# Entity Taxes under TCJA

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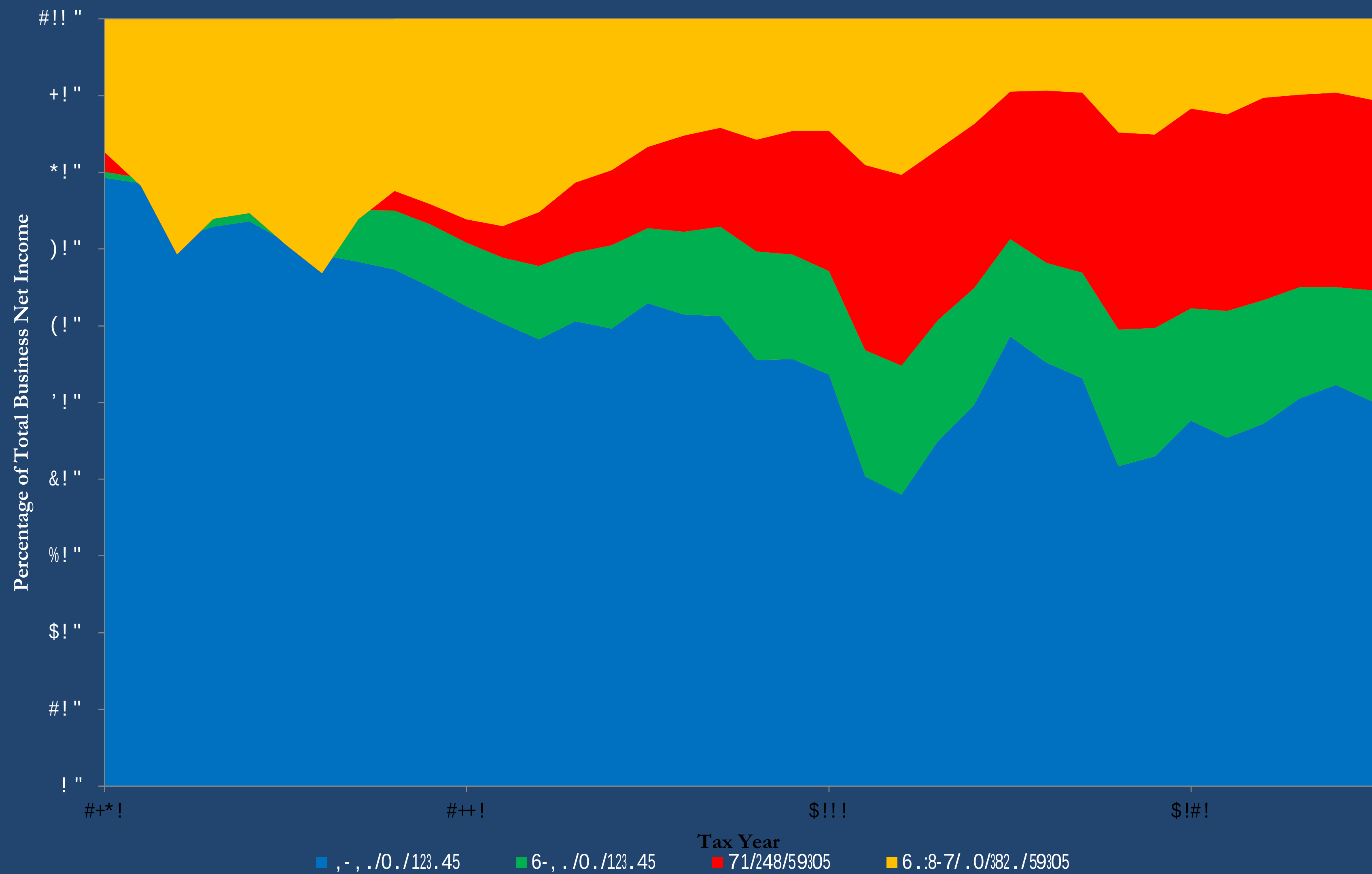
# Figure 1: Percentage of Total Net Business Income by Entity Type, 1980-2015



# Which Entity Type?

A Firm's choice of business structure is likely a function of both tax and non-tax concerns.

