EQUITY UNDERMINED: THE 1918 CHECK-THE-BOX ENTITY CLASSIFICATION ELECTION*

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FOR DECADES, A NUMBER OF SUBSTANTIVE qualities of an unincorporated business were taken into account to determine whether the business should be treated as an association (and therefore equivalent to a corporation) for tax purposes. This practice can be traced as far back as 1921, when the government adopted a regulation that identified a number of "corporate" characteristics that would be employed to distinguish associations from trusts and partnerships.[1] After a series of administrative pronouncements and court decisions addressing the subject, the government in 1960 adopted a set of regulations that used six substantive qualities to determine whether to treat an unincorporated business as an association for tax purposes.[2] Known as the *Kintner* regulations, those rules remained in effect until 1996, when the government completely abandoned that approach in favor of one that permits any unincorporated business entity to be treated as an association for tax purposes if it simply elects to be so treated.[3]

Widely referred to as the check-the-box entity classification regulations, the current rules were promoted by the government as a way to simplify the process of classifying business organizations at a time when the substantive differences that used to exist between partnerships and corporations had all but faded away.[4] Although the check-the-box entity classification regulations represent a dramatic break from the approach taken under the *Kintner* regulations and its predecessors, the idea of allowing a business virtually unrestricted freedom to choose its tax classification dates back to the earliest days of the modern income tax. In fact, the first elective entity classification rule was enacted as part of the Revenue Act of 1918, just five years after Congress enacted the permanent income tax and long before it enacted the subchapter S provisions to permit a large class of corporations to elect to be treated as if they were partnerships for tax purposes.[5]

This brief article recounts the story behind that first, relatively obscure, elective entity classification provision. It also explains how that provision and its modern-day cousin may undermine certain basic notions of equity that any sound tax system should seek to advance.

THE SETTING

The first elective entity classification provision was adopted largely as a way to offset certain inequities produced by the modifications that Congress made to the overall tax system in 1918. Therefore, in order to fully appreciate the significance of the measure, one must understand the setting in which it was enacted.

The income tax system first designed by Congress after passage of the Sixteenth Amendment actually consisted of two separate taxes on individuals.[6] The first was the normal tax and the second was the surtax.[7] The income tax system also contained an entity level tax on corporations and similar business forms.[8] However, that tax did not interact with the normal tax in the same way that it interacted with the surtax, creating disparities that lawmakers struggled to address for years to come.[9] Specifically, as described more fully below, undistributed corporate profits enjoyed substantial tax relief compared to corporate profits paid out as dividends and profits derived by an unincorporated business. The Revenue Act of 1918 magnified those disparities in a number of ways, creating a need for Congress to include provisions that would address those disparities. An elective entity classification rule was one such measure.

CHANGES TO THE NORMAL TAX AND THE CORPORATE TAX

In the Revenue Act of 1918, Congress adjusted the income tax system in ways to make it even more progressive than existing law. This primarily involved tinkering with the tax rates on individuals and corporations. However, Congress didn't just adjust the surtax, which previously had been the sole vehicle for pursuing progressive tax objectives. It also restructured the normal tax by replacing the single flat rate with a graduated tax

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consisting of two brackets. As described below, the normal tax and corporate tax operated in a way that caused corporate profits to bear a heavier burden than the profits of an unincorporated business. However, the surtax operated in a way that more than offset this burden on corporate profits.

Under the normal tax for calendar year 1918, the first $4,000 of net income above an exempt amount was taxed at 6 percent, while any remaining net income was taxed at 12 percent.[10] As under existing law, the normal tax applied to an individual's share of partnership profits.[11] However, corporate dividends were exempt from this tax, as they had always been.[12] To make up for this exemption, the corporation had to pay a 12 percent tax on its net income.[13]

The adoption of a two-tiered normal tax alongside a flat corporate tax perpetuated and magnified existing disparities between the taxation of corporate profits and the taxation of other business profits. Now, in the few cases where a married shareholder's income did not exceed the relatively modest $2,000 exemption, there would be a 12 percent tax on income that would otherwise be tax free. In addition, if the shareholder's income fell between $2,000 and $6,000, the corporate tax would be double the tax the shareholder would pay on his share of profits from an unincorporated business. Under existing law, by contrast, corporate dividends were overtaxed in those few cases in which a married couple's income did not exceed a $4,000 exemption amount.[14]

After 1918, the normal tax rates were scheduled to be adjusted in a way that would magnify the disparities even further. Starting in 1919, the first $4,000 of net income above an exempt amount was taxed at 4 percent, while all other net income was taxed at 8 percent.[15] By contrast a flat tax of 10 percent applied to corporate profits, higher than both rates established for the normal tax.[16] As a result, corporate dividends were overtaxed in all cases, with the difference being no less than 2 percentage points.

