The TCJA and the Questionable Incentive to Incorporate, Part 2

Michael S. Knoll
University of Pennsylvania Law School

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The TCJA and the Questionable Incentive to Incorporate, Part 2

by Michael S. Knoll

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The TCJA and the Questionable Incentive to Incorporate, Part 2

by Michael S. Knoll

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In this second installment of a two-part report, Knoll looks beyond the basic federal tax rate structure to determine whether the Tax Cuts and Jobs Act has in fact given top-bracket business owners a strong incentive to convert from the passthrough form to the corporate form.

I. Introduction

The 2017 tax reform law, commonly known as the Tax Cuts and Jobs Act, has been criticized on several grounds, one being that it undermines the corporate tax as a backstop for the individual tax. Critics claim that the TCJA encourages owners of successful businesses structured as self-proprietorships or passthrough entities to incorporate their businesses to avoid the full burden of the individual income tax. According to the economists at the Penn Wharton Budget Model, the TCJA will lead to a “mass conversion” of passthrough entities into subchapter C corporations. They estimate that more than 230,000 individual business owners will incorporate their businesses, at a cost to the fisc of $11 billion annually.

This two-part report examines the tax incentives for business owners to convert their passthrough entities into C corporations. Part 1 focused on the flat corporate tax rate and the top individual statutory tax rates for ordinary income.

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2 Although a sole proprietorship is not technically a passsthrough entity because it is not a legally recognized entity separate from its owner, it is treated as a passthrough entity throughout this report.
4 Penn Wharton Budget Model, “Projecting the Mass Conversion From Pass-Through Entities to C-Corporations” (June 12, 2018).
5 Both parts of this report focus on high-bracket taxpayers because the flat corporate rate likely poses the strongest conversion incentive for them.
and long-term capital gains.\textsuperscript{6} It concluded that
business owners receive little or no tax advantage
from incorporating existing passthrough entities. This Part 2
expands the analysis to consider various provisions in the tax system beyond the
basic rate structure that could affect the incorporation incentive.

II. Statutory Tax Rates

The TCJA’s basic rate structure provides some
top-bracket business owners a very small
incentive to incorporate and receive their current
earnings as dividends.\textsuperscript{7} Under the TCJA, the
corporate tax rate is a flat 21 percent; the top
individual ordinary income tax rate, which
applies to salaries and business profits, is 37
percent; and the top long-term capital gains tax
rate is 20 percent. Therefore, income earned
through a corporation and paid as a dividend is
subject to a top rate of 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).

Further, the increased consumption available
from incorporation when all income is paid out
immediately as dividends is $2 (an increase from
$630 to $632) on every $1,000 of pretax earnings —
a miniscule 0.31 percent increase in after-tax
consumption. This is illustrated in Table 1 and can
be seen by comparing the fourth column with the
second and the fifth columns.

However, for taxpayers who can take
advantage of new section 199A — the so-called
passthrough provision, which gives owners of
unincorporated businesses a 20 percent deduction
on their qualified business income — a
passthrough entity can deliver substantially more
consumption than can a corporation.\textsuperscript{8} For an
individual in the top tax bracket, the section 199A
deduction can reduce the marginal tax rate by 7.4
percent, from 37 percent to 29.6 percent. Various
restrictions and limitations apply to section 199A.
For example, the deduction is unavailable to
employees\textsuperscript{9} and corporations.\textsuperscript{10} Although the
deduction is available to sole proprietorships and
owners of passthrough entities,\textsuperscript{11} it is phased out
for most service businesses (including law,
consulting, and investment firms) once income
reaches a specified threshold.\textsuperscript{12} As the third
column of Table 1 shows, a top-bracket owner of a
successful passthrough entity who can take full
advantage of section 199A can consume $704 out
of $1,000 of pretax income, which is 11.75 percent
(or $74) more than can be consumed if the
deduction cannot be used.

The leading argument for switching from a
passthrough entity to a corporation does not
assume all income is consumed as earned.

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\textsuperscript{6} Michael S. Knoll, “The TCJA and the Questionable Incentive to
Incorporate,” Tax Notes, Mar. 4, 2019, p. 977 (Part 1).

\textsuperscript{7} See id.

\textsuperscript{8} Section 199A(a).

\textsuperscript{9} Section 199A(d)(1)(B).