Shifts:

- Intertemporal
- Base
- Flavor
- Combination

# Which Entity Type?

Ease of Conversion

- Check the Box rules allow Pass-Throughs to be taxed under the corporate system
- Conversion to C-Corp is largely costless
- Conversion to Pass-Through is *not*

# Why C-Corporation?

A Firm's choice of business structure is likely a function of both tax and non-tax concerns.

C-Corporations:

- Double Taxation
- "Broad access to Capital Markets"
- Deferral
- Pre-1986 the Preferred Mechanism for Tax Avoiders

# Why Pass-through Business?

1) Sole Proprietorships
   - Single Layer of Tax but must include Self-Employment Contribution Act (SECA) taxes
   - Filed on 1040 Schedule C
   - Simplest Form
   - Receive Direct Payments or 1099s (information Returns)
   - Report Earnings on 1040 Schedule C
   - Fill out Schedule SE

# Why Pass-through Business?

2) S-Corporations (“subchapter S entities”)

- Subject to Closely Held Rules
- Some income avoids SECA taxes
- ‘100’ or less Individual Shareholders only
- One Class of Stock (Pro Rata)
- Income Retains Flavor
- The Reasonable Compensation Problem

# Why Pass-through Business?

3) Partnerships

- Some income avoids SECA taxes
- Flexibility in Distribution/Form
- Most Complicated Form
- Partners Receive Payments vis K-1
- Report Earnings on
  - 1040 Schedule E (individual)
  - 1120 (corporate)

# Observations about Business Owners

C-Corporation

- “Everyone”

