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HAS THE S-CORP RUN ITS COURSE?

THE PAST SUCCESSES AND FUTURE POSSIBILITIES OF THE S CORPORATION

*David Branham**

I. INTRODUCTION

A corporation's primary goal is to make money. Government's primary role is to take a big chunk of that money and give it to others.

- Larry Ellison

The above quotation is one successful person's opinion on a matter in which all people have an interest: earning money. Specifically, the idea is that corporations exist, *inter alia*, to create revenue for their shareholders, while the government comes in and takes "a big chunk of that money." Larry Ellison is not the only person to voice opposition or support for different tax policies. The perpetual debate centers around how much of the "chunk of that money" should stay with the corporations (or other business enterprises), and how much leeway should business owners have in deciding how they are taxed.

The importance of a thriving United States economy might be one of the only things upon which a nation full of diverse people can agree. The structure and laws of the United States Government have been credited with providing a foundation whereon the economy can flourish. This has required analysis and adaptation at many times throughout United States history.

The "economy" encompasses many moving parts. Forces outside the control of the government and populace can influence the economy. In today's world, our domestic economy can be affected by the economies of other large developed nations. Nevertheless, there are many factors that contribute largely to a healthy economy that have been and can continue to be controlled. An important controlling factor is encouraging opportunities for entry into the free marketplace. In a briefing given by Innosight, a company that is commercializing some of Clayton Christensen's ideas from the best selling book *Innovator's Dilemma*, they made some startling discoveries about companies in the S&P 500 Index¹: in 1958, the tenure for the average firm

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1. The S&P 500 is widely regarded as the best single gauge of large cap U.S. equities. There is over USD 5.14 trillion benchmarked to the index, with index assets comprising approximately USD 1.6 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

was 61 years, by 1980 the tenure for the average firm was 25 years, and at the time the research was published it was 18 years.² The reasons why these large and successful companies have a shorter lifespan on the index are varied. So what are we to internalize as a take away from the data? The obvious observation is that there is a quicker turnover of large corporations and smaller barriers to entry. It is of extreme importance that the United States remains a place where new ideas and companies can be in a position to grow and thrive. One method the government, and the legislative branch in particular has to incentivize the hard work and risk associated with starting new companies is the ability to control the amount of taxation levied against new and small businesses.

II. A UNIQUE ANALYSIS

This note will address small business taxation and more specifically the S-Corporation (“S-Corp”). First, a brief explanation will be given of how taxation differs between Partnerships and the standard C-Corporation. Then the history of the S-Corp will be explained. It is important to understand how and why the S-Corp came about so that it can be determined when and why it should be updated. Congress initiated the S-Corp to take action to address the tension between taxation of corporations and partnerships.³ The S-Corp was created to address the specific problems faced by small business looking to enter markets dominated and controlled by large corporations.⁴ Congress noted the potential danger in prohibitively high barriers to entry in an evolving economy. The note will explain the goals set forth at the time of the creation of the S-Corp and the elements of what it takes to qualify for S-Corp status. Then it will examine the effectiveness of the S-Corp in relation to its goals. The paper will additionally look at the requirements and elements that a corporation must have to retain S-Corp status.

With the evolution of business, it is necessary to evolve business regulation. The note will also look at how the S-Corp has evolved and changed since its first enactment in 1958.⁵ This will be accomplished by looking at each individual element as it currently stands in comparison to the way it was originally enacted. Many of the elements have been updated; sometimes the same element has been updated multiple times. Some proposals that did not get passed into law will also be noted. Additionally, an analysis will be done as to whether the S-Corp remains relevant with even newer developments like the “check-the-box” regime and Limited Liability Companies (“LLCs”). The emergence of the LLC will be discussed and will be compared in a side-by-side comparison with the S-Corp. It will be noted that the LLC is the correct option for many who seek to start a small business. Nevertheless, the S-

2. Richard Foster & Sarah Kaplan, *Creative Destruction: Why Companies That Are Built to Last Underperform the Market—And How to Successfully Transform Them*, INNOSIGHT (February 2002), <http://www.innosight.com/innovation-resources/strategy-innovation/creative-destruction-whips-through-corporate-america.cfm>.

3. See generally The S Corp. Ass’n, *The History and Challenges of America’s Dominant Business Structure*, <http://s-corp.org/our-history/> (last visited Oct. 28, 2014).

4. *Id.*

5. Scott E. Friedman, *The LLC And S Corporation: Choice of Entity Redux*, 69 N.Y. ST. B.J. 36 (1997).

Corp remains the correct choice for others. An important discussion will follow analyzing whether further adjustments need to be made for the S-Corp to continue to accomplish its purposes.

Ultimately, a unique suggestion and proposal will be made that keeps the S-Corp in line with its original goals and the three main tax policy criterion: equity, efficiency, and simplicity, and at the same time makes it more attractive in today's global marketplace. It will be noted that three of the four elements of the S-Corp have been addressed by Congress, and that the fourth is in need of revision as well. The suggestion is to do away with the third, and previously unaddressed, element: the restriction on having a nonresident alien as a shareholder.

III. A SIMPLIFIED VIEW ON TAX

The Federal Government is funded by the ability to tax.⁶ The main function of the tax system is to raise revenue.⁷ The ways in which the tax system, or a particular tax, is measured or evaluated is threefold: its equity (fairness), its efficiency, and its simplicity (administrability).⁸

A. Equity

Equity, or fairness, aims at fair tax treatment to everyone.⁹ The definition of what is fair is a hotly debated topic. For example, does fair mean everyone pays the same percentage of his or her income as Federal Tax? Perhaps a better definition of fair would suggest that those who earn more money should shoulder more of the tax load? Looking closer into the details, does fair suggest that if two people make the same amount of money the tax code should give preference to the way in which the taxpayer chooses to spend that money? As an example, should the legislature use the ability to tax to encourage things like owning a home versus renting a home? The ideas and questions cited above can be reconciled into two main categories: vertical fairness and horizontal fairness.

