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threshold level of income below which no tax is due (see Personal exemption, federal). In addition, the more generous the amount of the standard deduction, the fewer the number of taxpayers who will itemize deductions. Historically, between six and seven out of 10 taxpayers have claimed the standard deduction instead of itemizing deductions on their federal tax returns.

Cross references: adjusted gross income; income tax, federal; inflation indexation of income taxes; personal exemption, federal.

Subchapter S corporation

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An incorporated business that, having met certain eligibility requirements and made an effective federal tax election, is generally not subject to the federal corporate-level income tax.

The income (and losses) of a Subchapter S corporation flow through to shareholders as they are realized by the entity, much like a partnership rather than a corporation. As a general principle, actual distributions of dividends to shareholders are received free of tax up to the basis of each shareholder in his or her shares. These corporations continue to share all other attributes of incorporated entities (e.g., separate legal entity, limited liability, unlimited life).

For tax purposes there are four forms of business organizations: C corporations (all other than S), S corporations, partnerships, and proprietorships. The choice may have important tax consequences.

Subchapter S of the Internal Revenue Code (§ 1361 through § 1379), for and by which these corporations are named and governed, was enacted in 1958 and substantially revised in 1982 and 1996. The basic eligibility requirements to be met by a Subchapter S corporation are: (1) that it be a U.S. corporation with no more than 75 shareholders, with married couples counting as a single shareholder, (2) that only individuals may be shareholders, with the exception of some estates and trusts, (3) that it may not have a nonresident alien as a shareholder, (4) that it may have only one class of stock, and (5) that it may not be a bank, an insurance company, or a member of an affiliated group, or any of certain other types of corporations. Individual states set their own rules for the state income tax treatment of S corporations, which range from full conformability to federal rules to the nonrecognition of S corporations, which subjects all of the entity's income to the state corporate income tax.

An S election requires the unanimous consent of shareholders. Unlike C corporations, S corporations must generally use a calendar year tax year, but may choose either the cash or the accrual method of accounting. Unlike C corporation shareholders, an S corporation employee who owns more than 2 percent of the corporation's stock will face partnership treatment of fringe benefits.

Additional taxes may apply to C corporations converting to S corporations. A C corporation that used the last-in, first out (LIFO) in its inventory accounting will have to pay a recapture tax. If the corporation has carryovers of net operating losses or tax credits, they cannot be used by the S corporation. An S corporation that formerly was a C corporation may also be taxed on its passive income (e.g., interest, dividends, rents, and royalties) if it has Subchapter C earnings and profits at the time of conversion. A final issue in the conversion decision is the "built-in gains" tax of IRC § 1374, enacted in 1986. This provision requires an S corporation to pay a corporate-level tax on any preconversion Subchapter C "built-in" gains if they are realized within 10 years of the conversion. (Conversions that took place before 1987 remain subject to an earlier form of the rule that contained a three-year recognition period.)

While an S corporation can voluntarily revoke its status at any time, care must be exercised to ensure that S treatment is not involuntarily terminated. Involuntary termination can take place if the corporation fails to continuously meet the eligibility requirements listed above. A voluntary revocation during the first two and one-half months of a tax year is effective for that year; otherwise it will take effect at the beginning of the next taxable year. A termination becomes effective on the date the firm violates any of the eligibility requirements. A firm that either revokes or terminates its S status cannot elect to become an S corporation again for five years (although relief can be granted for accidental termination). This prohibits firms from making frequent changes to take advantage of the differing tax treatments accorded S and C corporations.

Subchapter S is an attractive option for startup firms that are able to meet the eligibility requirements. In the early years of operation, when firms are likely to have negative income, the losses would flow through to shareholders and be deducted against their individual income. Losses passed through to shareholders are deductible up to each individual's basis in the corporation's stock and debt. Losses in excess of basis can be carried forward to offset future Subchapter S income. The S corporation's income is taxable to the individual

shareholder as it is received or accrued, regardless of whether the income is distributed (as in a partnership). The amount of income recognized by each shareholder increases his or her basis in the corporation. This basis affects the amount of distributions receivable tax-free. Unlike a partnership, all gains and losses must be allocated pro rata to each share.

