2019 ■ Number 23
https://doi.org/10.20955/es.2019.23

ECONOMIC Synopses

Do Firms Switch Their Legal Form of Organization When Taxes Change?

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An individual or group of individuals that operate a business must choose the way the business is legally organized. The primary legal forms of organization are the C corporation, S corporation, nonprofit corporation, sole proprietorship, partnership, and limited liability company (LLC). As shown in Table 1, the essential differences among the forms are the number of owners allowed, the personal liability of the owners, and the tax obligations of the owners.[1]

> Tax-law changes can cause firms to change their organizational structure.

Operating a business entails some legal costs, which vary by state and legal form of organization. In general, these costs include a fee to create a statutory entity, an annual registration fee, and possibly attorneys' fees. Tax law changes are much more likely than legal fees to influence which legal form of organization a firm chooses.

In 2012, the state of Kansas reduced business tax rates to spur economic growth and job creation. The tax changes favored pass-through firms, which have personal income tax obligations but not corporate income tax obligations. As a result, pass-through firms would grow and hire more workers.

Given these results, Kansas implemented additional tax cuts in 2012 that reduced the personal income tax obligations of pass-through firms to zero. Unfortunately, this tax policy did not have the desired impact. After observing several years of falling tax revenues and little job creation, the Kansas Senate repealed this tax cut in 2017.

An important issue is how firms in Kansas responded to the tax experiment. A personal income tax rate change favoring pass-through firms would not only encourage the creation of new pass-through firms but also induce existing firms to reconsider their legal forms of organization. In the latter case, firms wanting to avoid double taxation might switch from the C-corporate form to a pass-through form. If these firms were already operating at their efficient scales before the policy change, after becoming pass-through firms they would not have needed to significantly change their business operations and therefore would likely not have hired additional employees or undertaken additional investment. In this case, the tax cut would have accrued to business owners without affecting growth. On top of that, these businesses would no longer have had to pay state corporate income taxes, causing state tax revenues to fall.

Table 1
Type and Features of Primary Forms of Legal Organization

Business structure	Number of owners	Personal liability	Taxes
Sole proprietorship	1	Yes	Personal income tax
Partnership	2 or more	Yes	Personal income and self-employment tax
LLC	1 or more	No	Personal income or corporate income tax
C corporation	1 or more	No	Corporate and personal income tax
S corporation	1 or more but not exceeding 100	No	Personal income tax
Nonprofit corporation	1 or more	No	Tax exempt, but profits cannot be distributed

Table 2
Firm Response to the Kansas Tax Law Change

		Switching rates (%)		Entry rates (%)	
Year	C corporations (%)	(P → C)	(C → P)	Pass-through firms	C corporations
2012	24.9	0.06	0.20	8.8	2.2
2013	23.9	0.09	0.41	9.9	2.0
2014	23.2	0.06	0.26	8.9	1.9
2015	22.5	0.06	0.21	8.8	1.9
2016	18.8	0.05	0.24	7.8	1.5

NOTE: P, pass-through firms. C, C corporations.

Using data from the Kansas Department of Revenue for the tax years 2012 through 2017, we evaluate the effects of the tax experiment, which are summarized in Table 2. Calendar year 2013 is the first full year of the tax law change. The entry rate of pass-through firms increased from 8.8 percent in 2012 to 9.9 percent in 2013, but the increase did not continue. The entry rate of C corporations marginally declined over the period. The law encouraged some businesses, whether existing or new, to organize as pass-through firms rather than C corporations. In 2013, the percentage of C corporations that switched to pass-through firms more than doubled, from 0.20 percent to 0.41 percent. The share of pass-through firms that switched to C corporations is close to zero. The overall result is a decline in the percentage of C corporations in Kansas, from 24.9 percent in 2012 to 18.8 percent in 2016.

In 2012, the state of Kansas reduced business tax rates to spur economic growth and job creation. The main effect of that change, however, was to induce some firms to change their organizational form to minimize tax obligations. This effect far outweighed any increase in economic activity. The change reduced the state government's revenue and did not noticeably spur job growth. ■

Note

[1] The personal liability of a legal structure refers to whether the owner(s) of a firm has legal obligations beyond that of the firm. A "No" answer in the table means the firm has "limited liability." The issue of tax obligation deals with the double taxation issue. Double taxation occurs when the firm must pay the corporate income tax on its profits and the owners must pay the personal income tax on any dividends received. Another difference between the legal forms is the ability to raise capital, which is an advantage of the C-corporate form.

Posted on October 4, 2019

ISSN 2573-2420