Vertical fairness deals with how we tax people or corporations of different income levels.¹⁰ Proponents of vertical fairness suggest that it is fair for the tax rate to be different for people of different income levels.¹¹ In other words, vertical fairness suggests that those who earn more money should shoulder more of the tax burden. The rationale would be that a million-dollar earner has a greater ability to pay tax than a minimum wage earner.¹² This is the type of system, known as the progressive tax system, the United States has used since 1913.¹³ Notwithstanding our progressive

6. Nat'l Priorities Project, *Federal Revenue: Where Does the Money Come From*, National Priorities Project <https://www.nationalpriorities.org/budget-basics/federal-budget-101/revenues/>

7. *Id.* (noting that the government has other ways to control economic activity aside from taxation; for example, the Government can and does borrow money both domestically and abroad).

8. CHARLES H. GUSTAFSON, ET AL., *TAXATION OF INTERNATIONAL TRANSACTIONS: MATERIALS, TEXT AND PROBLEMS* 28-29 (4th ed. 2011).

9. *Id.* at 28.

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.*

system, the percentages and cutoffs used have changed and the view of how progressive the taxes should be is consistently in flux.

Horizontal fairness deals with how we tax people in similar economic circumstances.¹⁴ Horizontal fairness responds to the question of whether and how the tax code gives preference to how income is spent.¹⁵ Instances of horizontal unfairness are prevalent in the United States as well. For example, if Bob and Joe have the same taxable income, but Bob owns his home while Joe rents. Our tax code differentiates and gives favorable treatment to Bob.¹⁶

B. Efficiency

Efficiency (neutrality) suggests that the ideal tax should interfere as little as possible with people's economic behavior.¹⁷ The free market should allocate resources most efficiently and any interference with the free market hurts its efficiency. For example, if Nate owns a restaurant and has enough resources and customer base to open a second location, it would be an inefficiency for him to decide against opening the second location based solely on tax considerations. Taxes are, of course, a part of all major personal and business decisions. Therefore, almost all taxes have some sort of efficiency cost. The neutrality of a tax can work the other way as well. Congress has passed legislation to discourage activities. Examples of this would include special taxes placed on cigarettes and alcohol.¹⁸ Congress's influence in this way, picking industries as winners and losers in regard to taxes, also incentivizes various business activities and structures.

C. Simplicity

Simplicity or administrability is a measure that performs a cost benefit analysis of imposing the tax from the perspective of the taxpayer and the IRS.¹⁹ It is in the Government's best interest to simplify the ability for taxpayers to understand the law and their tax liability. The easier it is for taxpayers to ascertain their tax liability, the less administrative costs the IRS will incur in collecting taxes. The IRS needs the ability to enforce the tax at a reasonable cost.

IV. ENTITY VS. CONDUIT TAXATION

The IRS is charged with administering tax affairs as a function of the Treasury Department.²⁰ Employees of the IRS include accountants to perform audits, attor-

14. *Id.*

15. *Id.* at 28-29.

16. See I.R.S. PUBL'N 936, Home Mortgage Interest Deduction For Use in Preparing 2014 Returns (2015) (allowing for deduction of home mortgage interest).

17. GUSTAFSON, ET AL., *supra* note 8, at 30.

18. See Nat'l Priorities Project, *supra* note 6.

19. GUSTAFSON, ET AL., *supra* note 8, at 29-30.

20. GEORGE K. YIN & DAVID J. SHAKOW, FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTITIES 35 (1999).

neys working in the national office who promulgate guidance, and litigators who litigate disputed matters.²¹

Business enterprises can include, *inter alia*, partnerships, corporations, limited liability partnerships, or limited liability companies. Business enterprises are classified according to their formal characterization under the law of business organizations.²² The tax treatment between the different characterizations can be vastly different. Part of the drive for profitability of an organization includes establishing governing terms of the enterprises in search of favorable tax treatment. In response, the tax laws have adjusted to try and control these effects and make the treatment as partnership or corporation more elective.²³ Many organizations, including the ALL, have explored the tax code and looked for a reasonable way to do away with the dichotomy between partnerships and corporations in search of a more uniform approach.²⁴

A. Entity Taxation

Corporations are typically taxed according to Subchapter C under entity taxation.²⁵ Entity taxation means that the firm is treated as a taxable entity in its own right.²⁶ This results in what is commonly referred to as double taxation.²⁷ The corporation is taxed on business income as it arises and then the owners are taxed again upon a distribution of profits.

There are advantages to organizing a business as a corporation as well. Due to the fact that corporations are a separate entity, the shareholders are generally not personally liable for the affairs of the corporation.²⁸ This means that a shareholder or executives maximum potential loss is the money they invested in the corporation.²⁹ The ability to sue a shareholder in a personal capacity in a suit against the corporation is referred to as “piercing the corporate veil.” Successfully “piercing the corporate veil” is extremely rare.³⁰ This protection from corporate liabilities leaves the investors and owners to operate the business and take risks without fear of losing additional personal assets.

Additionally, there are rare circumstances in which entity taxation lessens the overall tax burden on a growing corporation. In the 1950’s and 1960’s, the United States’ individual tax rates for top earners were as high as 90 percent.³¹ At no point

21. *Id.*

22. See Friedman, *supra* note 5, at 36.

23. Geoffrey C. Hazard, Jr., *Foreword* to GEORGE K. YIN & DAVID J. SHAKOW, FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTITIES 35, 35-36 (1999).

24. *Id.*

25. Friedman, *supra* note 5, at 38.

26. *Id.*

27. *Id.*

28. *Id.* at 38.

29. Other advantages might be centralized management, free transferability of interests, and continuity of entity life if an owner dies.

