The TCJA and the Questionable Incentive to Incorporate

Michael S. Knoll
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by Michael S. Knoll

Michael S. Knoll is the Theodore K. Warner Professor of Law at the University of Pennsylvania Law School, a professor of real estate at the Wharton School of the University of Pennsylvania, and co-director of the Center for Tax Law and Policy at the University of Pennsylvania.

In this report, the first of two parts, Knoll challenges the claim that the rate changes under the Tax Cuts and Jobs Act give top-bracket business owners a strong incentive to convert passthrough entities to C corporations.

I. Introduction

The politically contentious Tax Cuts and Jobs Act (P.L. 115-97) has drawn much criticism, as well as some praise. Much of the criticism is normative, focusing on the distributive and budgetary effects of the legislation. However, there is also a structural critique that emphasizes the inconsistencies and perverse incentives created by the hastily enacted 2017 law. 1 One such criticism is that the law encourages owners of successful businesses structured as sole proprietorships2 or passthrough entities to restructure their businesses as subchapter C corporations. 3

The advantage of restructuring is said to stem from the relatively low corporate tax rate (21 percent) as compared with the maximum personal tax rate on ordinary income (37 percent) and the deferral of individual-level tax. According to its critics, the TCJA will drive wealthy business owners to incorporate their businesses and use their new corporations as pocketbook investment vehicles to invest in and hold portfolio investments, substantially reducing wealthy individuals’ tax obligations and Treasury’s tax collections. 4

The economists at the Penn Wharton Budget Model (PWBM) predict a “mass conversion” of passthrough entities into C corporations, and they have put numbers to that prediction. 5 They estimate that “235,780 individual business owners — especially higher income business owners or

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2 Although a sole proprietorship is not technically a passthrough entity because it is not a legally recognized entity separate from its owner, it is treated as a passthrough entity throughout this report.
4 See, e.g., Avi-Yonah et al., supra note 1.
5 PWBM, “Projecting the Mass Conversion From Pass-Through Entities to C-Corporations” (June 12, 2018).
The economists further estimate that the shift will result in an annual revenue loss of $11 billion, which equals roughly 17.5 percent of pre-TCJA ordinary business income earned through pass-through entities.

As a result of the TCJA, the long-held wisdom that pass-through entities are tax advantaged relative to C corporations is being questioned. And business owners — encouraged by academics, commentators, and consultants — are seriously considering converting their pass-through entities to C corporations. Judging by the widespread interest and the PWBM’s calculations, the change could be substantial.

Recent articles that model choice of entity under the TCJA further support the view that there will be a large shift from the pass-through to the corporate form. The consensus is that the choice of entity decision is now more complicated and that there are many situations in which the corporate form would be tax preferred to a pass-through structure.

This report takes a largely different position. It questions the general claim that there will be a mass conversion of pass-through entities into C corporations. It also questions the specific claim that C corporations will be widely used as investment vehicles to hold portfolio investments. The analysis in this Part 1 is limited to top statutory tax rates. Part 2 will expand the analysis to include other tax considerations. The report concludes that predictions of widespread conversions to the corporate form at a substantial cost to the fisc are overstated.

II. Background

It is important to first examine the argument supporting the claim that the TCJA gives high-bracket business owners a strong incentive to convert pass-through entities to C corporations. There are two components to that argument. First is the widely accepted claim that after the TCJA, the tax burden on income earned through corporate and pass-through entities and consumed when earned is close to equal for high-bracket individuals. Second is the argument that when a portion of taxable income is saved and invested in portfolio investments, the corporate form can be preferable to the pass-through form because of the relatively low corporate tax rate and the deferral of individual-level tax.

A. Rate Changes

Under pre-2018 tax law, business owners had little tax incentive to incorporate. The corporate tax rate on successful businesses (34 percent) was 5.6 percentage points below the top tax rate on ordinary income (39.6 percent). Because retained earnings were also subject to individual-level tax at 20 percent, the total tax on retained earnings eventually distributed to shareholders was 47.2 percent — 7.6 percentage points higher than the tax on income earned through pass-through entities. That 7.6 percent difference in the tax burden was a large disadvantage for business owners to overcome if they were going to use corporations for tax deferral.