\textsuperscript{10} Section 199A(a).

\textsuperscript{11} Section 199A(b).

\textsuperscript{12} Section 199A(d)(3).
Instead, it emphasizes the reinvestment of profits and the deferral of personal tax. Because the corporate tax rate is well below the top ordinary income tax rate, a business owner can invest more through a corporation than on personal account, and the additional investment, which will generate additional income, will only be taxed later. It’s the deferral of individual tax on the reinvested proceeds that is thought to provide a substantial tax advantage from switching to a corporation.

That intuition is wrong, however — at least for investments in portfolio assets. It is wrong because it does not account for the corporate tax on investment income, which is incurred when investment income is earned through the corporation but is avoided when that income is earned on personal account.

When earned through a corporation, investment income is subject to two levels of tax: the 21 percent corporate tax and the 20 percent individual investment tax. In contrast, when

---

Table 2. Deferred Consumption With Different Entities

<table>
<thead>
<tr>
<th></th>
<th>Passthrough Entity</th>
<th>C Corporation</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No Section 199A</td>
<td>Section 199A</td>
<td>Dividend</td>
</tr>
<tr>
<td>Investment grows to(^a)</td>
<td>$1,360.12</td>
<td>$1,519.88</td>
<td>$1,689.82</td>
</tr>
<tr>
<td>Payment (grossed up)</td>
<td></td>
<td></td>
<td>$1,689.82</td>
</tr>
<tr>
<td>Dividend tax</td>
<td>$337.96</td>
<td></td>
<td>$1,689.82</td>
</tr>
<tr>
<td>Ordinary tax</td>
<td></td>
<td></td>
<td>$791.44</td>
</tr>
<tr>
<td>Net consumption</td>
<td>$1,360.12</td>
<td>$1,519.88</td>
<td>$1,689.82</td>
</tr>
<tr>
<td>Percentage difference</td>
<td>11.75%</td>
<td>-0.61%</td>
<td>-0.92%</td>
</tr>
</tbody>
</table>

Panel 1. All Investment Income Is Taxed Currently

<table>
<thead>
<tr>
<th></th>
<th>Deductible; Gross-Up</th>
<th>Not Deductible; No Gross-Up</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment grows to</td>
<td>$2,139.02</td>
<td>$1,689.82</td>
</tr>
<tr>
<td>Payment (not grossed up)</td>
<td>$791.44</td>
<td>$625.23</td>
</tr>
<tr>
<td>Dividend/ investment tax</td>
<td>$200.81</td>
<td>$2,259.06</td>
</tr>
<tr>
<td>Ordinary tax</td>
<td></td>
<td>$835.85</td>
</tr>
<tr>
<td>Net consumption</td>
<td>$1,360.12</td>
<td>$1,519.88</td>
</tr>
<tr>
<td>Percentage difference</td>
<td>11.75%</td>
<td>-0.61%</td>
</tr>
</tbody>
</table>

Panel 2. All Investment Income Is Tax Deferred

<table>
<thead>
<tr>
<th></th>
<th>Deductible; Gross-Up</th>
<th>Not Deductible; No Gross-Up</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment grows to</td>
<td>$1,634.06</td>
<td>$2,049.06</td>
</tr>
<tr>
<td>Corporate tax</td>
<td>$264.40</td>
<td>$264.40</td>
</tr>
<tr>
<td>Payment (not grossed up)</td>
<td>$2,139.02</td>
<td>$1,689.82</td>
</tr>
<tr>
<td>Payment (grossed up)</td>
<td>$2,259.06</td>
<td>$1,689.82</td>
</tr>
<tr>
<td>Dividend/ investment tax</td>
<td>$200.81</td>
<td>$2,259.06</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>$1,601.60</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 the payment of any tax incurred annually. Thus, for passthrough entities (the second and third columns) there is no further tax, and for C corporations (the fourth, fifth, and sixth columns) 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 any tax. Thus, in the second and third columns, there is individual-level tax at the investment tax rate. In the fourth and fifth columns, there is corporate tax. In the fifth and sixth columns, there is individual-level tax at the ordinary tax rate.