30. Piercing the corporate veil requires serious misconduct like abuse of the corporate form.

31. Ritchie King, *Check Your US Tax Rate for 2012—and every year since 1913*, QUARTZ (2013), <http://qz.com/74271/income-tax-rates-since-1913/>.

during the 1950's or 1960's did corporate tax rates reach significantly above 50 percent.³² Therefore, at that time if you were a top earner and major shareholder in a corporation, it might have been advantageous to choose entity taxation. In this scenario, you, as the owner, are maximizing the amount of money retained to grow the business. This, however, is not the tax environment in which we currently find ourselves. Top earning individuals in the year 2013 can pay up to 39.6 percent, while the top rate for corporations is comparable.³³

B. Conduit Taxation

Partnerships are typically taxed as a conduit.³⁴ Partnerships are not treated as a taxpayer separate and apart from its owners. Therefore, the tax items pass through to the owners of the firm who are required to pay taxes according to their total income.³⁵ The partners pay the tax in the year money is earned regardless of whether any distributions are taken from the partnership.³⁶ Due to the fact that there is no entity, the partners themselves are potentially personally liable for the affairs of the partnership.³⁷

In today's tax environment (and through most of the United States history after the imposition of the modern income tax in 1913) conduit taxation has been the better option for growing a business. This benefit on the tax sheet does not translate to all areas of the business. As already mentioned above, there is the potential for personal liability in a partnership. Additionally, there is a whole separate body of law that governs partnerships versus corporations.

Entrepreneurs and small business owners are faced with a difficult initial analysis in the inherently risky venture of starting a business: choosing the proper business enterprise. The decision will likely involve many factors with the overall goals of the organization in mind, but certainly a dilemma to some will be whether to register as a corporation to secure personal protection from the obligations of the venture, or form as a partnership and enjoy the benefits of conduit taxation, but be subject to the additional risk of personal liability. The S-Corp was codified into the Internal Revenue Code as a potential solution to this difficult problem.

V. HISTORY OF THE S-CORPORATION

Republican President Dwight Eisenhower responded to concerns that too much economic power was being consolidated into the hands of a few wealthy, multinational corporations by embracing a proposal of the United States Treasury to create a special small business corporation classification.³⁸ In 1958, Congress acted on the President's recommendation and created Subchapter S of the tax code.³⁹ Subchapter

32. *Id.*

33. *Id.*

34. Yin, *supra* note 20, at 35.

35. *Id.*

36. *Id.*

37. *Id.*

38. The History and Challenges, *supra* note 3, at 1.

39. *Id.*

S provided the liability benefits of a large corporation to a small business while still maintaining the tax benefits of a partnership.⁴⁰

To qualify for this special treatment, those registering for S-Corp status were required to be within the limits of the following: they were required to be a domestic enterprise, they were required to have a limited number of shareholders, they were limited by who those shareholders could be, and they could have just one class of stock.⁴¹

Choosing the S-Corp designation is simple and the steps are provided in 26 U.S.C. § 1362. An election is valid only if all persons who are shareholders in the corporation on the day on which such election is made consent to such election.⁴² An election may be made by a small business corporation for any taxable year at any time during the preceding taxable year, or at any time during the taxable year and on or before the 15th day of the third month of the taxable year.⁴³

Revocation of status as a S-Corp is also simple. An election may be revoked only if shareholders holding more than one-half of the shares of stock of the corporation on the day on which the revocation is made consent to the revocation.⁴⁴ An election as a S-Corp is also terminated whenever such corporation ceases to be a small business corporation. In other words, the corporation fails to fall within the limitations of the elements.⁴⁵ The corporation can elect to regain S-Corp status after termination. If S-Corp status has been terminated, such corporation shall not be eligible to make an election to regain S-Corp status for any taxable year before its fifth taxable year which begins after the first taxable year for which such termination is effective, unless the Secretary consents to such election.⁴⁶

26 U.S.C. §1361 contains the current definition of the S-Corp. It explains that the term “small business corporation” means a domestic corporation which is not an ineligible corporation and which does not have more than 100 shareholders, have as shareholder a person who is not an individual, have a nonresident alien as a shareholder, and have more than one class of stock.

VI. GOALS OF THE S-CORPORATION

The goals of the S-Corp are simple. The goal is to provide small business owners a chance to survive and grow without exposure to potentially crippling liability.⁴⁷ Some of the difficulties entrepreneurs face in starting a business have been addressed above, but there are still others that the S-Corp helps to remedy. Typically, small firms have a harder time securing funding from banks because they are by nature more volatile and risky.⁴⁸ The S-Corp, *sua sponte*, does not lessen the inherent risks of starting a business, but allowing for conduit taxation in effect lowers the overall

40. *Id.*

41. *Id.* at 1-2.

42. 26 U.S.C. §1362 (2014).

43. Subject to limitations and extensions listed as exceptions in 26 U.S.C. §1362(b)(2)-(5).

44. 26 U.S.C. §1362

45. *Id.*

46. 26 U.S.C. § 1362(g).

47. The History and Challenges, *supra* note 3, at 1.

48. *Id.*

tax expenses on these small businesses allowing for a greater reinvestment in the company. More retained earnings lessens the need for outside institutions, such as banks, to extend risky credit.

The S-Corp was also implemented to encourage small and family business creation and innovation in the United States.⁴⁹ Innovation is a key component of a world leading economy. Large companies have a harder time innovating than smaller companies, and often times lack of an ability to innovate leads to a company breaking apart or failing entirely.⁵⁰ Therefore, it is in the best interest of the United States to foster an environment friendly to innovation by small business owners and entrepreneurs.

An additional consideration by Congress was the possibility that private enterprises might become a thing of the past.⁵¹ The industrial revolution saw major efficiency increases and the basic concept of economies of scale made it harder for smaller shops to stay in business. Years later, in what has become known as the Gilded Age⁵², the United States economy was expanding rapidly, especially in areas of heavy industry. For example, in 1869 the completion of the first transcontinental railroad allowed a passenger to travel from New York to San Francisco in only six days, a trek that previous lasted six months.⁵³ This growth greatly benefitted the nation. Those who were employed as part of this expansion saw salaries grow exponentially, but not everyone at the time saw the rapid expansion as a positive. Critics of the big business tycoons sometimes referred to the wealthy businessmen as “robber barons.”⁵⁴ The high level of unemployment led to riots in the streets.⁵⁵ This high level of unemployment resulted mostly from thousands of immigrants who were unable to find employment with the big businesses. There was also a rising concern that America was being dominated by a select few wealthy individuals who ran the economy to the exclusion of the masses.⁵⁶ It was feared that the United States would become a place dominated by one major industry and by a select number of individuals.

Looking ahead to 1958, Congress acted in a way to recognize that private and small enterprises are the surest way to make sure the United States incentivizes an entry point where risk and innovation can be rewarded.