Once the TCJA provisions came into effect, incorporation became relatively more favorable than it had been before 2018. The TCJA lowered the corporate tax on profitable small and medium-size businesses by 13 percentage points (from 34 percent to 21 percent), whereas it lowered the top ordinary income tax rate by only 2.6 percentage points (from 39.6 percent to 37 percent). Thus, the spread between the top personal tax rate and the corporate tax rate...
increased by 10.4 percentage points, from 5.6 percent to 16 percent.\textsuperscript{11} As a result, for taxpayers in the top individual tax bracket, the total tax burden on corporate earnings and pass-through earnings is now almost equal.

The total tax rate on pass-through earnings is 37 percent — the top individual tax rate. The total tax rate on corporate earnings distributed immediately as dividends is 36.8 percent (the sum of the 21 percent corporate tax rate and 15.8 percent, which is the product of the 20 percent individual tax rate and the 79 percent of pretax earnings left in the corporation after payment of the corporate tax). Hence, when all income is used for current consumption, the total tax burden on income earned through corporate and pass-through entities is very similar, with the corporate form enjoying a tiny advantage. This is illustrated in Table 1, which assumes there is $1,000 of pretax income going toward immediate consumption.

The second column shows that when the taxpayer’s business is a pass-through entity, the taxpayer will be taxed on $1,000 of earned income. That will generate $370 personal tax (assuming a top-bracket individual), leaving the taxpayer with $630 to spend on consumption.

The fourth and fifth columns describe the taxation of current consumption when the entity is a corporation. If the taxpayer receives a dividend (fourth column), the corporation pays $210 corporate income tax, leaving it with $790 to pay as a dividend. The dividend is taxed to the individual recipient at 20 percent (assuming the recipient is in the top tax bracket), incurring a $158 tax liability, thereby leaving $632 available for consumption. That is $2 (or 0.31 percent) more than the taxpayer can spend with a pass-through entity. Alternatively, if the individual is paid a $1,000 salary (fifth column), the corporation has no income and hence no corporate income tax liability. The individual who receives the payment pays $370 salary and is left with $630 to spend — the same as with a pass-through entity.

That doesn’t exhaust all possibilities, however, because the TCJA created a new category of income for tax purposes under the so-called pass-through provision of section 199A.

### B. The Pass-through Deduction

Among the most controversial provisions of the TCJA, section 199A gives owners of unincorporated businesses a 20 percent deduction on their qualified business income (QBI).\textsuperscript{12} For an individual in the top tax bracket, the section 199A deduction can reduce the marginal tax rate by 7.4 percentage points, from 37 percent to 29.6 percent.

The section 199A deduction is unavailable to employees\textsuperscript{13} and corporations,\textsuperscript{14} but it is available to sole proprietorships and owners of

\begin{table}[h]
\centering
\begin{tabular}{|l|c|c|c|c|}
\hline
 & \textbf{Passthrough Entity} &  & \textbf{C Corporation} &  \\
 & \textbf{No Section 199A} & \textbf{Section 199A} & \textbf{Dividend} & \textbf{Salary} \\
\hline
Corporate income &  &  & $1,000 &  \\
Corporate tax &  &  & $210 &  \\
Individual income & $1,000 & $1,000 & $790 & $1,000 \\
Individual tax & $370 & $296 & $158 & $370 \\
Net consumption & $630 & $704 & $632 & $630 \\
Percentage difference &  & \textbf{11.75\%} & \textbf{0.31\%} & \textbf{0} \\
\hline
\end{tabular}
\caption{Consumption With Different Entities}
\end{table}

\textsuperscript{11} The spread between the top ordinary income tax rate and the corporate tax rate on successful small and medium-size businesses increased from 5.6 percent (39.6 percent - 34 percent) to 16 percent (37 percent - 21 percent), an increase of 10.4 percentage points.

\textsuperscript{12} Section 199A(a). The provision is temporary through the end of 2025, Section 199A(i).

\textsuperscript{13} Section 199A(d)(1)(B) (excluding performance of services as an employee from the ambit of the term “qualified trade or business”).