S-Corporation

- 7.2 million K-1s to 4.8 million individuals
- 4.5 million Entities

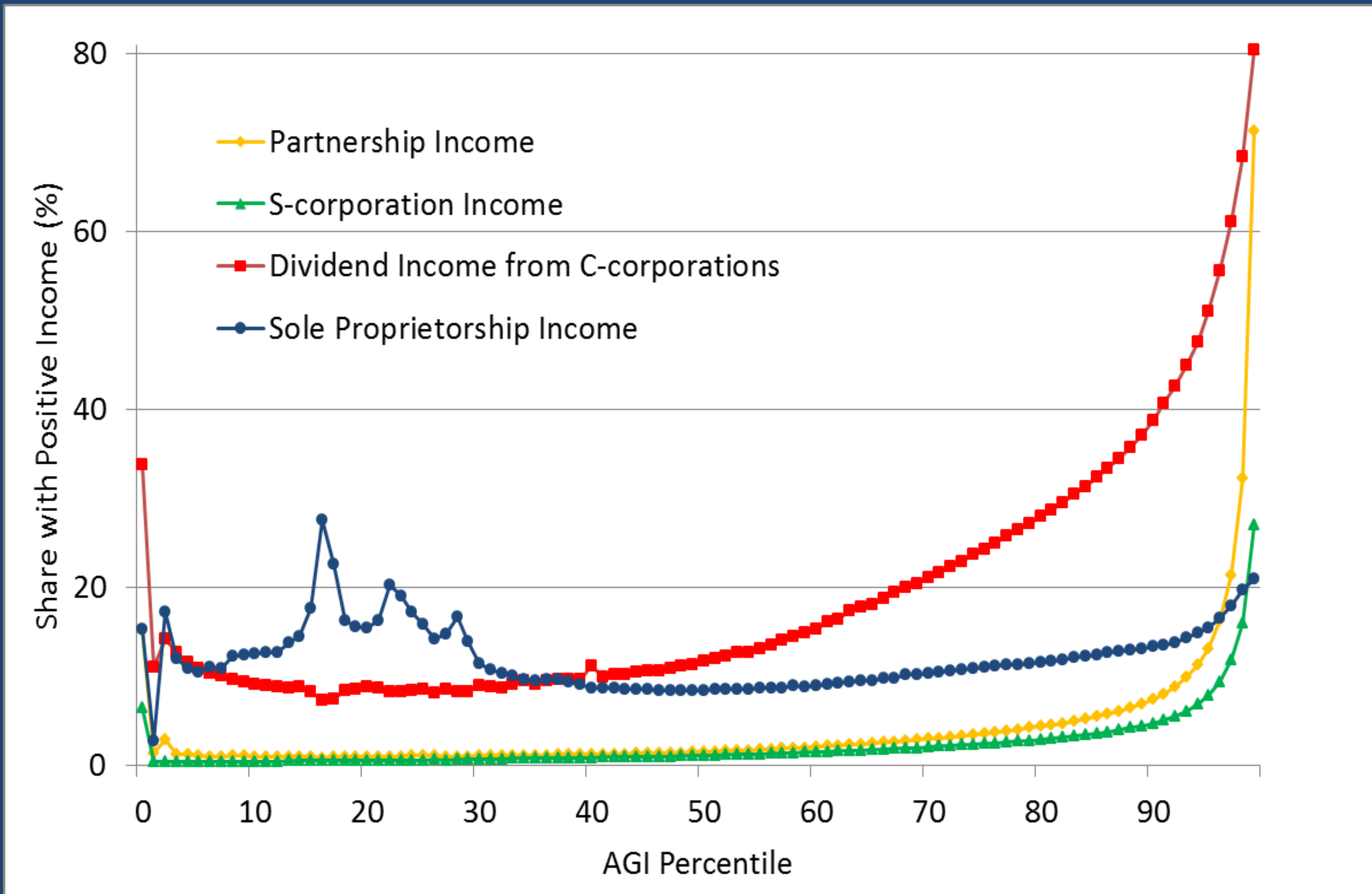
Partnerships

- 25.5 million K-1s from 3.6 million Entities
- 74% Individuals, 6% Partnerships, 5% Estates, 3% Corporations

Sole Proprietors

- 23.4 million returns filed a Schedule C

# Observations about Business Owners



# Tax Rate Comparison of Entity Types

Tax wedge between the corporate and individual tax base is:

$$W = T_{\text{net corp}} - T_{\text{ind}}$$

Where:

$$T_{\text{net corp}} = T_{\text{corp}} + (1 - T_{\text{corp}}) \cdot (\alpha \cdot T_{\text{div}} + (1 - \alpha) \cdot \beta \cdot T_{\text{cg}})$$