\(^c\)The payment is the amount the investment grows to before tax. The corporation can pay this amount because the payment is assumed to generate a tax benefit to the payer corporation to the extent of the corporation’s income from the investment.
earned on personal account, investment income is subject to just one level of tax: the 20 percent individual investment tax. The tax benefit from making portfolio investments through a corporation, which is deferral of the 20 percent individual investment tax (and which is equivalent to exemption of the income earned on those investments from that tax), is slightly more than offset by the 21 percent corporate income tax imposed on that income (which is avoided when that income is earned on personal account).

As illustrated in Table 2, there is no tax benefit from incorporation when some income is saved and invested in portfolio assets, regardless of whether the portfolio investments generate income that is taxed each year as earned (Panel 1) or instead is taxed only when the investment is liquidated and distributed to shareholders (Panel 2).  

Using actual tax rates under the TCJA for high-income individuals, Table 2 shows the amount of money a business owner can spend in 10 years out of $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 earned (so the current tax on investment is included in the fifth row (“Investment grows to”)). In contrast, Panel 2 assumes that all investment income is taxed after 10 years, when the investment is assumed to be liquidated. In both tables, the second and third columns treat the business as a passthrough entity. In the second column, the section 199A deduction is unavailable; in the third column, the section 199A deduction is available. In both panels, the fourth, fifth, and sixth columns assume the business is a C corporation. In the fourth column, the payout takes the form of a dividend; in the fifth column, the payout, which is grossed up to reflect the corporation’s deduction, takes the form of salary. (Ignore the sixth column for now.)

Looking at both panels of Table 2, comparing the fourth and fifth columns with the second column shows that there is a small disadvantage to using a corporation as a vehicle to invest in portfolio assets rather than using a passthrough entity (without a section 199A deduction). That disadvantage arises because the corporate tax rate exceeds the individual tax rate on investments.

III. Four Potential Tax Advantages of Incorporation

The result described earlier — that there is no increase in available long-run consumption by switching from a passthrough entity to a C corporation if income is saved and invested in portfolio assets — can be thought of as a baseline result. The earlier discussion does not preclude the possibility that other tax provisions could still make the corporate form more tax efficient when business owners are looking to invest substantial proceeds in portfolio investments. I next examine four provisions that have been offered as potential incentives for incorporation.

A. Interest and Dividends

The first suggestion is that corporations are taxed at lower rates than individuals are on some forms of investment income. For example, on interest income, corporations are taxed at the corporate rate of 21 percent, whereas individuals are taxed at ordinary income rates of up to 37 percent. Further, corporations that hold shares in other corporations are eligible for a dividends received deduction.  

The deduction, which is a function of the payee’s ownership of the payer, is 50 percent when the corporate payee holds less than 20 percent of the payer’s stock. Thus, the effective tax rate on cash dividends is 10.5 percent when stock is held through a corporation, and 20 percent when held on personal account — meaning that interest and dividends are taxed at lower rates when the same shares are received by corporations.

As for interest income, corporations and high-bracket investors are rarely the proper tax clientele for taxable bonds. Municipal bonds, the interest on which is exempt from federal taxation (and often state taxation, too), are a good substitute for taxable bonds. When the implicit tax rate on municipal bonds (the reduction in yield of tax-exempt bonds as compared with

\[13\] See Knoll, supra note 6.

\[14\] Section 243.
taxable bonds) is less than 20 percent, which it often is, both corporations and high-bracket individuals are part of the tax clientele for municipal bonds. Thus, only when the implicit tax rate on municipal bonds is more than 21 percent are investors better off holding bonds through corporations than on personal account. And even then, the benefit is only the difference between the 21 percent statutory corporate tax rate and the implicit tax rate on municipal bonds.\(^\text{15}\)

As for the dividends received deduction, the corporate tax advantage from holding equity securities is less than the 9.5 percent rate difference on dividend income. That is because the lower corporate tax rate applies only to dividends, not to capital gains. In recent years, dividends have accounted for only a small portion of the total return from holding stocks,\(^\text{16}\) thereby reducing the tax benefit from investing in stocks through a corporation. Of course, a taxpayer investing in stocks through a corporate “pocketbook” could increase the dividend portion of income by purchasing high-yield dividend stock, but that strategy would likely lead to a poorly diversified portfolio.\(^\text{17}\)