\textsuperscript{14} Section 199A(a) (the deduction is available to “a taxpayer other than a corporation”).
passthrough entities that are qualified trades or businesses (QTBs). A QTB is any trade or business other than the performance of services as an employee. Because holding portfolio investments is not considered a trade or business, income from portfolio investments is not eligible for the deduction. However, the deduction is available, without further restrictions, on all QBI for the deduction. However, the deduction is phased out for specified service trades or businesses (SSTBs).

An SSTB is “any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners.” An SSTB also includes any trade or business that involves “the performance of services that consist of investing and investment management, trading, or dealing in securities.”

For businesses that are not SSTBs, the deduction is available to the extent of the greater of 50 percent of wages or 25 percent of wages plus 2.5 percent of invested depreciable capital. Unsurprisingly, the passthrough deduction can be attractive to businesses with many employees, but it can also appeal to some businesses with few or no employees, especially real estate businesses. The section 199A deduction is attractive to owners of rental real estate because if, for example, 20 percent of the acquisition cost is (nondepreciable) land and 80 percent is (depreciable) structures, the deduction can cover all income, assuming a taxable rate of return as high as 10 percent, which is a very high return on real estate at the time of acquisition.

As the third column of Table 1 shows, for taxpayers who can take advantage of the section 199A deduction, a passthrough entity can deliver substantially more consumption than can a corporation. In the example, a top-bracket owner of a successful passthrough entity who can take full advantage of section 199A can consume $704 out of $1,000 pretax income, which is 11.75 percent more than can be consumed using a passthrough entity without the deduction. However, this discussion focuses exclusively on immediate consumption and thus ignores the possibility of tax deferral.

C. Deferral

Because it can be quite valuable, deferral drives the argument for incorporation. When a portion of income is saved and invested, the corporate form appears more tax-friendly than the passthrough form. That is because the personal tax on long-term capital gains and qualified dividends can be deferred, possibly indefinitely, when saving and investment take place through a corporation. Although the principal and income will be taxed later, in the interim the additional money that would have gone to pay taxes immediately with a passthrough entity can be invested through the corporation and earn a return. The after-tax portion of that return is said to be the source of the tax advantage from incorporation.

Table 2 indicates how much can be saved and reinvested with a passthrough entity or a corporation from $1,000 of pretax income designated for investment.

As illustrated by the second column in Table 2, a taxpayer in the top individual tax bracket whose business is taxed as a passthrough entity and who earns $1,000 destined for investment can, after paying $370 tax, invest $630. If the taxpayer qualifies for the section 199A deduction, she can take advantage of the section 199A deduction, a passthrough entity can deliver substantially more consumption than can a corporation. In the example, a top-bracket owner of a successful passthrough entity who can take full advantage of section 199A can consume $704 out of $1,000 pretax income, which is 11.75 percent more than can be consumed using a passthrough entity without the deduction. However, this discussion focuses exclusively on immediate consumption and thus ignores the possibility of tax deferral.

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15 Section 199A(b).
16 Section 199A(d)(1)(A).
17 For married taxpayers, the threshold is $315,000; for unmarried taxpayers, it is $157,500. The threshold is indexed for inflation. The deduction phases out more than $100,000 for married individuals and more than $50,000 for unmarried individuals. Section 199A(e).
18 Section 199A(d)(3).
19 Section 199A(d)(2)(A) (defining SSTBs as any trade or business described in section 1202(e)(3)(A), excluding engineering and architecture and substituting “owners or employees” for “employees”).
20 Section 199A(d)(2)(B).
21 Section 199A(d)(2)(B).
22 See Repetti, supra note 3, at 695 (noting that a 12.5 percent return on real estate could be sheltered if the land was leased and not purchased). A return of 10 percent or less is equivalent to a capitalization rate of 10 or higher.
cannot use the deduction. However, as the fourth column illustrates, if the business is instead held through a corporation, that same taxpayer can invest $790 ($160 or 25.4 percent) more than the owner of a passthrough entity who cannot use the section 199A deduction. Although the shareholder will later have to pay tax on the distribution, the second-level (individual-level) tax is deferred, and the taxpayer keeps a portion of the return generated by earnings on the incremental investment.