For closely held corporations, S and C status can be used as part of a tax-minimizing strategy. In the case of loss corporations, S is preferred because the losses can be immediately deducted at the individual level. For profitable corporations, election of S status would eliminate the corporate-level tax. However, in some cases (particularly before the Tax Reform Act of 1986), an S election may subject the income to an individual tax rate that is higher than the corporate rate. In 1986, the maximum tax rates were 46 percent for corporations and 50 percent for individuals (as recently as 1981 individual tax rates were 70%). When shareholder rates are higher than the corporate rate, a strategy of paying the corporate tax as a C corporation and not distributing income to shareholders may result in less tax being paid in the current year, and a deferral of the individual tax. If capital gains are more favorably taxed than ordinary income, the deferral of income also benefits from lower tax rates if it is ultimately recognized through a sale of the stock in the corporation. There are various strategies to remove income from the taxable corporate sector without paying two levels of tax. Because these are closely held corporations, managers and employees of the firm may also be shareholders. Thus, payments of wages and salaries, deductible at the corporate level, will be taxed only once when received by individuals (and not at all in the case of some benefits). In addition, subject to some constraints, the corporation could reduce its exposure to the corporate tax by borrowing from its shareholders because interest payments (and rents and royalties) are deductible at the corporate level (Plesko 1994).

After the Tax Reform Act of 1986, the maximum individual and corporate marginal tax rates were reduced, with the maximum corporate rate (34%) being higher than that for individuals (28%). This had the effect of making C corporations less attractive as a means of minimizing taxes. Since 1986, the use of S corporations has expanded dramatically, even though in 1993 the maximum individual federal income tax rates were raised above the maximum corporate rate. An S election eliminates one of the two taxes, amounting to integration of the corporate and shareholder taxes by election.

S corporations grew from 6.2 percent of corporate returns in 1960 to 20.1 percent in 1980 to 24.1 percent in 1986. The number of S corporations increased to 1,575,092 of the 3,716,650 corporate returns filed in 1990 (42.4%). Accompanying the growth in the number of S corporations is their share of corporate economic activity. Before 1986, S corporations were responsible for less than 6 percent of business receipts, increasing to 10.1 percent in 1987. In 1990, S corporations were responsible for 14.2 percent of total receipts. Despite these increases in returns, S corporations remain a small proportion of corporate assets: In 1990, 4.1 percent of corporate assets were in S corporations. Petska and Wilson (1994) provide information on trends in business organizations during the 1980s.

While 35 was, until the 1996 legislation, the maximum number of shareholders allowed under federal law, the constraint seemed to affect only a small percentage of firms; the typical firm had fewer than three shareholders and more than 90 percent of firms had 10 or fewer (Nelson 1992; Plesko 1994). In 1990, the average S corporation had $472,550 in assets, compared to an average of approximately $8.1 million for non-S corporations. Thirty-two percent of S corporations are in services, 26.7 percent in trade. The smallest number of S corporations are in mining (1 percent of the total), agriculture (3.5 percent), and transportation and utilities (4.1 percent) (Internal Revenue Service 1993). Nelson (1993) and Plesko (1995) provide data on the characteristics of business corporations after the Tax Reform Act of 1986.

Limited liability corporations (LLCs) and limited liability partnerships (LLPs) have become popular alternatives to S corporations. Recognized in nearly all 50 states, these entities offer the same benefits of limited liability and pass-through tax treatment as S corporations, but have fewer operational restrictions. For example, LLCs have no limits on the number of shareholders of classes of stocks.

Additional readings

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Cross references: dividends, double taxation of; income tax, corporate, federal; income tax, federal; partnerships.

Sumptuary taxes

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Excise taxes intended to discourage the consumption of specific commodities or services.