$\alpha$ = share of corporate income paid out as dividends

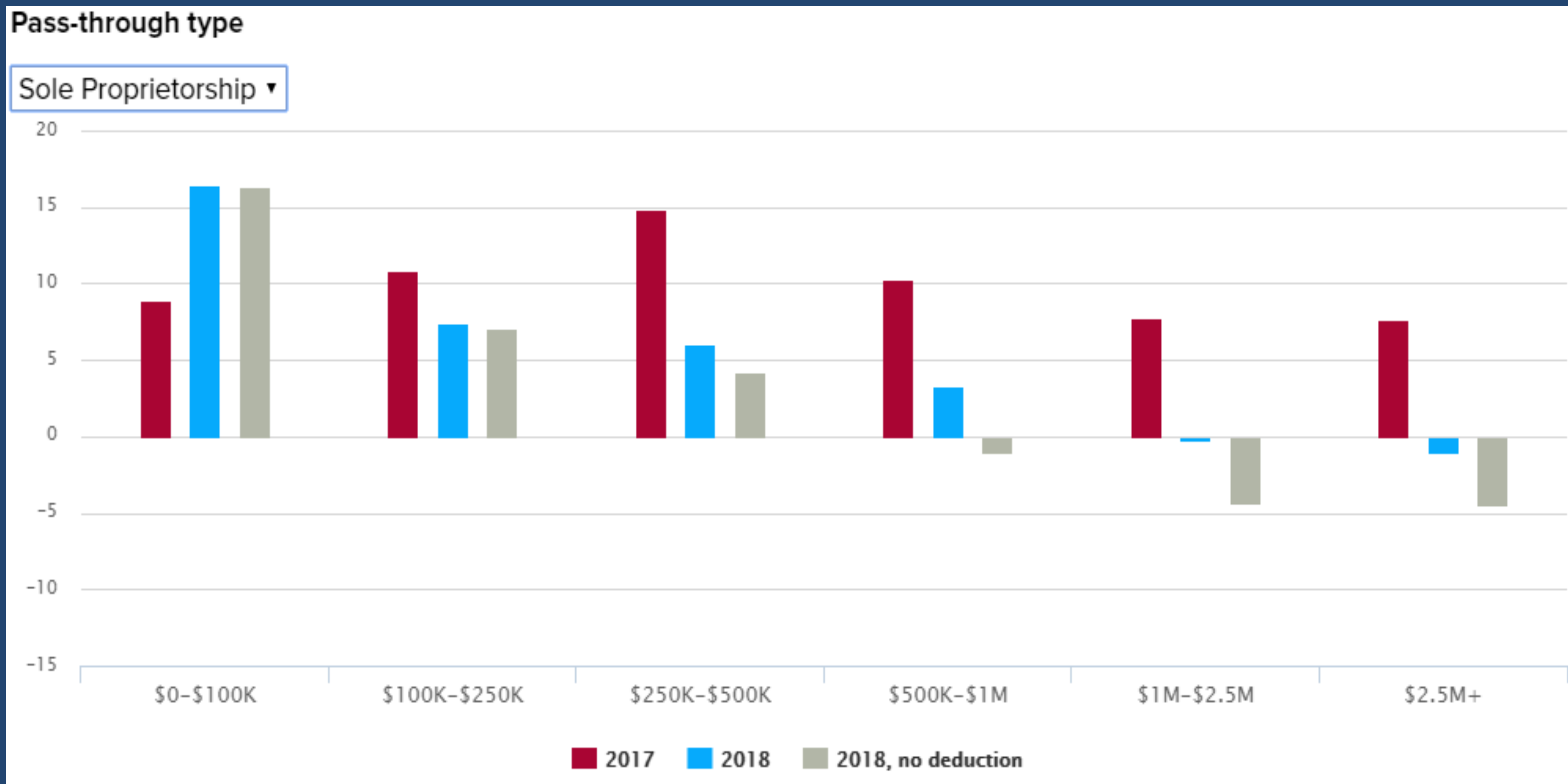
$\beta$ = a measure of the benefits of capital gains deferral

# Tax Rate Comparison of Entity Types

| | 0% Retained | | | | |
|---|---|---|---|---|---|
| | 2017 | | 2018 | | |
| Type of Tax | C-corporation | Pass-through | C-corporation | Pass-through | w/ 20% Deduction |
| Entity Tax | 35.0% | 0.0% | 21.0% | 0.0% | 0.0% |
| Individual Tax | 20.0% | 39.6% | 20.0% | 37.0% | 29.6% |
| Net Investment Income Tax | 3.8% | 3.8% | 3.8% | 3.8% | 3.8% |
| Net Rate | 50.5% | 43.4% | 39.8% | 40.8% | 33.4% |
| Rate Differential | | 7.1 | | -1 | 6.4 |
| | 100% Retained | | | | |
| | 2017 | | 2018 | | |
| Entity Tax | 35.0% | 0.0% | 21.0% | 0.0% | 0.0% |
| Individual Tax | 0.0% | 39.6% | 0.0% | 37.0% | 29.6% |
| Net Investment Income Tax | 0.0% | 3.8% | 0.0% | 3.8% | 3.8% |
| Net Rate | 35.0% | 43.4% | 21.0% | 40.8% | 33.4% |
| Rate Differential | | -8.4 | | -19.8 | -12.4 |