### Table 2. Investment With Different Entities

<table>
<thead>
<tr>
<th></th>
<th>Passsthrough Entity</th>
<th>C Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No Section 199A</td>
<td>Section 199A</td>
</tr>
<tr>
<td>Corporate income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual income</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Individual tax</td>
<td>$370</td>
<td>$296</td>
</tr>
<tr>
<td>Net investment</td>
<td>$630</td>
<td>$704</td>
</tr>
<tr>
<td>Percentage difference</td>
<td>11.75%</td>
<td>25.4%</td>
</tr>
</tbody>
</table>

Of course, taxpayers who can take the section 199A deduction can consume substantially more current income with a passthrough entity than with a corporation. That can leave the corporate form at a tax disadvantage even if some income is saved and invested. However, for taxpayers who can’t take the deduction, current consumption is almost equal regardless of ownership form, whereas investment can be much larger with a corporation. Because the personal-level tax on the larger investment is deferred, there appears to be a powerful incentive to incorporate for high-bracket business owners who save and invest some of their profits.

### III. A Basic Equivalence Result

Despite its intuitive appeal, the claim that top-bracket taxpayers who can’t take advantage of the section 199A deduction and who invest a portion of their earnings in portfolio assets can reduce their taxes by incorporating their business is largely incorrect. As demonstrated next, for top-bracket taxpayers who intend to invest some of their earnings in portfolio investments rather than spend all their after-tax income immediately, the tax burden of passthrough entities (whose income is ineligible for the section 199A deduction) will likely almost equal that of C corporations under the TCJA.

The following notation is used for the different tax rates that a high-income business owner-investor incurs: The top marginal tax rate on ordinary income is \( t_p \); the top individual tax rate on investment income, including qualified dividends and long-term capital gains, is \( t_i \); and the flat corporate tax rate is \( t_c \). Assume the section 199A deduction does not apply.

The individual owner of a passthrough entity who earns $1 before taxes that is designated for portfolio investment will, after paying taxes of \( t_p \), be left with \( 1 - t_p \). Assume that the investor earns an annual pretax rate of return of \( r \) and that the investment is taxed annually at the rate \( t_i \). Each dollar of investment will grow annually by the factor \( [1 + r(1 - t_i)] \). Assume the initial investment continues to grow for \( n \) years, after which the owner liquidates the investment and consumes all proceeds. The amount the owner has available for consumption in \( n \) years after paying all taxes for each dollar of pretax income designated for saving is \( V_p^n \). For each such dollar, the owner will have available for consumption in \( n \) years the following amount:

\[
V_p^n = (1 - t_p) [1 + r(1 - t_i)]^n.
\]

Consider an otherwise identical investment held in a corporation. Conceptually, it might be easiest to think of the corporation as having one shareholder who is also employed by the company. A shareholder who earns $1 before any taxes (including corporate taxes) that is designated for investment can, after paying the corporate tax, invest \( 1 - t_c \). Assume that the corporation earns an annual pretax rate of return of \( r \) (the same return as the individual investor holding the investment directly); that the annual return is taxed at the corporate tax rate, \( t_c \); and that the corporation invests the proceeds in the same assets and for the same time as the individual investor. After \( n \) years, the corporation will hold
(1 - t)(1 + r(1 - t))n on the shareholder’s behalf for each pretax dollar of corporate earnings that did not go to the shareholder’s immediate consumption.23

There are two ways that a payment from the corporation to the shareholder-employee can be treated for tax purposes. First, the transfer can be treated as a payment to the taxpayer in her capacity as a shareholder. A distribution on stock will be taxed as a dividend, taxable at the long-term capital gain rate (tL) to the extent of earnings and profits.24 That payment is not deductible by the corporation because the distribution is considered to have come out of E&P rather than as an expense incurred in generating E&P.