The structure of the corporate tax was the result of a compromise. Under the bill reported out of the Ways and Means Committee and passed by the House, a corporation was subject to a two-tiered tax. A 12 percent tax applied to that portion of the corporation's net income that was either (1) distributed to shareholders as a dividend, (2) paid out to satisfy certain debt of the corporation, or (3) paid out to buy Liberty Bonds.[17] Meanwhile, an 18 percent tax applied to the rest of the corporation's net income.[18] This compares to a two-tiered normal tax on individual incomes that imposed a 4 percent levy on the first $4,000 of income and 12 percent on the rest.[19]

The House adopted this plan, but the Senate Finance Committee rejected it, believing that it failed to acknowledge that a corporation should not be taxed at a higher rate on amounts spent on investments that would lead to increased production in future years.[20] However, the committee openly acknowledged that it would be difficult to implement a system that would relieve from tax all "legitimate uses of earnings" including, in particular, amounts that a corporation invested in the business.[21] Because it was impossible to implement such a system, the committee decided to restore the flat 12 percent tax (8 percent after 1918) on corporations and to limit the existing war-excess profits to corporations.[22] Thus, the Senate Finance Committee viewed the flat rate as the best of all options and treated the war-excess profits tax on corporations as a substitute for a tax on undistributed earnings.[23]

The two competing measures were reconciled in the Conference Committee. Under that compromise, the House reluctantly agreed to restore the flat tax on the condition that it would be set at 10 percent after 1918, not the 8 percent that was part of the bill passed by the Senate.[24] The House conferees also believed that the pressure to raise revenue had been considerably reduced between the time the measure was voted out of committee and the time it was in the hands of the Conference Committee. When the Ways and Means Committee was drafting the bill, World War I was still going on and the 18 percent tax was part of an overall effort to raise all the revenue that the government could reasonably justify. The conferees were particularly mindful of the fact that other provisions of the bill imposed the high surtax rates on individual incomes without a corresponding levy on corporations, creating an irresistible incentive for corporations to accumulate profits and not to pay them out to shareholders as dividends.[25] In fact, the excess burden of the corporate tax paled in comparison to the tax relief that undistributed corporate profits enjoyed under the surtax.

CHANGES TO THE SURTAX

Congress changed the surtax by adding more brackets and increasing the tax rate for the highest bracket. There were 54 surtax brackets (up from 13) with rates ranging from 1 percent to 65 percent.[26] As in all past Revenue Acts, the surtax applied to an individual's share of partnership profits, whether distributed or not, but it only applied to an individual's share of corporate profits actually distributed.[27] The 1917 War Revenue Act addressed this disparity by taxing a corporation on a portion of its undistributed profits.[28] One year later, Congress changed its approach. It discarded the undistributed profits tax in 1918 and replaced it with a slightly modified version of the tax on accumulated earnings that was first adopted in 1913.[29]

Under the revised version of the accumulated earnings tax, any corporation that fraudulently accumulated earnings was subject to the rules that apply to personal service corporations, while the corporate income tax did not apply.[30] The personal service corporation rules expressly required the shareholders to be taxed on their share of firm profits as if they were members of a partnership.[31] The result was that each shareholder would have to pay the normal tax and the surtax on their share of firm profits, whether paid out to them or not.[32] However, the accumulated earnings tax was not self-assessed, as was the undistributed tax. Rather, the IRS had to identify cases of potentially unlawful conduct and assess the tax after making a finding. This is something that happened extremely rarely, making the accumulated earnings tax a feeble substitute for a self-assessed tax on undistributed profits. Therefore, for all practical purposes, there was no tax on undistributed corporate profits.

To make up for the absence of a tax on undistributed profits, Congress recalibrated the war-excess profits tax and restricted its application to corporations.[33] This represented a change from existing law, which imposed the war-excess profits tax on corporations, partnerships, and individuals alike.[34] The recalibrated war-excess profits tax, together with the other taxes that would have to be paid by the firm and its shareholders on corporate profits, had severe consequences in a substantial category of cases. In order to provide some relief to that class of corporations, Congress adopted a measure that expressly treated them as partnerships for federal income tax purposes.

PARTNERSHIPS CAN ELECT TO BE TAXED LIKE CORPORATIONS

Corporations enjoyed a substantial tax advantage over partnerships under the Revenue Act of 1918. The war-excess profits tax was supposed to function as the corporate counterpart of the individual surtax on partnership profits. As a matter of fact, each tax was imposed at a top rate of 65 percent. However, there was one crucial difference that caused the two taxes to produce significantly different outcomes. A corporation could reduce its war-excess profits tax liability by investing in the business.[35] By contrast, if a partnership invested its earnings in the business, the partners realized absolutely no relief from the surtax, even if the firm invested all of the profits in the business and paid out nothing to the partners.