49. *Id.*

50. FOSTER & KAPLAN, *supra* note 2, at 127.

51. *The History and Challenges*, *supra* note 3, at 1.

52. Referring to the time period between around 1870 and 1900.

53. June 04, 1876: Express train crosses the nation in 83 hours, HISTORY.COM (2009), <http://www.history.com/this-day-in-history/express-train-crosses-the-nation-in-83-hours/print>.

54. Gus Lubin, Michael B. Kelley & Rob Wile, *Meet The 24 Robber Barons Who Once Ruled America*, BUSINESS INSIDER (March 20, 2012, 12:56 PM), <http://businessinsider.com/americas-robber-barons-2012-3?op=1>. The “robber barons” might have included Andrew Carnegie (steel), Marshall Field (retail), J.P. Morgan (finance), John D. Rockefeller (oil), Cornelius Vanderbilt (railroads), etc. Also noteworthy, Andrew Carnegie’s “Gospel of Wealth” which described the duty of philanthropy of the new American self made rich class. The perspective as robber barons was not shared by all.

55. *Id.*

56. *The History and Challenges*, *supra* note 3, at 1.

VII. THE S-CORP HAS REACHED IT'S OBJECTIVES

The S-Corp has helped in accomplishing many of the goals listed above. As with any topic relating to business and economic growth, there are a number of factors that contribute to the way in which the economy evolves. Nevertheless, it is doubtless that individuals used the S-Corp to their advantage as will be explained hereafter.

First, it is important to analyze how the S-Corp should be measured or evaluated according to the criterion previously established: equity, efficiency, and simplicity.

A. *Equity*

Equity in its purest form aims at similar tax treatment to everyone regardless of how or from where the income is derived. The implementation of the S-Corp impacts equity of a tax system differently depending on whether the aim is to achieve greater vertical equity or horizontal equity.

Vertical equity refers to how people are taxed at different income levels. As was mentioned above, the United States uses a progressive income tax. As comparing the S-Corp to the standard C-Corporation, there is very little effect. In the S-Corp, shareholders take the corporate earnings directly into their gross income and pay tax according to the regular tax tables as established in 26 U.S.C. § 1. Therefore, as it pertains to vertical equity, the S-Corp is in keeping with the overall view of progressive taxation, which has long been established in the United States. The S-Corp that earns more money will pass those earnings through to the shareholders who will pay a higher marginal rate of tax, just like any individual who earns more money will pay a higher marginal rate of tax.

Horizontal equity refers to how people are taxed when they have the same or similar income levels. In this instance, the S-Corp could be seen as violating equity. If a S-Corp earns 10 million dollars, and a C-Corporation earns 10 million dollars, with the current rates, initially the tax difference will be negligible. The 10 million dollars from the S-Corp will go straight to the shareholders who will pay tax, and the C-Corporation will be taxed on the 10 million dollars as an entity. The difference lies in the effective tax rate once the C-Corporation takes those same earnings and distributes them to the shareholders. In that instance, the second level of taxation imposed on salary and dividends makes the C-Corporation's 10 million dollars subject to more overall tax than the 10 million dollars earned by the S-Corp.

In going through the equity analysis, it is important to note that with the implementation of the S-Corp, nothing was changed or taken away from the existing and future C-Corporations. The C-Corporations who had budgeted, anticipated and planned for upcoming taxes did not have to make adjustments in light of the new option to operate as a S-Corp. With that in mind, it is fair to say that the implication of the S-Corp did not directly impact the taxation of existing C-Corporations.

B. *Efficiency*

Efficiency, or neutrality, suggests that the ideal tax should interfere as little as possible with people's economic behavior. That is to say, that the free market should

allocate resources and investment. As mentioned above, all taxes have some sort of efficiency cost. The S-Corp helps efficiency as compared to the C-Corporation. The S-Corp allows those who have ambition and ideas a more realistic opportunity to take the risk of starting a business because there is less of a burden of tax and less potential overall liability. It is likely that this is the area that the drafters of the S-Corp were most hoping to address. The efficiency increases likely outweigh the violation of horizontal equity in looking at the total public utility derived from having the S-Corp.

C. *Simplicity*

Simplicity, or administrability, is twofold: the ability and costs of the taxpayers to understand and abide by the law, and the ability of the IRS to enforce the law at a reasonable cost. This is another instance where implementation of the S-Corp does not cause difficulty. The S-Corp is intuitively being treated the same as a partnership for tax purposes. Taxpayers are familiar with this taxation. The IRS is also familiar with partnership taxation. For corporations registered as S-Corps, the IRS should not incur any additional costs in collecting or administering the taxes.

D. *S-Corp Successes*

S-Corps became the most common corporate entity type in 1997.⁵⁷ In fact, the IRS estimates that there were 4.5 million S-Corps in the United States in 2007- about twice the number of C-Corporations.⁵⁸ As was mentioned above, there are likely other colluding factors taking place in the economy at large that facilitated this growth. Perhaps, for example, this growth coincided with the tech boom and .com bubble where innovation became possible with very little human and intrinsic capital. The trend continued past 1997, as the total number of returns filed by S-Corps for Tax Year 2003 increased 5.9 percent to nearly 3.3 million, from nearly 3.2 million reported in Tax Year 2002.⁵⁹ The most recent statistics show that S-Corps account for 61.9% of all US corporations.⁶⁰

Given the statistics, it is safe to say that S-Corps have been effectively reaching the goal of creating an environment where small businesses and their owners can enter the market place and compete. Not only are these corporations surviving, but they are thriving and make up a majority of corporations today. S-Corps grew from about 800,000 in 1986 to 4.2 million in 2011.⁶¹ As of 2011, more than 60 percent of net U.S. profits are attributable to pass-through businesses of all types, a ratio that generally increases every year.⁶²

Not all economists welcome the growth of the S-Corp and other pass-through entities as a positive development. The rate of growth of S-Corp and other pass

57. *SOI Tax Stats – S Corporation Statistics*, IRS.GOV (last updated Apr. 7, 2014), <https://www.irs.gov/uac/SOI-Tax-Stats-S-Corporation-Statistics>.

58. *The History and Challenges*, *supra* note 3, at 1.