The amount the shareholder has available for consumption in n years — after receiving a dividend and after the payment of all taxes (both corporate and individual) — on each pretax dollar of corporate earnings designated for investment is $V^s_d$. (The subscript “d” indicates that the investment is held through a corporation and is distributed to the owner as a dividend.) If the payment is taxed as a dividend, after n years the corporation will have for each pretax dollar invested the following amount available for consumption:

$$V^s_d = (1 - t_c)(1 + r(1 - t_c))^n$$

Alternatively, the transfer can be treated as the corporation’s payment of (deferred) salary to an employee. In that case, the payee is taxed at her ordinary tax rate, $t_p$. The corporation, however, can deduct the salary payment from its income. Accordingly, the corporation can pay more in salary than as a dividend because the salary payment will generate a tax deduction for the corporation. As a result, the corporation can increase (gross-up) its dividend payment of $(1 - t_c)[1 + r(1 - t_c)]^n$ by $(1 - t_c)$ so that the salary payment becomes $(1 - t_c)[1 + r(1 - t_c)]^n/(1 - t_c)$, which can be rewritten as $[1 + r(1 - t_c)]^n$.25

The amount the taxpayer has in n years — after receiving a payment of deferred salary and after the payment of all taxes (both corporate and individual) — on each pretax dollar designated for investment is $V^s_p$. (The subscript “s” indicates that the investment is held through a corporation and is paid out as deferred salary.) If the payment is salary, after n years the taxpayer will have for each pretax dollar invested the following amount available for consumption:

$$V^s_p = (1 - t_c)(1 + r(1 - t_c))^n$$

Assume (in close proximity with current income tax rates) that the corporate tax rate and the individual investment tax rate are equal and can be denoted by $t_c$ so that $t = t_c = t_p$. Assume further that the personal tax rate on ordinary income, $t_p$, equals the total tax rate on both corporate and investment income, which is to say that $t_p = 2t - t_c$. Substituting $t$ for both $t_c$ and $t_p$, and substituting $2t - t_c$ for $t_p$ and rearranging terms, equations 1, 2, and 3 can all be rewritten as:

$$V^s_p = V^s_d = V^s_s = (1 - t)(1 + r(1 - t))^n$$

As Equation 4 indicates, the amount the owner has available to spend on consumption after n years is the same regardless of whether the business is structured as a passthrough entity or a corporation as long as (as is almost true): (1) the corporate tax rate ($t_c$) and the personal tax rate on investment income ($t_p$) are equal, and (2) the personal ordinary income tax rate ($t_p$) equals the combined corporate tax rate ($t_c$) and personal tax rate on investment income ($t_p$). In those circumstances, it therefore follows that there is no tax benefit from using a corporation rather than a passthrough entity to retain and invest earnings in portfolio assets.

Of course, the corporate tax rate (21 percent) and the personal investment tax rate (20 percent)

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23 Of course, if the money were held in a separate account for the benefit of the employee and secure from the corporation’s creditors, the employee would be taxed when the account was funded.

24 If the distribution exceeds the distributing corporation’s accumulated E&P, the excess will be treated as return of capital and then as long-term capital gain.
are not precisely equal, and the individual ordinary tax rate (37 percent) doesn’t exactly equal the combined corporate and personal investment tax rate (36.8 percent). Both relationships, however, are very close to being equal.

Using actual tax rates under the TCJA for high-income individuals, Table 3 shows the amount of money a business owner can spend in 10 years from $1,000 of pretax income that is invested at a 10 percent annual pretax rate of return, depending on how the business is structured and how profits are paid out and taxed. Panel 1 assumes that all investment income is taxed as it is earned (so the current tax on investment is included in the fourth row). In contrast, Panel 2 assumes that all investment income is taxed at the end of 10 years when the investment is assumed to be liquidated.

A comparison of the second and third columns in both panels shows that the advantage from the section 199A deduction (relative to using a passthrough entity when the deduction is unavailable) remains the same (11.75 percent) when excess funds are invested in portfolio assets. Thus, the section 199A advantage is the same whether the funds are immediately consumed, as in Table 2; are invested and taxed currently, as in Table 3; or are invested and taxed at the end of the holding period.