Congress was well aware of the advantage that corporations were expected to enjoy. One lawmaker even cited the case of one partnership that would have to pay nearly $1 million more in tax than a corporation engaged in the same business and making the same profits.[36] Faced with the possibility of saving tax dollars by operating as a corporation, partnerships were expected to convert to corporate form. However, the Revenue Act of 1918 was not passed until February 24, 1919, even though its provisions took effect as of January 1, 1918.[37] This meant that if a partnership decided to convert to corporate form, it would have missed out on a full year of tax savings even if it under went a conversion immediately after the Act was signed into law. Congress addressed the situation by permitting any partnership or sole proprietorship that incorporated before July 1919 to be treated as a corporation retroactively to January 1, 1918.[38] This election was only available to a business in which capital was a material income producing factor.[39] In other words, a firm that was a partnership for up to 18 months could have made an election to be taxed as if it were a corporation throughout that period of time.

The election available under the 1918 Act is similar to the election available under the check-the-box rules in that in each case the election is one that is only available to an unincorporated business. Furthermore, in each case the business is treated as a corporation only if it affirmatively elects to be so treated. Otherwise, the default rule is to subject the business to the rules that apply to a partnership or sole proprietorship, as the case may be. The two provisions do not extend the option to the same range of businesses. Under the 1918 rule, the option was available only if capital was not a material income producing factor of the unincorporated business, and the business actually made the conversion to corporate form by a certain date. Meanwhile, under the check-the-box rules, the election is available to any unincorporated business other than a sole proprietor.

Perhaps the most noteworthy feature of the 1918 rule and its modern day counterpart is that each one has abandoned any effort to base the classification of a business on any meaningful principal. As a result, each provision seems to operate as nothing more than an invitation for the business and its owners to control tax outcomes. Taxpayers who have the freedom to make the choice may not object to this flexibility. However, simply giving taxpayers the power to control tax outcomes may not be compatible with basic notions of tax equity.

As a general rule, a tax system operates in an equitable way if persons with an equal ability to pay tax, in fact, pay equal amounts in tax. It seems difficult to see how this ideal of equity can be realized if some individuals have an option to reduce or otherwise control their tax liability, while others with an equal ability to pay do not. To that extent, both the 1918 provision and the check-the-box rules do not represent sound tax policy. However, as between the two elective provisions, the one made available in the 1918 Act may represent a more serious problem solely because the election took effect retroactively and not prospectively. As a result, a taxpayer could look back and determine with virtual certainty just how its tax liability would be impacted if it made the election. At least with the check-the-box rules, the tax impact would appear to be less than certain simply because the taxpayer is forced to make assumptions about what it expects to happen in the future. That is not to say that the current check-the-box rules represent progress toward achieving a measure of tax equity. After all, there still seems to be no sound principal at work to determine the tax that should be paid on the firm's profits.

Notes

1 Treas. Reg. 45, art. 1504, T .D. 3146, 23 Treas. Dec. Int. Rev. 352 at 591 (1921).

2 See Treas. Reg. § 301.7701-2(a)(1) (1960). Those qualities were (1) the presence of associates, (2) an objective to carry on business and to distribute the profits, (3) continuity of life, (4) centralized management, (5) limited liability, and (6) free transferability of interests. See Hobbs (1995) for a thorough history of the rules as they evolved during this period.

3 T.D. 8697 (Dec. 12, 1996).

4 Notice 95-14, 1995-1 C.B. 297 (Mar. 29, 1995).

5 Technical Amendments Act of 1958, P.L. 85-866; 72 Stat. 1606, § 64, 85th Cong., 2d Sess. Even before it enacted subchapter S in 1958, Congress enacted subchapter R in 1954, which permitted partnerships to be treated as associations for tax purposes. I.R.C. 1361 (1954), 68A Stat. 3, repealed by Act of April 14, 1966, P.L. No. 89-389.

6 Revenue Act of 1913 § II(A)(2), 38 Stat. at 166.

7 *Id.*

8 The corporate tax applied to "[e]very corporation, joint-stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships . . . ." *Id.* § II(G)(a), 38 Stat. at 172.

9 It is not entirely clear why Congress adopted the system that it did. The corporate income tax replaced a virtually identical tax adopted in 1909. The normal tax seems to have been viewed as an extension of that tax to individuals. See 50 Cong. Rec. 1302 (1913) (remarks of Rep. Anderson). Lawmakers may have viewed the surtax as the vehicle for achieving its progressive objectives.