59. *SOI Tax Stats – S-Corporation Statistics*, *supra* note 58.

60. *Id.*

61. William McBride, *America's Shrinking Corporate Sector*, Tax Foundation (Jan. 6, 2015), <http://tax-foundation.org/article/america-s-shrinking-corporate-sector>.

62. *Id.*

through entities has been coupled with a slowing in growth of tradition C-Corporations.⁶³ The number of traditional C-Corporations in the United States has fallen to historically low levels, which has eroded the corporate tax base.⁶⁴ Given this argument, it must be countered that a substantial portion of the decline in corporate tax revenue is offset by increased individual tax revenue from pass-through businesses. Furthermore, it should not be assumed that an increase in S-Corp and other pass-through entities is the direct cause of all declines in C-Corporation revenue and activity. It is well documented that the United States has one of the world's highest corporate tax rates.⁶⁵ Aside from any analysis in regard to the S-Corp, corporate inversions and other similar modern tax planning techniques have contributed to the erosion of the corporate tax base. An analysis of C-Corporation tax successes and failures is not the chosen topic, but it should be stated that the successes and growth of the S-Corp do not come at the expense of the C-Corporation. The C-Corporation needs to be analyzed and assessed individually.

An important realization given the downward trend of C-Corporations is that S-Corps are relied on to grow and replace the revenue and leadership once provided by large C-Corporations when they dissolve or cease operations. The average lifespan of a Fortune 100 and 500 company is in a steady decline.⁶⁶ According to an Innosight study, 75% of the S&P 500 will be replaced by 2027.⁶⁷ The important question associated with this statistic is: where will the replacement companies come from?

VIII. IMPORTANT TO CONTINUE TO INCENTIVIZE SMALL BUSINESS GROWTH

The information cited above by Innosight should spark further discussion on how to ensure new companies and ideas are being developed. Further investigation in the Innosight studies provides a clearer picture of how rapidly large corporation turnover can take place. Listed below is a sample of companies that have entered and exited the S&P 500 index since 2002⁶⁸:

Entered	Exited
Google	RadioShack
eBay	Circuit City
Ralph Lauren	Wendy's
Amazon.com	Texaco
Whole Foods	Sears

63. *Id.*

64. *Id.*

65. *Id.*

66. FOSTER & KAPLAN, *supra* note 2, at 147.

67. *Id.*

68. Information taken from graphics in *Creative Destruction*. See generally FOSTER & KAPLAN, *supra* note 2.

Netflix	Compaq
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This information does not suggest that the companies that exit the S&P 500 are no longer relevant, but rather it highlights that companies emerge quickly in today's world and grow even quicker. The economic assumption is that competition is good for the market place. More businesses and ideas means more goods are being produced, more goods being produced means more goods are changing hands, and ultimately, the more jobs are being created.

The laws of the United States cannot force innovation any more than the laws of the United States can force an individual into the labor markets.

Nevertheless, the laws of the United States can incentivize innovation and job creation. The tax code as currently constituted provides many such examples: currently the Government provides tax incentives to producers of alternative energy.⁶⁹

IX. OTHER ALTERNATIVES TO THE S-CORPORATION

There are other entities that small businesses might choose that have emerged after the S-Corp. In 1996, in an effort to clarify the confusion surrounding the "multi-factor test," Congress allowed for what is now called "check-the-box" entity election.⁷⁰ By allowing newly formed, and existing, non-publicly traded business entities to merely check a box to determine how they would be recognized and taxed, many organizations began to be characterized as limited liability companies. Limited liabilities companies ("LLC") provide the pass through taxation of a partnership with the limited liability of a corporation.⁷¹ Of course, this sounds very similar to the S-Corp. LLCs additionally do not have a list of qualifying elements that is as extensive as the S-Corp. To qualify to elect to be an LLC, the organization must be an eligible entity.⁷² Being an eligible entity means that the entity is not publicly traded. In the aftermath of check-the-box, there have been efforts to reverse or lessen its effects on taxation both domestically and internationally, but it remains in full force and a very popular choice for small businesses.

Many look to LLCs as a more modern solution to what the S-Corp set out to do when enacted by Congress. As with any business decision, this can be a highly specific choice dealing with multiple factors. Listed below are some of the basic ways in which the LLC and S-Corp are different:

S-Corp	LLC
100 owners	Unlimited
Limitations on types of owners	No limitations
One class of stock permitted	No limitations
Ownership interests generally	Profits Interest may be transferable

69. Eric Savitz, *Government Subsidies: Silent Killer of Renewable Energy*, FORBES, (Feb. 14, 2013), <http://www.forbes.com/sites/ciocentral/2013/02/14/government-subsidies-silent-killer-of-renewable-energy/> (last visited Oct. 16, 2015).

70. Joseph Isenbergh, *International Taxation* (3rd ed. 2010).

71. *Id.*

72. *Id.*

freely transferable in absence of shareholder agreement	but Membership Interests are not without consent of at least a majority of members in absence of Operating Agreement to contrary
Foreign investors not permitted	Permitted

*Source: *The LLC and S Corporation: Choice of Entity Redux*

Much of what a transactional attorney will do in practice will be to tailor the needs of their client to the best available option for establishing and growing a business. This is the essence of business planning. The advantages of the LLC over the S-Corp are readily apparent in the above table, but the S-Corp still has a unique edge to the LLC in a number of areas.

The S-Corp is incorporated as a corporation. This means that to potential investors and for outsiders looking at the business entity it may appear more established and permanent. It likely shows these same potential investors and outsiders that the owners and shareholders are intent on growing and becoming a well-established entity. This can yield a lot of peripheral benefits as far as gaining business relationships and client loyalty. If an organization's goals and vision includes positing themselves with a future that includes being publicly traded, then being a corporation could help further that goal.

The S-Corp has a structure that matches that of a large corporation with officers and board members.⁷³ This supports the claim made above that it makes the organization look more legitimate and permanent, but also facilitates a more structured organization and the ability to bring in talent to advise the company in taking direction in the important beginning years. Board members are often paid salaries at the cost of the corporation and its shareholders, but are also experienced business people who can make key decisions to help the long-term success of the company. Board members are also likely better connected with the business community and may have connections to help bring in top level talent as officers to run the company and oversee the day to day operations and decision making. For example, a few members of the board might have worked previously with a highly sought after CEO, and could provide leverage to bring that CEO on board to direct the affairs on the new company.