**B. The Medicare Tax**

The second factor potentially encouraging a shift to the corporate form is the Medicare tax. The basic Medicare payroll tax is 2.9 percent, and it is split evenly between employer and employee. (The Medicare tax also applies on the same terms to self-employment income, but in that case it is paid entirely by the individual.) Unlike Social Security, there is no income limitation on the Medicare tax. Moreover, there is an additional Medicare tax of 0.9 percent on wages exceeding $200,000 (single) or $250,000 (married filing jointly), which brings the Medicare tax up to 3.8 percent. Before 2013, taxpayers did not pay Medicare tax on their investment income. Since 2013 high-income taxpayers have been subject to a 3.8 percent Medicare surtax on their investment income.\(^\text{18}\) Accordingly, a high-bracket taxpayer with a pass-through entity would be subject to the 3.8 percent Medicare tax on earnings from that entity. The taxpayer would also be subject to the 3.8 percent Medicare surtax on investment income when realized.\(^\text{19}\)

In contrast, corporations are not subject to the Medicare tax. The Medicare tax is imposed only when a corporation pays wages to its employees or dividends to its shareholders (or when shareholders sell their shares and realize capital gains). Accordingly, because the Medicare tax is not imposed while the corporation retains earnings, and because there is only one level of Medicare tax, there can be a tax benefit from using a corporation to defer the Medicare tax. This result stands in contrast with the income tax result described earlier, in which there was no tax benefit from using a corporation to defer the income tax.

There are two potential Medicare-related tax benefits from using a corporation. First, when a shareholder takes profits as dividends, the corporate tax is effectively deductible from the Medicare tax base. This can be seen in Table 3 by comparing the fourth column with the second and fifth columns in Panel 1.

Second, deferral of the Medicare tax on retained earnings is a tax benefit of using the corporate form. As noted earlier, tax deferral is equivalent to exempting the investment return on the proceeds on which tax is deferred. Accordingly, using a corporation to defer the Medicare tax effectively exempts the return on the corporation’s income from the Medicare tax. Unlike the earlier-discussed result with income

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\(^{15}\) Assume, for example, that corporate bonds pay 5 percent compounded annually and that tax-free municipal bonds pay 3.75 percent compounded annually, which implies a 25 percent tax rate on municipal bonds. Corporations then would earn 3.95 percent on bonds, whereas individual investors would earn 3.75 percent — a difference after tax of 20 basis points.

\(^{16}\) Although historically dividends have accounted for more than two-fifths of total return, in the 2010s dividends have so far accounted for much less, about one-sixth of total return. Ben Reynolds, “S&P 500 Dividend Yield: Past, Present, Future,” Sure Dividend, Aug. 9, 2018. And the current dividend yield on the S&P 500 is less than 2 percent. Multpl, “S&P Dividend Yield” (1.92 percent as of February 25). That suggests that only a small portion of expected return will come from dividends.

\(^{17}\) Less obviously, an individual investor could purchase a derivative, such as a total yield swap, thereby converting dividends into long-term capital gains and further deferring income.

\(^{18}\) The higher tax rate applies to the lesser of a taxpayer’s net investment income or the excess of modified adjusted gross income exceeding $250,000 ($200,000 for unmarried individuals).

\(^{19}\) The Medicare tax is not imposed on distributions from a subchapter S corporation (but is imposed on salary payments from an S corporation). S corporations, of course, are pass-through entities. Therefore, the ability to avoid Medicare tax on business profits not paid as salary tends to encourage the use of S corporations over C corporations.
taxes — in which the tax benefit from deferring the individual income tax was offset by the corporate tax on the income from retained earnings — there is no Medicare tax imposed at the corporate level that would eliminate the benefit from using a corporation to defer the Medicare tax.

Therefore, because of the Medicare tax, there is a tax benefit from incorporation and investing retained earnings. That tax benefit, which is equivalent to exempting the return on retained earnings and profits from the Medicare tax, is illustrated in the last two panels of Table 3.

