax rates, these amounts are taxed at 35% because the income re-receipts are within the bracket of $200,001 and $500,000.[74] Excluding the standard and other deductions, each owner owes $122,500 in tax and keeps $227,500 in after-tax income.

In contrast, consider that a C corporation makes $700,000 in profits after subtracting the business costs for the tax year. Applying the new annual 21% corporate income tax, the corporation owes a $147,000 tax and keeps $553,000 in income. As a conservative estimate, the C corporation decides to distribute an ordinary dividend. Ordinary dividends are taxed as ordinary income.[75] Supposing that the C corporation distributes the entire $553,000 evenly, each owner gets a $276,500 dividend with a 35% tax. Each owner owes $96,775 in taxes and keeps $179,725 in individual income.

Alternatively, supposing the C corporation issues a qualified dividend of $276,500 eligible for a capital gains tax, the owners are subjected to a 23.8% tax. Given that the dividend is over $200,000 for both single filers, the 20% capital gains tax rate adds on an additional 3.8% in investment income tax.[76] Each owner owes $65,807 in taxes and keeps $210,693 in personal income. In this arbitrary example devoid of deductions and exemptions, the S corporation subjected its owners to high individual income taxes, but each came out with a better tax outcome than if they held stock in a C corporation. The dividend tax—in either scenario—removes significant amounts of money from the C corporation's treasury despite the facially lower tax rate of 21%.

These examples did not account for corporations that are owned by other corporations and provide deductions for inter-corporate dividends. They also did not account for corporations waiting years to distribute dividends to shareholders and never distributing all its profits, as most corporations retain money for various projects and operations. The examples are meant to show that the single level of taxation imposed on S corporations with limited earnings sustains the appeal of pass-through corporation status.

Pass-through election for federal tax purposes will certainly continue for the next few years given an important deduction for pass-through firms. The Act provides a 20% deduction on "qualified business income" ("QBI") for pass-

74. Lauren Lyons Cole, *Here's How Your Tax Bracket Will Change in 2018*, BUS. INSIDER (Feb. 14, 2018, 11:07 AM), http://www.businessinsider.com/tax-brackets-2018-trump-tax-plan-chart-2017-12.

75. *Topic No. 404 - Dividends*, *Form 1099-DIV*, INTERNAL REVENUE SERV., https://www.irs.gov/taxtopics/tc404 (last visited Mar. 1, 2018).

76. I.R.C. § 1411(a)(1) (2010).

through entities,[77] which is available until 2025.[78] QBI includes any income generated in the ordinary course of business minus expenses.[79] It does not include interest income, dividend income, or capital gains from sales of assets.[80] Therefore, a pass-through firm that deals in the sale of furniture can factor in all income generated from its normal sales. However, the large capital gain it acquired from selling some real estate it held for a number of years will not be included in the QBI calculation.

The taxable income used to compute the QBI must not exceed $157,500 for single filers and $315,000 for joint filers.[81] Those within these income limits may take the full deduction regardless of their business or trade. However, the Act limits eligibility for the deduction once the income limits are exceeded.[82] For example, certain service businesses—such as doctors, lawyers, and financial advisors—can no longer access the deduction at that point.[83] In other instances, an otherwise eligible partner cannot access the deduction while another can by having a high-earning spouse whose income coupled with the partner's will exceed the $315,000 joint filing limit.[84]

The deduction is also limited by the amount that is "the lesser of either 20% of qualified business income or 50% of the total W-2 wages paid by the business."[85] The W-2 wage limit does not apply if the *total* taxable income of a business is less than the $157,500 single filer income limit or the $315,000 joint filer income limit.[86] Suppose the furniture dealer was an S corporation that earned $150,000 of income each to single filer S corporation owners A and B. Their single employee C earns $50,000 per year. Their total taxable income of $300,000 exceeds the single filer limits. Therefore, their 20% QBI deduction rests on 50% of the furniture corporation's W-2 wages. They earn a QBI deduction that is 25% of $25,000 or $6250. While small, the deduction provides more non-taxable income to individual owners A and B. This illustration indicates that the full QBI deduction is very limited in accessibility among pass-through firms—including S corporations—based on statutory restrictions to eli-

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77. I.R.C. § 199A(a) (2017).

78. I.R.C. § 199A(i) (2017).

79. Tony Nitti, *The New 'Qualified Business Income Deduction' Varies Based On Your Business Type—Or Does It?*, FORBES (Jan. 4, 2018, 10:50am), https://www.forbes.com/sites/anthonynitti/2018/01/04/the-new-qualified-business-income-deduction-varies-based-on-your-business-type-or-does-it/#2413a0262076.

80. *Id.*

81. *Id.*; *see* I.R.C. § 199A(e)(1) (defining "taxable income"); *see also* I.R.C. § 199A(e)(2)(A) (defining the threshold amount).

82. Darla Mercado, *How to Know Whether Your Business Qualifies for That 20 Percent Tax Break,* CNBC (Jan. 9, 2018, 2:58 PM EST), https://www.cnbc.com/2018/01/09/how-to-know-whether-your-business-qualifies-for-that-20-percent-tax-break.html.