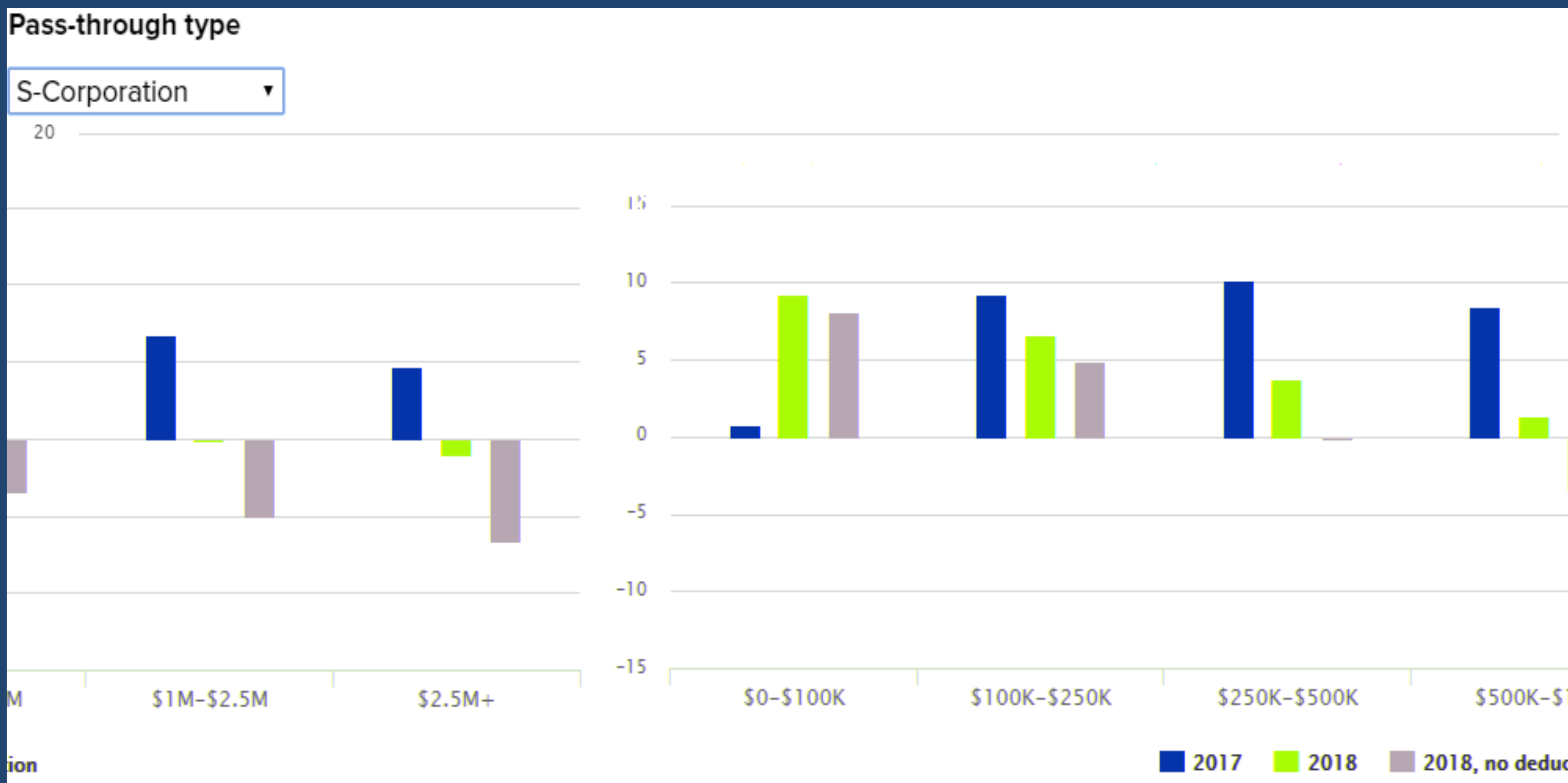
# Tax Rate Comparison 52% Retained

## Sole Prop



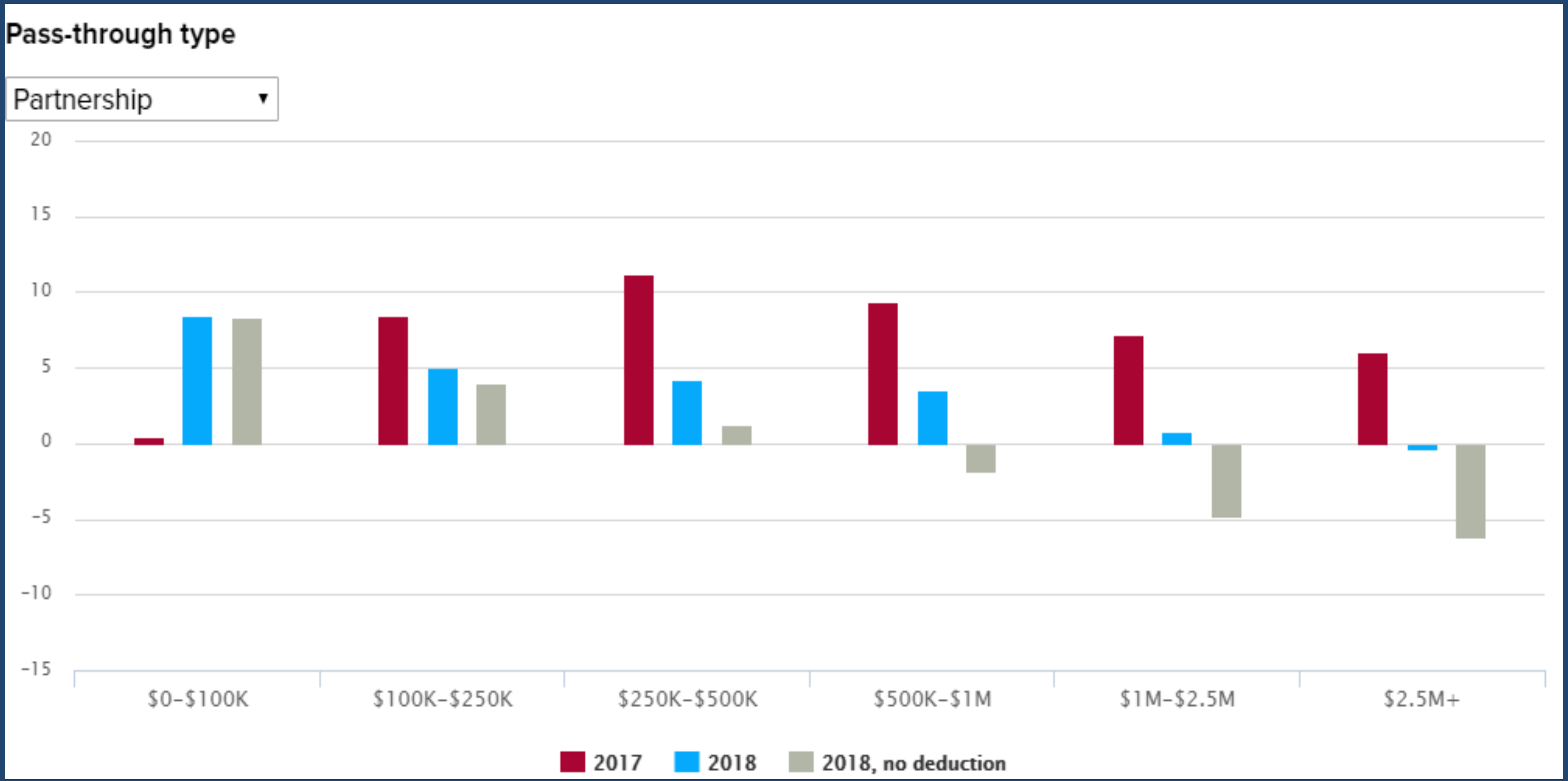
# Tax Rate Comparison 52% Retained

## S-Corporation



# Tax Rate Comparison 52% Retained

## Partnership



# Observations from TCJA

- Not Everyone Optimizes Their Tax Position

- Projection
  - 77% of Beneficiaries have AGI > $500K
  - 17.5% of Pass-Through Ordinary Business Income Convert

- Changes in Net Business Income

| | |
|---|---|
| C-Corporation | +20.9% |
| S-Corporation | -6.5% |
| Partnerships | -9.7% |
| Sole Proprietorship | -4.8% |