A very important factor in the consideration between small business entities is that S-Corps can sell stock, while LLCs can only sell interest in their company.⁷⁴ This is a major factor as far as growth potential and raising capital. It is also a factor when considering the liquidity of those with ownership interests. For example, if an original shareholder in an S-Corp wants to sell his shares and retire away from the stresses of corporate life, he is free to do so assuming he finds a buyer. The shareholder in an LLC, on the other hand, will have a more difficult time finding a buyer for his shares because the original shareholder will retain the voting power and partnership-like obligations within the organization. In essence, the only way to fully remove him or herself from the equation is to amend the founding documents of the LLC or receive consent of the majority of the LLC members. Alternatively, the LLC

73. Friedman, *supra* note 5, at 39.

74. *Id.* at 38.

can be disbanded. This would be similar to a partnership disbanding when a partner wants to sell their interests.

As was briefly mentioned above, an S-Corp is already a corporation, which means that if they decide not to elect S-Corp status (either proactively or because they fail to qualify) the move to become a corporation is seamless.⁷⁵ If the S-Corp grows such that the investors decide it is in the best interest of the company to go public, they may do so and not re-elect S-Corp status. The LLC would have a much more laborious process to reach the same end if the shareholders wanted to make a similar move.⁷⁶ The change likely would also have to be explained to the customer base and business partners. This type of movement might cause nervousness that the business is going through a major overhaul.

Lastly, the S-Corp (being a type of corporation) provides much more certainty when it comes to how legal issues would be handled.⁷⁷ There are a lot of statutes regulating corporations, and there is a lot of case law in regard to corporations. LLCs and other new small business entities are not only very unique as to their governing dynamics, but they do not have a long history of case law to look to when they have questions or concerns. This provides uncertainty. This uncertainty can provide obstacles as a planner trying to grow a business. Uncertainty can also be a hard sell to a potential customer.

In summary, when choosing a small business entity a lot of factors should be considered. The S-Corp still plays an important role both in the overall economic business environment, and as a viable option for those looking to organize as a small business organization.

X. CURRENT AND PAST UPDATES TO THE S-CORP

As is evidenced by the updates through the Small Business Jobs Protection Act, and the American Jobs Creation Act of 2004, the market place has changed, and so should the elements of the S-Corp. Three of the four elements have already been addressed and legislation has been passed to keep the elements up to date. Much of the change that has occurred was a result of the Small Business Jobs Protection Act.⁷⁸

President Clinton signed the Small Business Jobs Protection Act on August 21, 1996 and overhauled the rules applicable to the formation and operation of S-Corps.⁷⁹ With regard to the first element, the number of allowed shareholders was increased from 35 to 75, where husband and wife are considered one shareholder.⁸⁰ The American Jobs Creation Act of 2004 subsequently increased the number to 100.⁸¹

75. See 26 U.S.C. § 1362(d)(2) (2014).

76. See *Converting an LLC to a Corporation*, NOLO, <http://www.nolo.com/legal-encyclopedia/converting-llc-corporation-s-corporation.html> (last visited Oct. 24, 2015, 3:44 PM)..

77. Friedman, *supra* note 5, at 39.

78. *Id.* at 36.

79. *Id.* These changes came a few years after the introduction of Limited Liability Companies (“LLC”). The LLC is viewed by many lawyers and planners as another alternative to the S-Corp for family owned and small businesses. For similarities and difference between the two forms of small business entities, please see the section entitled “Other Alternative to the S-Corporation.”

80. *Id.*

81. The American Jobs Creation Act of 2004, 26 U.S.C. § 232 (2004).

In regard to the second element, the inability to have as shareholder a person who is not an individual, amendments have also been made. S-Corps previously could not be members of affiliated groups under §1504, and as a result S-Corps could not own 80% or more of the stock in another C-Corporation or S-Corp.⁸² Additionally, because S-Corps could not have corporate shareholders, they could not own stock in subsidiary corporations that were also S-Corps since that would require the “parent corporation” to serve as a “corporate shareholder” to such subsidiary.⁸³ The Small Business Jobs Protection Act repealed these restrictions and provided that S-Corps can be members of affiliated groups, can own more than 80% of the stock in a C-Corporation, and can own wholly owned S-Corps that meet certain requirements.⁸⁴

Addressing the fourth element, which provides a restriction on having more than one class of stock, in order to avoid a situation where a corporation uses debt that is later “recharacterized” as stock and, so, inadvertently causes termination of S-Corp status, certain “safe harbor guidelines” have been established.⁸⁵ In other words, debt would not be considered a second class of stock if the debt is evidenced by a written unconditional promise to pay a sum certain on a specified date or on demand, the interest rate on the debt is not conditioned on either the borrower’s discretion, profits, or similar factors, the debt is not convertible into stock, and the creditor was either an individual (except for nonresident alien), an estate, or a qualified trust.

There have also been attempts at other modifications that have either died at the end of a Congressional session, or are still currently being considered. The S Corporation Modernization Act of 2013 (H.R. 892) (previously introduced and died as H.R. 1478 (112th)) provides what it calls “critical measure(s) to modernize outdated rules that apply to S Corp.” This bill had bi-partisan support of six co-sponsors (3 Democrat and 3 Republican). It ultimately died with the House Ways and Means committee where the committee chair determines whether a bill will move past the committee stage. The bill made an attempt at making the “built in gains” holding period of 5 years permanent. It also sought a modification to Passive Income Rules (relating to tax imposed when passive investment income of a corporation having accumulated earnings and profits exceeds 25 percent of gross receipts) as amended by striking 25 percent and inserting 60 percent. Additionally, the bill attempted to repeal excess passive investment income as a termination event (consecutive years of only passive investment income acting to terminate S-Corp status). It also attempted an expansion of S-Corp eligible shareholders to include IRAs.⁸⁶

Later, Congress again tried to address the S-Corp in the S Corporation Permanent Tax Relief Act of 2014 (H.R. 4453). This bill passed house on 6/12/2014 and has been placed on Senate Legislative calendar. This bill addresses only the “built in gains” issue cited above in the S Corporation Modernization Act of 2013.