Table 3. Medicare Comparison for Conversion From a Passthrough Entity to a C Corporation

<table>
<thead>
<tr>
<th>Panel 1. Current Distribution; No Investment</th>
<th>Passthrough</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Section 199A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distribution</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Payment</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Individual tax</td>
<td>$408</td>
<td>$334</td>
</tr>
<tr>
<td>Net consumption</td>
<td>$592</td>
<td>$666</td>
</tr>
<tr>
<td>Percentage difference</td>
<td>12.5%</td>
<td>1.69%</td>
</tr>
<tr>
<td>Entity tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distribution</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Payment</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Individual tax</td>
<td>$408</td>
<td>$334</td>
</tr>
<tr>
<td>Net consumption</td>
<td>$592</td>
<td>$666</td>
</tr>
<tr>
<td>Percentage difference</td>
<td>12.5%</td>
<td>1.69%</td>
</tr>
<tr>
<td>Panel 2. Reinvestment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distribution</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Individual tax</td>
<td>$408</td>
<td>$334</td>
</tr>
<tr>
<td>Net investment</td>
<td>$592</td>
<td>$666</td>
</tr>
<tr>
<td>Percentage difference</td>
<td>12.5%</td>
<td>1.69%</td>
</tr>
<tr>
<td>Panel 3. All Investment Income Is Taxed Currently</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment grows to</td>
<td>$1,233.82</td>
<td>$1,388.05</td>
</tr>
<tr>
<td>Payment (grossed up)</td>
<td>$2,139.02</td>
<td></td>
</tr>
<tr>
<td>Dividend tax</td>
<td>$402.18</td>
<td></td>
</tr>
<tr>
<td>Ordinary tax</td>
<td>$872.72</td>
<td>$689.45</td>
</tr>
<tr>
<td>Net consumption</td>
<td>$1,233.82</td>
<td>$1,388.05</td>
</tr>
<tr>
<td>Percentage difference</td>
<td>12.5%</td>
<td>4.36%</td>
</tr>
<tr>
<td>Panel 4. All Investment Income Is Tax Deferred</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment grows to</td>
<td>$1,535.50</td>
<td>$1,727.43</td>
</tr>
<tr>
<td>Corporate tax</td>
<td>$264.40</td>
<td>$264.40</td>
</tr>
<tr>
<td>Payment (not grossed up)</td>
<td>$1,535.50</td>
<td>$1,727.43</td>
</tr>
<tr>
<td>Payment (grossed up)</td>
<td>$2,259.06</td>
<td>$2,049.06</td>
</tr>
</tbody>
</table>
As a comparison of the second column with the fourth and fifth columns shows, the amount a taxpayer who cannot take advantage of the section 199A deduction can consume after 10 years is slightly higher, between 2 and 4.4 percent, when the investment is made through a corporation. This benefit — which I would describe as modest but not nothing — is the result of the deferral of the Medicare tax and the deduction of corporate taxes from the Medicare tax base.

### C. Step-Up in Basis

The third reason that has been offered for favoring corporations when reinvesting is that the step-up in basis at death can eliminate the individual-level tax on both business profits and investment income. If the profits of a corporation are retained and invested, and if a taxpayer holds the corporation’s stock until death, the taxpayer’s heirs and beneficiaries will receive their shares with a stepped-up basis equal to the shares’ fair market value at the time of the decedent’s death. The effect of the step-up, therefore, is to wipe out the decedent’s accumulated capital gain upon her death. Although the shareholder’s death eliminates the individual-level capital gain tax, it does not eliminate the corporate tax on (the decedent’s share of) the corporation’s unrealized capital gain. That gain, which remains, will ultimately be taxed at the corporate rate. Thus, the taxpayer can potentially avoid a portion of the tax ultimately due on her investment gain by holding the corporation’s stock until death.

Death has been called the great equalizer, and a passthrough owner’s heirs and beneficiaries can also benefit from a step-up in basis when the owner dies. Although the individual owner of a passthrough entity is taxed on income as realized at her ordinary income tax rate, any gains not realized whether from the business itself or from investments, are eliminated by the step-up in basis upon death. The unrealized gain over the decedent’s life escapes tax because the decedent’s beneficiaries receive their interests with stepped-up bases. So the question becomes, where is the tax saving from the step-up greater? Is it larger with passthrough or corporate ownership?

It is helpful to separate realized from unrealized income. The value of the step-up in basis at death on unrealized income is greater with passthrough entities than with corporations. That is because the unrealized income entirely escapes taxation when held by passthrough entities but will eventually be subject to corporate tax when held by C corporations. Conversely, the potential tax saving on realized income is greater with corporations than with passthrough entities. That is because income realized by the corporation escapes individual-level tax if the taxpayer dies before the income is realized at the individual level. However, with a passthrough entity, when income is realized at the entity level, it is passed through and realized at the individual level and thus does not escape taxation when the owner dies.