Table 3. Deferred Consumption

<table>
<thead>
<tr>
<th>Panel 1: All Investment Income Is Taxed Currently</th>
<th>Passthrough Entity</th>
<th>C Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment grows to(^a)</td>
<td>$1,360.12</td>
<td>$1,689.82</td>
</tr>
<tr>
<td>Payment (grossed up)</td>
<td></td>
<td>$2,139.02</td>
</tr>
<tr>
<td>Dividend tax</td>
<td>$337.96</td>
<td></td>
</tr>
<tr>
<td>Ordinary tax</td>
<td></td>
<td>$791.44</td>
</tr>
<tr>
<td>Net consumption</td>
<td>$1,360.12</td>
<td>$1,351.86</td>
</tr>
<tr>
<td>Percentage difference</td>
<td>11.75%</td>
<td>-0.61%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Panel 2: All Investment Income Is Tax Deferred</th>
<th>Passthrough Entity</th>
<th>C Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment grows to(^b)</td>
<td>$1,634.06</td>
<td>$2,049.06</td>
</tr>
<tr>
<td>Corporate tax(^c)</td>
<td>$264.40</td>
<td></td>
</tr>
<tr>
<td>Payment (not grossed up)</td>
<td>$1,634.06</td>
<td>$1,784.64</td>
</tr>
<tr>
<td>Payment (grossed up)</td>
<td></td>
<td>$2,259.06</td>
</tr>
<tr>
<td>Dividend/investment tax</td>
<td>$200.81</td>
<td>$365.93</td>
</tr>
<tr>
<td>Ordinary tax</td>
<td></td>
<td>$835.85</td>
</tr>
<tr>
<td>Net consumption</td>
<td>$1,433.25</td>
<td>$1,427.72</td>
</tr>
<tr>
<td>Percentage difference</td>
<td>11.75%</td>
<td>-0.39%</td>
</tr>
</tbody>
</table>

\(^a\)The amount that an investment grows to in Panel 1 is after payment of any tax incurred annually. Thus, for passthrough entities, there is no further tax, and for C corporations, there is no further corporate tax, but there is individual income tax.

\(^b\)The amount an investment grows to in Panel 2 is before payment of tax. Thus, in the second and third columns, there is individual-level tax at the investment tax rate. In the fourth column, there is corporate tax and individual tax at the investment tax rate. In the fifth column, there is individual-level tax at the ordinary tax rate.

\(^c\)In the fourth column, there is corporate tax on the investment gain because the gain is paid out to the shareholder as a dividend. In the fifth column, there is no corporate tax because the salary payment is fully deductible.
Panel 1; or are invested and tax deferred, as in Panel 2. The 11.75 percent advantage reflects the 20 percent deduction of the original earned income amount.

Looking at both panels, comparing the fourth and fifth columns with the second column shows that there is a small disadvantage to using a corporation rather than a pass-through entity (without a section 199A deduction) as a vehicle to invest in portfolio assets. Although the difference is negative, it is small — which is an important and surprising point. Despite a 10-year holding period and a 10 percent compounded annual rate of return, the initial larger investment fund with a C corporation does not yield a larger amount available for consumption. That result directly conflicts with claims about the TCJA’s incorporation incentive, and it probably conflicts with the intuition of many tax specialists.

IV. The Intuition Behind the Equivalence

How is it that there is little or no tax benefit from deferring tax on retained earnings through the use of a corporation when the corporate tax rate is so far below the ordinary tax rate? The logic is easiest to see if the tax rates are changed slightly, so that the corporate tax rate and the individual investment tax rate are both 20 percent and the individual ordinary income tax rate is 36 percent (which is also the total tax burden of the corporate tax and the individual investment tax combined). 

With the pass-through entity, the taxpayer incurs a 36 percent personal tax obligation. The personal tax is equivalent to the 20 percent corporate income tax and the 20 percent individual investment income tax rate are both 20 percent and the individual ordinary income tax rate is 36 percent (which is also the total tax burden of the corporate tax and the individual investment tax combined).

The total tax burden of 36 percent is calculated as the sum of 20 percent and 20 percent of the 80 percent remaining after the first 20 percent tax.