82. See Friedman, *supra* note 5, at 36.

83. *Id.*

84. *Id.*

85. *Id.*

86. See S Corporation Modernization Act of 2013 (H.R. 892) (previously introduced and died as H.R. 1478 (112th)).

XI. NEW IDEAS TO MODERNIZE THE S-CORPORATION

As has been cited above, the S-Corp has been adjusted and updated a number of times since it originally became an option in 1958. The S-Corp continues to be the subject of and included in many bills that are on the docket for current and future legislatures to consider. A study of what has been done and what is being done will show that three of the four elements that are required to elect S-Corp status have been addressed. The element of number of shareholders has been adjusted. The element of shareholder who is not a person has likewise been discussed. The element of classes of stock has been addressed to the advantage of the S-Corp.

Having addressed three of the four elements, it is time to examine the remaining element to see if it needs to be updated. In other words, it is time to address the element of the inability to have a nonresident alien as a shareholder. There are a number of logical reasons why this element should be addressed, and ultimately updated.

First, the element in itself is a little arbitrary as currently constituted. A nonresident alien is a designation given to someone who has not elected to be a resident alien or does not spend an adequate amount of time in the United States to be deemed a resident alien.⁸⁷ That being the case, it is entirely possible that a person or investor is considered a resident alien capable of being a shareholder in an S-Corp over a span of a couple of years, and then a nonresident alien the following year. The consequence of this change would be that the S-Corp would not be eligible to continue as a S-Corp with that same person continuing as a shareholder. Without changing the make-up of their ownership, the entire planning aspect of the corporation would have to change.

Perhaps an even more telling reason why this element needs to be addressed is that we now live in a global economy that is becoming more and more globalized by the year. Many of the new, entrepreneurial, and innovative ideas can and should combine talent and resources from other countries. As was previously mentioned, innovation is most likely to take place at the small business level. It is much harder for large companies to adapt and adjust to new ideas and changing preferences. Innovation across borders should be incentivized (or at the very least not discouraged). The obvious question that needs to be addressed is how this will affect the regulation of the S-Corp. Currently, foreign investors in our markets must abide by laws and regulations of the United States. Whether these individuals are resident aliens, or nonresident aliens, they have tax obligations to the United States. As a result of their tax obligation, they are subject to oversight by the IRS as a function of the Treasury Department. This is to say that the infrastructure is already in place for the United States to allow and regulate foreign investors, whether resident aliens or nonresident aliens, to be investors and shareholders in S-Corps. There would have to be certain guidelines to ensure proper taxation of the foreign shareholders. The ideas and suggestions in this note do not excuse the necessity for regulation, but suggest the benefits in spite of the increased regulation.

The S-Corp had as its purpose the idea of providing an opportunity for new ideas

87. GUSTAFSON, ET AL., *supra* note 8, at 49.

to grow from behind the shadow of larger corporations that were feared to have too much control in the market place. The Government and laws of the United States have opportunities to align incentives more properly with the changing economy. Cooperation among countries and their people should be incentivized similar to the way small business was incentivized by the addition of the S-Corp in 1958. Importantly, providing the incentive in this way also helps ensure that it is America that claims these ideas and the fruits of the labor.

For example, let's take a look at a simple hypothetical. Let's say that the next Apple, Inc. is being started by John. He does not yet know that his company will develop into the most profitable company in the world, but he has aspirations to develop his ideas toward that ideal. John is a savvy individual and looks at all the benefits of small business entities before choosing how to classify his company. Due in large part to his future ambitions for the company, John decides that registering as a corporation and filing for S-Corp status is his best option because he foresees his company being a large publicly traded company in the future. Additionally, John wants to enlist some of his talented acquaintances as members of the company's board of directors. John begins to network his idea to some former classmates who he believes would make good co-workers and shareholders in the company. Among his former classmates is William. John considers William an essential component of manufacturing and establishing the company's product. William is a resident of the UK and only rarely visits the United States. John becomes discouraged when he learns his plans to file for S-Corp status are frustrated by William's residency. William then convinces John to come to the UK and start the company in London. William has many acquaintances there that would be more than willing to be shareholders and investors.

The above example seems a little overly simplistic and extreme, but it is entirely realistic given the state of the global economy. International collaboration on ideas and projects is not unique, and neither is relocation to take advantage of opportunity and tax environment. In fact, Apple has been the subject of criticism for sending technical legal ownership of some intangibles overseas for the suspected purpose of tax savings.⁸⁸ It would be prudent of the United States to play the role it has historically played in attracting these people and ideas to U.S. soil. That is the aim of this note: to raise awareness that the S-Corp needs to be adjusted to better fit the global economy. This would serve to keep the United States as a leader in innovation, as has historically been the case. According to Forbes, immigrants or their children found 40% of the largest United States companies.⁸⁹ Some examples would be the Co-Founder of Google Sergey Brin, and the founder of Tesla Motors Elon Musk.⁹⁰ They were both immigrants to the United States who came and started thriving businesses. We want to make sure the talent from around the world sees the United States

88. See Nelson D. Schwartz & Charles Duhigg, *THE NEW YORK TIMES*, *Apple's Web of Tax Shelters Saved it Billions, Panel Finds*, (May 20, 2013) http://www.nytimes.com/2013/05/21/business/apple-avoided-billions-in-taxes-congressional-panel-says.html?pagewanted=all&_r=0.

89. See Robert Lenzner, *FORBES MAGAZINE*, *40% Of the Largest U.S. Companies Founded by Immigrants or Their Children*, <http://www.forbes.com/sites/robertlenzner/2013/04/25/40-largest-u-s-companies-founded-by-immigrants-or-their-children/>.

90. On 1/27/2012, Tesla stock (trading as TSLA) closed at \$29.33 per share. On 1/23/2015, Tesla stock closed at \$201.29 per share.

as a place to collaborate and invest in their ideas. The United States makes a major effort to attract top world-wide talent into our Universities, why would we not want to allow that same world-wide talent to come back as investors and shareholders in small businesses? It would seem logical for the United States to want to share the advantages given to its own citizens to other similarly motivated and educated individuals from around the world.