83. *See* Nitti, *supra* note 79.

84. *See id.*

85. *Id.*

86. *Id.*

gible incomes. A high-earning corporation will probably exceed the single filer or joint filer income limits and will lose out on exploiting the full deduction. It will also suffer further restrictions when the nature of the business is triggered, such as a high-earning accounting firm or a private physician's practice. Regardless, there is a volume of small S corporations whose special circumstances would welcome some benefit that the QBI deduction has to offer. It is these incentives that will prompt many S corporations to hold off on electing back to C corporation status immediately.

This discussion is not to discount the appeal of the QBI deduction or dismiss the deduction as insignificant. Some lower-earning S corporations could greatly benefit under the temporary regime. Now suppose that the S corporation dealing in furniture earns only $75,000 for each owner and pays employee C $50,000 in wages. The dealer's total taxable income of $150,000 is less than the $157,500 income limit for single filers. As such, A and B can calculate their QBI deductions based on 20% of the qualified business income. In this case, the deduction is $30,000 each to A and B, which substantially increases their non-taxable income.[87] In this scenario, the furniture dealer's owners have a better tax outcome using the QBI deduction than previously discussed. They also have a better outcome than if the dealer was a C corporation. Owners A and B each get a pass-through share of $75,000. Each uses $30,000 in QBI deductions to reduce their taxable income to $45,000 each, which is taxed at 22% given the tax bracket for single filer individuals. This generates $9,900 tax, a $35,100 after-tax amount, and a $65,100 after-tax income for each owner.

Let us then suppose the owners A and B elected for C corporation status in order to use the 21% corporate tax. The $150,000 in profits yields a $31,500 tax and a $118,500 after-tax amount. Split evenly and distributed as ordinary dividends, A and B each get a taxable $59,250 dividend, which is taxed at 22% when in a single filer bracket for amounts between $38,701 and $82,500.[88] The $13,035 tax for each dividend yields $46,215 in individual income for A and B. A and B should have remained as S corporation owners because their after-tax incomes were greater than their after-tax dividend incomes as C corporation investors. S corporation status remains attractive when the business's earnings, access to the QBI deductions, and tax rates align. As such, the QBI deduction remains a strong incentive for many S corporations to retain their elective status despite the lower corporate tax rate for C corporations. Presumably, once the QBI deduction expires, many S corporations will be in a position to seriously contemplate whether to remain S corporations or elect back to C corporation status. This original hypothesis will be examined in the next section.[89]

As demonstrated, a lower tax rate for C corporation status might still pale in comparison to the burden of taxation. While many corporations might not pro-

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87. Of course, the Service might scrutinize under I.R.C. § 199(c)(4) whether the QBI includes "reasonable compensation paid to the taxpayer," which is prohibited from inclusion.

88. *See* Cole, *supra* note 74.

89. *See Infra*, Part III: The Persistent Tax Appeal of S Corporations.

vide annual dividends to shareholders and can sit on earnings for years, economic pressures could motivate corporations to distribute regularly enough to consider dividend taxations a disincentive for C corporation status. Double taxation and the QBI deduction will sustain the appeal of S corporations. The Act did not amend the statutory qualifications for S corporation election, rendering the reforms largely an unaltered version of the old regime.

III. THE PERSISTENT TAX APPEAL OF S CORPORATIONS

Under the Act, the tax appeal of S corporations remains despite the lowered C corporation tax rate due to the continuing imposition of double taxation on C corporations. Many corporations with limited market scope would not be able to sustain themselves if faced with such taxation. The only entities that could endure the burden are those who would otherwise be high-earning S corporations and might not need the election. Thus, the Act will not expand the volume of C corporations.

With continued double taxation and unchanged S corporation election requirements, the Act's limited reforms do not motivate S corporations to return to C corporation status. The Act addresses S corporations in only §§ 199A(e), 11012(a), 13301(a), 13541, 13542, 13543, 965(i), 965(j), and 59(e)(1)(A).[90] Only § 13541 amends I.R.C. § 1361 on the definition of S corporations, and it only applies to trusts as shareholders.[91] Hence, the dynamics governing business entity choice remain largely the same as well. Lesser corporate tax rates would mean that the initial cost of double taxation would be less irksome for those few S corporations lucrative enough to contemplate an IPO. Ultimately, the new tax law has simply shortened the time during which emerging startups classify as S corporations before shifting to C corporation status. It has also made the existence of high-earning S corporations all the more absurd.

Lower corporate tax rates do not ensure a higher after-tax income for C corporation shareholders. However burdensome double taxation is, higher-earning corporations would be better equipped to weather it. They would have sufficiently large earnings and profits to generate reasonably large after-tax dividends for shareholders to justify the additional level of taxation. Also, higher-earning corporations would be in a position to pursue business goals that would be better managed with flexible C corporation ownership: multiple, high-return, high-risk projects with multiple organizational and individual shareholders contributing capital to support the ventures.