Table 4. The Tax Benefit of Deferral

<table>
<thead>
<tr>
<th></th>
<th>Current Taxation</th>
<th>Deferred Taxation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pretax income</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Current tax</td>
<td>$200</td>
<td>0</td>
</tr>
<tr>
<td>Net investment</td>
<td>$800</td>
<td>$1,000</td>
</tr>
<tr>
<td>Investment grows to</td>
<td>$1,600</td>
<td>$2,000</td>
</tr>
<tr>
<td>Tax</td>
<td>$160</td>
<td>$400</td>
</tr>
<tr>
<td>After-tax cash</td>
<td>$1,440</td>
<td>$1,600</td>
</tr>
</tbody>
</table>

Applying the above logic, the benefit of deferring personal tax on retained corporate earnings is that the income the corporation earns from investing retained earnings effectively escapes tax at the individual level. For example, $1,000 in pretax business earnings destined for investment leaves — after paying $200 in taxes — $800 in the corporation to invest (versus $640 in the taxpayer’s hands when the business is taxed as a pass-through entity). If both the corporation’s and the individual’s funds are invested long enough to double before incurring further tax, the corporation will hold $1,600 on behalf of the taxpayer, but the taxpayer will hold only $1,280.

The example in Table 4 illustrates that the effect of deferring tax on a sum is equivalent to exempting from tax the income earned on that sum.

26 The total tax burden of 36 percent is calculated as the sum of 20 percent and 20 percent of the 80 percent remaining after the first 20 percent tax.

27 One important assumption is that tax rates are constant over time.
directly. After paying 20 percent tax on her gain ($128, which is 20 percent of $640 gain), the taxpayer will hold $1,152. If the corporation were to pay out $1,600 as a dividend, the shareholder would pay tax of $320 and be left with $1,280, which is the amount the pass-through owner had before paying any tax on her investment income. This is illustrated by the arrow linking the second and third columns of Table 5.

Table 5. The Tax Equivalence of Passthrough Entities and C Corporations

<table>
<thead>
<tr>
<th></th>
<th>Passthrough Entity</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No Corporate Tax on Investment Income</td>
<td>Corporate Tax on Investment Income</td>
</tr>
<tr>
<td>Pretax income</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Current tax</td>
<td>$360</td>
<td>$200</td>
</tr>
<tr>
<td>Net investment</td>
<td>$640</td>
<td>$800</td>
</tr>
<tr>
<td>Investment grows to</td>
<td>$1,280</td>
<td>$1,600</td>
</tr>
<tr>
<td>Corporate tax</td>
<td>$0</td>
<td>$160</td>
</tr>
<tr>
<td>Dividend</td>
<td>$1,600</td>
<td>$1,440</td>
</tr>
<tr>
<td>Individual tax</td>
<td>$128</td>
<td>$320</td>
</tr>
<tr>
<td>Net consumption</td>
<td>$1,152</td>
<td>$1,280</td>
</tr>
</tbody>
</table>

The above example illustrates a situation in which investing retained earnings with tax deferral allows the individual investor to effectively avoid the personal investment tax on portfolio income. If such an opportunity were available, well-to-do business owners looking to invest some of their earnings in portfolio assets would favor corporations.

The analysis is incomplete, however. The corporation cannot pay a $1,600 dividend. Before paying the dividend, the corporation has to pay the 20 percent corporate tax on its $800 investment gain, which reduces the money available to pay a dividend by $160 (in bold in the fourth column) to $1,440. The shareholder will then pay $288 tax, leaving her with the same $1,152 regardless of whether the business is incorporated. This situation is illustrated by the fourth column in Table 5 (and the arrow linking the last row of the second and fourth columns).

Although the amounts are not exactly the same using actual post-TCJA tax rates, they are very close. This is illustrated in Table 3, which shows using statutory tax rates that when the section 199A deduction is not available, there is little difference in consumption from using a passthrough entity or a corporation as a vehicle to hold portfolio investments.

As tables 3 and 5 illustrate, using a corporation to invest retained earnings does not reduce the tax burden on portfolio income. That is because the tax benefit from incorporation and the deferral it makes possible (earning investment income that is effectively untaxed) disappears when those earnings are taxed twice — once at the corporate level and then later at the individual level. In contrast, in the standard illustration of the tax benefit of deferral (Table 4), there is only one level of taxation, whether the income is taxed currently or deferred.