10 Revenue Act of 1918, ch. 18 § 210(a), 40 Stat. 1062. When computing net income for purposes of the normal tax only, a single person was allowed to exclude $1,000, while a married couple or head of a family could exclude $2,000. *Id.* ch. 18 § 216(c), 40 Stat 1069. In addition, any taxpayer was entitled to reduce his net income by an additional $200 for each dependent he could claim. *Id.* ch. 18 § 216(d), 40 Stat. 1069.

11 *Id.* ch. 18 § 218(a), 40 Stat. 1070.

12 *Id.* ch. 18 § 216(a), 40 Stat. 1069.

13 *Id.* ch. 18 § 230(a)(1), 40 Stat. 1076. A corporation was allowed to reduce its net income by $2,000 for purposes of computing its income tax liability. *Id.* ch. 18 § 236(c), 40 Stat. 1080.

14 The existing exemption for an unmarried individual was $3,000. Revenue Act of 1916, ch. 463 § 7(a), 39 Stat. 756, 761, as amended by War Revenue Act of 1917, ch. 63 § 1203, 40 Stat. 300, 331.

15 Revenue Act of 1918, ch. 18 § 210(b), 40 Stat. 1062.

16 *Id.* ch. 18 § 230(a)(1), 40 Stat. 1076.

17 H. Rpt. No. 767, 65th Cong., 2d Sess. (1918) reprinted in 1939-1 (part 2) C.B. 86, 94.

18 *Id.*

19 *Id.* at 88.

20 S. Rpt. No. 617, 65th Cong., 3d Sess. (1918) reprinted in 1939-1 (part 2) C.B. 117, 120. Indeed this approach was the exact reverse of the one taken under the undistributed profits tax, which did not impose tax on amounts reinvested in the business. Senator Penrose described the arrangement in the House bill as one that would penalize corporations that practiced "conservative methods of business administration which have characterized the most wisely handled corporations." 57 Cong. Rec. 549 (1919).

[21] *Id*.

[22] *Id*. At the time the war-excess profits tax applied to every individual, partnership, and corporation. War Revenue Act of 1917, ch. 63 § 200 – 214, 40 Stat. 302 – 308.

[23] 57 Cong. Rec. 3010 (1919) (exchange between Reps. Stafford and Kitchin).

[24] 57 Cong. Rec. 3005 (1919) (remarks of Rep. Kitchin); *id* at 3132 (remarks of Sen. Simmons).

[25] 57 Cong. Rec. 3005 (1919) (remarks of Rep. Kitchin).

[26] The 1 percent surtax applied on net income above $5,000 and up to $8,000, while the 65 percent surtax applied to net income in excess of $1 million. Revenue Act of 1918, ch. 18 § 211(a), 40 Stat. 1062 – 1064. Individuals were no longer subject to the war-excess profits tax enacted as part of the War Revenue Act of 1917.

[27] Revenue Act of 1918, ch. 18 § 213(a), 40 Stat. 1065; § 218(a), 40 Stat. 1070.

[28] War Revenue Act of 1917, ch. 63 § 1206(2), 40 Stat. 334.,

[29] Revenue Act of 1918, ch. 18 § 230(a), 40 Stat. 1075; ch. 18 § 220, 40 Stat. 1072.

[30] *Id*. ch. 18 § 220, 40 Stat. 1072.

[31] *Id*. ch. 18 § 218(e), 40 Stat. 1070.

[32] The application of section 220 appeared to be quite cumbersome. The Treasury declared in an early pronouncement that "[w]hether a corporation is taxable under section 200 can not be determined in advance; it must be determined at a later date in the light of what it has actually done with the profits retained." T.B.M. 2, 1 C.B. 181 (1919). The implication is that the corporation and its shareholders would report income and pay tax as if the provision did not apply. If the government determined that the provision did apply, then adjustments would have to be made at both the firm level and the shareholder level to reverse the original treatment and to conform to partnership treatment.

[33] Revenue Act of 1918, ch. 18 § 300, 40 Stat. 1088.

[34] War Revenue Act of 1917, ch. 63 § 201, 40 Stat. 303.

[35] See Revenue Act of 1918, ch. 18 § 301(a) and (b), 40 Stat. 1088 (1918 and later years). Compare War Revenue Act of 1917, ch. 63 § 201, 40 Stat. 303 (1917).

[36] 57 Cong. Rec. 3269 (1919) (remarks of Sen. Smoot).

[37] *Id.* ch. 18 § 210(a), 40 Stat. 1062; § 301(a), 40 Stat. 1088.

[38] Revenue Act of 1918, ch. 18 § 330, 40 Stat. 1094.

[39] *Id*.

Reference

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