In contrast, smaller-earning S corporations would lack either position. Smaller businesses include the local enterprise catering to only the community market, the regional corporations with limited brand appeal, and new corporations that generate more loss than income at the moment. These smaller S corporations would not want to subject their limited incomes to double taxation.

90. Tax Cut and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054.

91. *Id.* at § 13541.

These corporations would also not be in a position to pursue ventures like larger S corporations or C corporations: using a business reputation to secure multiple loans or securing more investors without giving up more control. Therefore, lower-earning S corporations would not elect for C corporation status despite the lower tax rate.

This is significant in terms of tax policy and trends. According to a 2017 Brookings Institution report, S corporations made up 15% of all American businesses in 2014 compared to 5% being C corporations.[92] The same report also indicated that most S corporations are considered small (where small is defined as income receipts less than $10 million).[93] The Brookings study also reported that S corporations with more than $10 million in income receipts generated more than 60% of sales and a little under 60% of profits attributable to all S corporations in 2014.[94] Despite being a substantial minority of the total S corporation population, these higher-earning S corporations generate most of the earnings attributed to all S corporations.[95] They are in a better position to exploit the lower corporate income tax compared to most, low-earning S corporations. As such, only the high-earning S corporations will enter the double tax regime as C corporations under the Act, as opposed to all S corporations.

Even with sufficient earnings, there is no guarantee that high-earning S corporations will elect for C corporation status. Hobby Lobby remains an S corporation. Perhaps it and other high-earners might consider an election for C corporation status once the QBI deduction expires, but this is not assured. Remaining a private, closely-held corporation allows a controller more power to influence considerations not directly related to business, such as retaining family control of the enterprise or dictating social policies.[96] The will of the controlling shareholder also influences whether an S corporation will trust the stock market enough to invite in more investors in return for exiting S corporation protection, which it no longer needs to properly compete, or remain under the elective regime.

Among this small class of lucrative, competitive S corporations, there is no guarantee that they will enter the double taxation regime due to there being no change in the requirements for S corporation status. They can continue to enjoy single taxation without repercussion and only need to litigate cleverly to avoid regulatory efforts to challenge their S corporation qualifications. While the

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92. Aaron Krupkin & Adam Looney, *9 Facts About Pass-Through Businesses*, THE BROOKINGS INSTIT., Figure 1 (May 15, 2017), https://www.brookings.edu/research/9-facts-about-pass-through-businesses/#footref-5.

93. *Id.* at Figure 2.

94. *Id.*

95. *Id.*

96. Take, for example, the emphasis placed on religion by Hobby Lobby's owners, the Green family. *See, e.g.*, Gordon Haber, *Investigating the Hobby Lobby Family*, RELIGION & POL. (Nov. 8, 2017), https://religionandpolitics.org/2017/11/08/investigating-the-hobby-lobby-family-an-interview-with-candida-moss-and-joel-s-baden/

corporate tax cut might overwhelmingly favor a limited class of C corporations that are subject to such tax, the continued ability of some corporations to not be subject to the corporate tax at all despite market success ought to be the actual concern for tax reformers.

In the past, some critics of the previous United States tax policy complained that the reduced tax rates and burdens of pass-through firms eroded corporate revenues and therefore eroded corporate tax revenues.[97] If the Act passed lower tax rates with the intent to produce more revenue with less taxpayer burden, it has not provided a strong incentive for S corporations, which make up most corporations, to move back into the double taxation regime. A small volume of high-earning S corporations might be prompted to become C corporations once the QBI deduction expires, but the vast majority of S corporations are in no position to become subject to double taxation. Whatever the future tax law will be for the next thirty years, whether it is the Act recently passed or a revision, policymakers should reassess the requirements for S corporation status. Policymakers and taxpayers should contemplate why the permissible requirements that help actual small corporations are also available to large corporations. This does not necessarily place the lowered corporate income tax rate in doubt because it has been rare for Congress to have the political will to increase tax rates. However, policymakers might have to adjust the overall regime, such as qualifications for the S corporation election, if they want to narrow tax inequity and raise the tax appeal of C corporations to higher-earning businesses while maintaining S corporations for truly small corporations.

CONCLUSION

Despite the appeal of the lower corporate income tax rate, it does not appear that many S corporations will elect back to C corporation status even if the corporate income tax rate is less than some individual income tax rates. Much like the old regime, the new regime does not impose an income requirement or any additional eligibility requirements. With the new tax law landscape, a lower-earning S corporation—the most common S corporation type—will not have the incentive or the earnings to elect for C corporation status compared to a small minority of high-earning S corporations.

However, the minority of high-earning S corporations with the incentive to change might still not elect back into C corporation status. As such, the Internal Revenue Code and Treasury Regulations provide no clear limits to stop large, lucrative corporations from escaping double taxation when they are more than capable of bearing the burden. As such, the share of United States tax revenues arising from traditional corporations is not likely to rise significantly. The next set of tax reform proposals should prevent large corporations or competitive smaller corporations that no longer require tax protection from making Sub-

97. *See id.* at Figure 8.

chapter S elections. Doing so will protect the institution of the S corporation and small enterprise while addressing one of many alternative solutions to tackling tax inequity and revenue collection.