In other words, the imposition of corporate tax on investment income offsets the benefit of the deferred individual-level tax when investment income is earned through the corporation. It is the deferral of the individual tax that is the potential benefit of investing through a corporation, but that benefit is offset by the imposition of corporate tax when investment income is deferred through the corporation.

In the simple example (Table 5), the tax burdens on the two alternatives are identical. That is because the corporate tax is assumed to exactly equal the individual tax on investment income (20 percent) and because the total tax on earned income is assumed to be exactly the same (36 percent) whether earned through a passthrough entity or a C corporation. At current tax rates (Table 3), there are (roughly) no such differences (assuming the section 199A deduction is unavailable). Accordingly, successful professionals and wealthy business...
owners cannot substantially reduce their tax burdens by converting their passthrough businesses to corporations, regardless of whether all income is paid out as earned or some income is reinvested in portfolio assets.

Yet it is frequently suggested that high-bracket taxpayers incorporate their businesses and use their corporations to invest in portfolio assets. There may be several reasons why corporations are thought to be more tax efficient even when they aren’t. First, because of real-world complexity and messiness, the tax rates don’t exactly measure up, which obscures the equivalence. Second, tax rates are not the only tax provisions relevant in making a choice of entity decision; other factors might have diverted attention from tax rates and the incentives they create. Third, while there is a widespread understanding of the basic proposition that taxes deferred are taxes reduced, there is a failure to recognize an implicit assumption: that the income deferred for tax purposes is not subject to additional or higher taxes than the income that is not tax deferred. That implicit assumption is so obvious that it does not usually need to be stated, but it applies here, although not in a way that is immediately obvious. Fourth, the equality becomes apparent only when the investment is liquidated and used for consumption. Until then, the investment held through the corporation is larger than the investment held on personal account. However, the tax imposed when the investment is liquidated is higher with the corporation, which restores the equality.

As the last reason suggests, the failure to appreciate the tax consequences over the entire life of the investment might well lead some taxpayers to incorporate in the mistaken belief that they will achieve a better result when their portfolio investments are held through a corporation rather than on personal account. One might readily believe that if one can save more with a corporation, one will have more to spend in the long run. And some advisers and promoters might not understand the whole picture or might not explain it fully. However, if passthrough entities are converted to corporations, even on a large scale, there would likely be little reduction in long-run tax revenue from shifting portfolio investments from personal accounts to corporations.

V. Conclusion

One commonly offered justification for the corporate income tax is that it serves as a backstop to protect the individual income tax. If corporate taxes are too low, taxpayers (especially the wealthy) will arrange to earn their labor and capital income through corporations. Although the TCJA’s combination of federal income tax rates eliminates the long-standing disadvantage from taking labor income as dividends, its rate changes do not provide an affirmative advantage from using the corporate form (other than the small 0.2 percent difference in total tax rates with current consumption).

However, simply imposing the same total tax rate on income earned through corporate and passthrough entities cannot ensure that there is no tax advantage from incorporation. When income is saved and invested, there can still be an advantage from using the corporate form. For example, if there were no corporate income tax but individuals were taxed at the same rate on ordinary income, dividends, and capital gains, then although there would be no tax advantage from using the corporate form for current consumption, there would be a large tax advantage when income is saved and invested. Because of deferral, the individual tax on the income earned on savings would be effectively eliminated (see, for example, Table 4).

Accordingly, it might appear that there is a similar, albeit smaller, advantage under the TCJA because of the relatively low corporate tax rate as compared with the top individual tax rate and the deferral of the individual-level investment tax. However, any such benefit is illusory. There is no tax advantage from using the corporate form to hold portfolio investments at current tax rates. That is because the (21 percent) corporate income tax on the corporation’s portfolio income eliminates the tax benefit from deferring the (20 percent) individual-level tax on that same income. Thus, looking at federal statutory rates, there is little reason to expect the mass conversion of passthrough entities into corporations that some predict, and any conversions that occur are unlikely to yield large tax savings.

29 Some of these factors are considered in Part 2.