The term sumptuary taxation has gone out of fashion. An earlier generation of writers used the term to categorize taxes imposed for moral or religious reasons. Contemporary economists would describe a tax intended to discourage consumption of a specific commodity as adjusting for a negative externality. Politicians and journalists might use the term "sin taxes."

Excise taxes have been and are widely used by governments to discourage consumption of specific commodities; taxes on alcoholic beverages and tobacco products are the obvious examples. Using the old-fashioned term "sumptuary tax" helps to clarify thinking about excise taxes of this sort. The need for clarity is illustrated by the literature regarding cigarette taxes and smoking. Those who view tobacco taxes as instruments for adjusting for externalities are interested in measuring the negative externalities and reaching a conclusion with respect to whether the tax, as a policy instrument for increasing the price by an amount that corresponds to the measured externalities, is too high, too low, or about right. Those who view cigarette taxes from a sumptuary stance argue for taxes above the externality-adjusting level because they regard protection of every individual's health a public policy obligation. In this view, it is a moral imperative to reduce consumption below what would occur when consumers are fully aware of the risks of smoking and cigarette prices include measured externalities.

Both advocates of externality-adjusting excise taxes and advocates of sumptuary taxes would agree that the revenue generated by the tax is not a primary objective. Similarly, they would agree that the distribution of either tax among taxpayers classified by income or consumption levels is largely irrelevant. For both, the object of the tax is to get the gross-of-tax price "right."

Sumptuary taxes set at "too high" a level verge upon prohibition through the tax system rather than by regulation. Because the social costs of prohibition can be significant—for example, the costs of controlling smuggling and illicit domestic production and distribution—a sumptuary tax rate that is in some sense optimal is not a rate that minimizes consumption. Clearly, sumptuary taxation involves issues that go well beyond traditional tax analysis.

The United States has a long history of sumptuary taxation of alcoholic beverages and tobacco products mixed with revenue-raising objectives. The first domestic tax enacted by the United States, in 1791, was on distilled spirits at rates ranging from 7 to 18 cents per gallon, depending on the alcohol content, or proof, of the liquor, and imposed on the distiller. The first secretary of the treasury, Alexander Hamilton, sought a revenue source not dependent on foreign trade. Sumptuary motives were also involved. As Hamilton put it, "The consumption of ardent spirits particularly, no doubt very much on account of their cheapness, is carried on to an extreme, which is truely to be regretted, as well in regard to the health and morals, as to the economy of the community (quoted in Forsythe 1977: 40). The tax was resisted in western Pennsylvania and other areas where whiskey was used as a medium of exchange. In 1794, troops had to be called out to put down the "Whiskey Rebellion." The military operation was successful in establishing the power of the new government to collect taxes, but the tax continued to be unpopular. Soon after the Jeffersonians took power, the whiskey tax was repealed. It was reenacted briefly during the War of 1812 and then not again until the Civil War, primarily as a revenue-raising measure. At the time, only a few members of Congress argued for the tax on sumptuary grounds. During the 1860s taxes were also imposed on beer, tobacco products, and wine, but again, sumptuary objectives were secondary to revenue. Taxes on alcoholic beverages and tobacco products have been part of the federal taxes ever since the Civil War. The sumptuary character of these taxes, and of similar state and local taxes, seems to form a substantial part of their continuing public acceptance.

The 10 percent tax on wagers on sporting events, elections, and contests enacted in 1951 might be regarded as a sumptuary tax. Its intent was to aid law enforcement efforts aimed at illegal bookmaking. The rate was reduced to 2 percent in 1974 and, in the case of legal wagers such as sports betting in Nevada, to 0.25 percent in 1982. Exemptions are provided for state lotteries, and state-sanctioned horse races and similar events. Given the low rate on legal wagers and the broad exemptions, the tax on wagers seems to have a role only in enforcement of laws against illegal bookmaking and thus is not truly sumptuary in nature.