Those who might oppose such an amendment to the S-Corp are the same who likely oppose the S-Corp and other small business entities like the LLC. The idea among some is that without the ability to form an S-Corp or LLC the options would be limited to forming a partnership or C-Corporation. Assuming more corporations are formed, the revenue from business related tax is likely to increase. Some sources report that business tax revenue is at all time lows.⁹¹ What these reports likely under emphasize is that, as can be empirically shown, the money missed out on by the IRS in business tax revenue by providing advantages like those found in the S-Corp is made up partly in personal income tax returns, and is likely received later upon success of the company and business growth.⁹²

It is important to analyze how the proposal to allow foreign investors to be shareholders in the S-Corp plays into how the tax system is measured or evaluated. This requires another look at equity, efficiency, and simplicity.

Equity, or fairness, deals with how we tax people of different income levels. As compared to the S-Corp as currently constituted, vertical and horizontal equity should not be affected by adding foreign investors as eligible shareholders in the S-Corp. In viewing the tax treatment of the foreign shareholders as compared to the United States citizen or resident alien shareholders, perhaps there could be some difference as applied to equity. These differences, however they manifest themselves, should not cause such a shift in equity as to detract from the equity, in a more colloquial sense, of allowing shareholders from foreign countries.⁹³

Efficiency, or neutrality, demands that the ideal tax should interfere as little as possible with people's economic behavior. The free market should allocate resources most efficiently. This is where the proposal to add foreign investors gains its traction. This is also where the S-Corp in general gained its traction. The now global economy allows for reach of talent and resources beyond the United States' borders. Given that technology and travel have advanced and have made business across borders much easier, it would be an extreme inefficiency to unnaturally restrict shareholders and investors solely by reason of residency. On the other hand, by eliminating residency limitations, investors can choose to become shareholders based on the substantive likelihood of synergy gains, innovation and collaboration.

The last way that a tax system is measured or evaluated is by its simplicity or administrability. This deals with both the ability for taxpayer to understand the law, and the costs and ability of the IRS to enforce the law at a reasonable cost. There is also a concern about the costs to the taxpayer to comply with the law. On its face, allowing foreign investors does not add to the complexity to the taxpayer in filing as

91. See McBride, *supra* note 62..

92. *Id.*

93. It should be noted that some countries are subject to trade restrictions because of sanctions or national security concerns. Any new updates to the S-Corp should be in keeping with those restrictions.

a S-Corp. The taxation of the S-Corp passes through to the shareholders, so those shareholders who pay United States taxes will continue to do so, while the foreign shareholders will abide by the laws in place for foreign investors who earn income in the United States. For these foreign investors, the taxation of income earned in the United States might lead to some complexity. From the perspective of the IRS, as was mentioned previously, the IRS is in the habit of collecting taxes from United States sourced income. This includes both the taxes of United States residents and citizens and foreign investors. With the S-Corp based in the United States, these taxes could be retained before sending the net earnings to the foreign investors. Similar issues arise in taxing foreign partners in a partnership. Any change in the tax code is coupled with an initial increase in complexity until it is understood and applied by those involved. The change to the current law as a matter of substance is very minor.

XII. EFFECT OF UPDATED S-CORP ON C-CORPORATIONS

The increased and strong incentive to strengthen the S-Corp does not diminish or hurt C-Corporations or their current mode of taxation. It should be noted that the C-Corporation and its tax treatment is under constant analysis and review for how it should be taxed. The C-Corporation has fluctuated in its rate historically just as the individual tax rate has fluctuated historically.⁹⁴ Lots of organizations, including the ALI, have written extensively on how to update C-Corporation taxation. Topics have included minor changes all the way to a complete overhaul of the corporate tax system. This note does not opine on the content of those reports, but does clarify that in no way does the suggestion herein stated prevent the ideas of those reports from moving forward. The ideas of this note are, and would be, beneficial regardless of any additional innovation by C-Corporations. If a major movement in the C-Corporation taxation were to occur obviously it would have an effect on S-Corps. As can be seen by looking at recent legislative history, this type of major tax overhaul is unlikely to occur in the near future. The potential ramifications of such an overhaul would be difficult to predict. It is worthwhile to look at small changes, like one element of one subchapter, which can make a major impact.

XIII. CONCLUSION

The progression of the economy is a universal interest. During every decade since its founding, the United States has used its resources to promote the cultivation and innovation of new ideas. The United States has the ability to continue to provide this environment even amid changing and evolving circumstances. Small business taxation needs to be addressed to ensure a continued strong economy.

S-Corps have had the impact that they were designed to have on small businesses and entrepreneurs. S-Corps are unique from LLCs and other “check the box” entities. S-Corps are not large international conglomerates that dominate industries. S-Corps,

94. See Ritchie King, QUARTZ, *Check Your US Tax Rate for 2012—and every year since 1913* (April 14, 2013) <http://qz.com/74271/income-tax-rates-since-1913/>.

and changes made to their elements, will not rattle the United States or global economy. The changes proposed to the S-Corp simply provide a slight modification to existing standards that will ensure the continued successes according to its original goals. Importantly, S-Corps need to adjust to continue to provide positive incentives to current and future innovators. S-Corps need the freedom to keep up with an evolving economy. The current elements to apply for S-Corp status, and requirements to remain an S-Corp, could be an inhibitor in the shared interest of remaining a leading world economy. Efforts have been made to “modernize” the S-Corp, but these efforts have yet to address the element prohibiting foreign investors. The law should be updated to drive incentives and global innovation. Adjusting the elements of the S-Corp to match today’s global economy to ensure a strong and continued small private business atmosphere is an essential and manageable endeavor for Congress in the near future. The change suggested in this note does not substantially offend the way in which taxes and tax systems are measure or evaluated. The impact as to fairness, efficiency, and administrability are almost insignificant when compared with the potential benefits that arise from an updated S-Corp.

The continued leadership of the United States economy in an increasingly globalized economy requires adaptability and an influx of ideas on how to effectively regulate businesses. It is of interest to the United States to continue to support small business growth. The S-Corp and the element of prohibiting nonresident aliens as being shareholders is a great place to start.