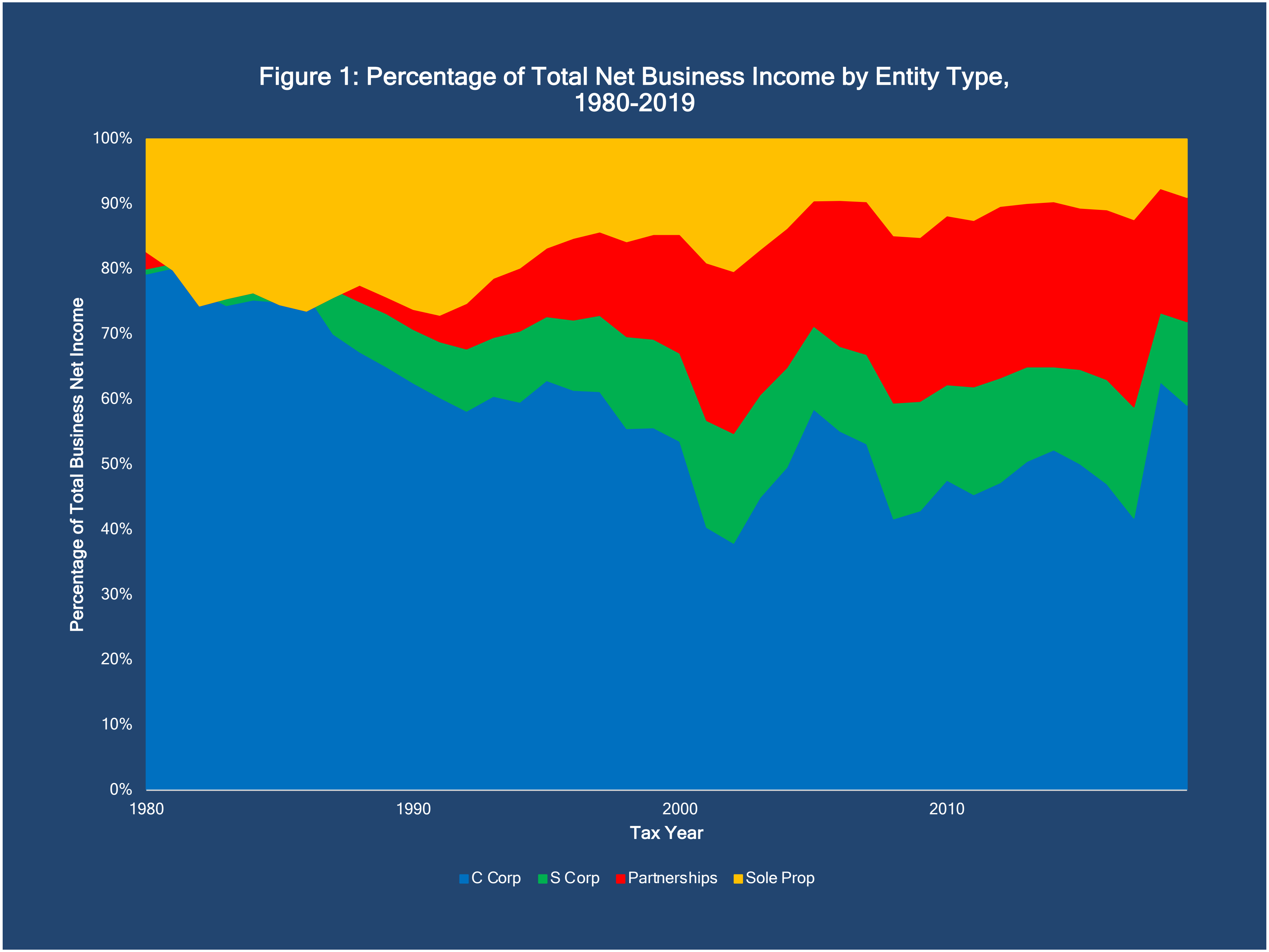
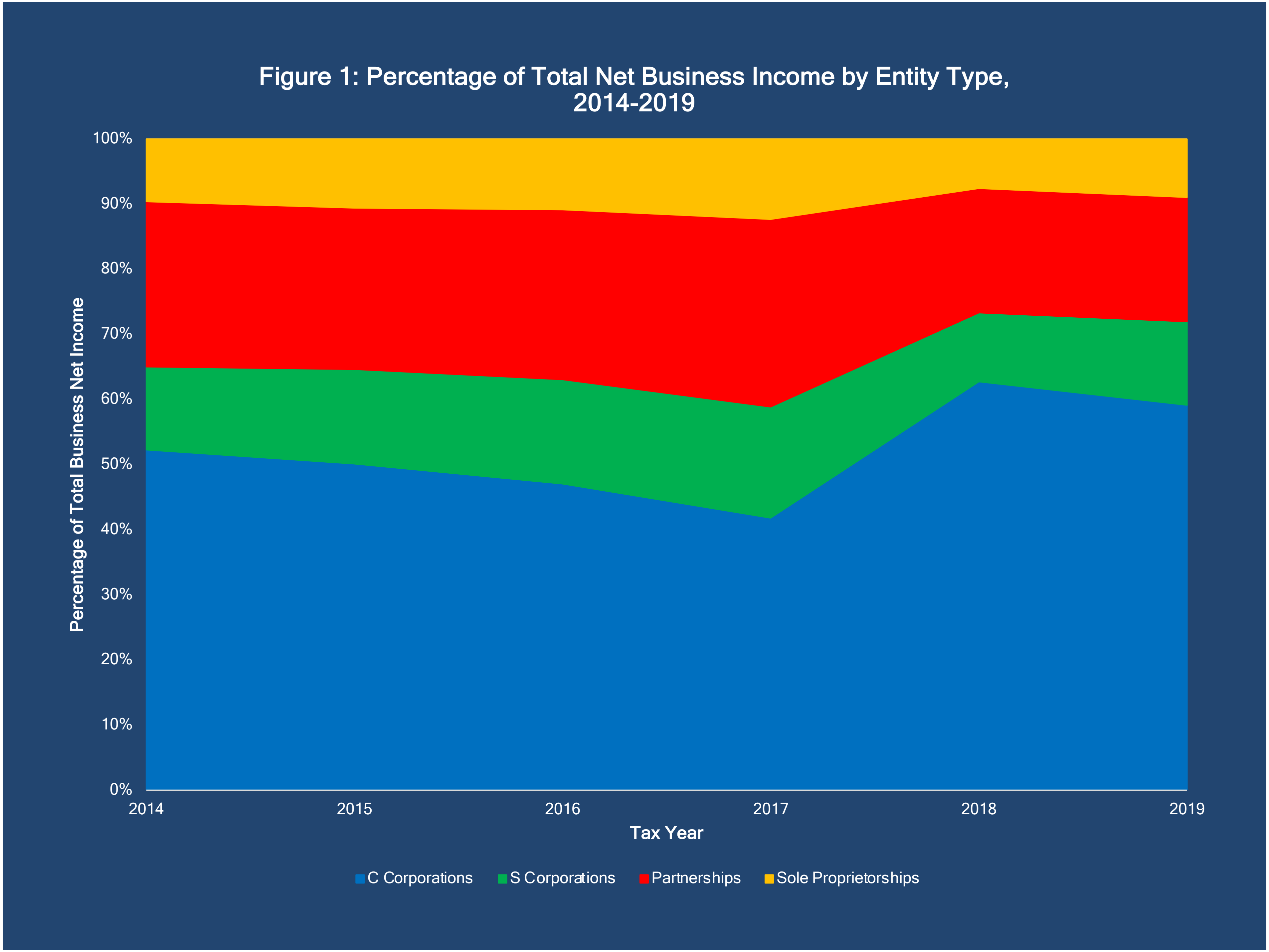


Figure 1: Percentage of Total Net Business Income by Entity Type, 1980-2019
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Percentage of Total Business Net Income
1980
1990
2000
2010
Tax Year
C Corp
S Corp
Partnerships
Sole Prop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Percentage of Total Business Net Income
100%
90%
80%
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60%
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40%
30%
20%
10%
0%
2014
2015
2016
2017
2018
2019
Tax Year
C Corporations
S Corporations
Partnerships
Sole Proprietorships

# Implications for States

- Expiration of 20% Deduction
- SECA Conformity
  - Reasonable Compensation Issue
  - Active/Passive Designation for NIIT
  - “Loophole” & Confuses Capital/Labor
  - “Hurts” Small Business

- End Stepped-up Basis
- Mark to Market Taxation
- Wealth Taxation

- Integration