---

Table 3. Medicare Comparison for Conversion From a Passthrough Entity to a C Corporation (Continued)

<table>
<thead>
<tr>
<th>Dividend/ investment tax</th>
<th>Passthrough No Section 199A</th>
<th>Passthrough Section 199A</th>
<th>Corporation Dividend Gross-Up</th>
<th>Corporation Dividend No Gross-Up</th>
</tr>
</thead>
<tbody>
<tr>
<td>$224.55</td>
<td>$252.62</td>
<td>$424.75</td>
<td>$921.70</td>
<td>$836.02</td>
</tr>
<tr>
<td>Ordinary tax</td>
<td></td>
<td></td>
<td>$1,310.94</td>
<td>$1,474.81</td>
</tr>
<tr>
<td>Net consumption</td>
<td>$1,359.13</td>
<td>$1,359.91</td>
<td>$1,373.36</td>
<td>$1,213.04</td>
</tr>
<tr>
<td>Percentage difference</td>
<td>12.5%</td>
<td>3.73%</td>
<td>2.02%</td>
<td>-7.47%</td>
</tr>
</tbody>
</table>

20 Section 1014(a).

21 Mitch Albom, Tuesdays With Morrie 51 (1997) (“Maybe death is the great equalizer, the one big thing that can finally make strangers shed a tear for one another.” — Attributed to Morrie Schwartz).
SPECIAL REPORT

In general, it is not clear whether the tax benefit from the step-up in basis at death is greater with passthrough entities or with C corporations. The answer in any specific case likely depends on the party’s circumstances.

D. QSBS Exclusion

A fourth proffered rationale for favoring C corporations is the qualified small business stock (QSBS) exclusion, which allows individual taxpayers to exclude from federal tax 100 percent of their gain on the sale of qualified corporations’ shares. The exclusion is limited to the greater of $10 million or 10 times the adjusted basis of the stock, and it is available only if specified conditions are met:

1. the stock was directly acquired from a C corporation at the time of issuance;
2. the corporation’s adjusted basis when the stock was acquired was less than $50 million;
3. the stock has been held for over five years; and
4. the corporation is engaged in specified qualified active trade or business activities.

The QSBS exclusion, which was originally enacted in 1992 with a smaller exclusion, was and is a strong incentive to incorporate small and medium-size businesses with strong growth potential. However, the exclusion and the incorporation incentive it creates precede the TCJA. Although the TCJA’s reduction in the corporate tax rate will further encourage owners of businesses that might qualify for the QSBS exclusion to try to do so, the impact on incorporations is probably modest. That is because businesses seeking to take advantage of the deduction were likely already C corporations.

Moreover, the QSBS exclusion does not make a corporation an effective vehicle for portfolio investments. Indeed, the effect is the opposite. For a shareholder to take advantage of the QSBS exclusion, at least 80 percent of the corporation’s assets by value must be used in at least one qualified trade or business. The excluded businesses, which are similar to the excluded businesses under section 199A, eliminate most service businesses. And those businesses not eliminated can invest only modest amounts in portfolio assets without violating the 80 percent requirement.

In summary, as the earlier discussion indicates, there are circumstances in which provisions in the tax law that can lead high-bracket business owners to favor the corporate form of ownership over the passthrough form (at least when the section 199A deduction is unavailable). However, even in those circumstances, the tax advantages available from using the corporate form as a vehicle for investing earnings in portfolio assets appear to be modest in many cases. Accordingly, none of these provisions seems likely to lead to a cascade of passthrough entities being converted to C corporations, and the effect on the fisc of the tax savings from those that do convert will probably not be particularly large.

IV. Reinvesting in the Business

The discussion thus far has focused on situations in which business owners invest some of their profits in portfolio assets. Absent special circumstances, such as the QSBS exclusion, the adoption of the corporate form is unlikely to yield a large tax advantage, and even then, because portfolio investment is constrained, the potential tax saving is limited. If, however, a business’s owners were to plow their earnings back into the business in a way that produced ordinary income, the tax benefits from incorporation would appear to increase substantially. Accordingly, this section considers the possibility of reinvesting in the business, which has been offered as a major driver for a shift to the corporate form.

There are two reasons to believe there can be a tax benefit from incorporation when reinvesting in the business. First, profits reinvested in the

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22 Section 1202.
21 Section 1202(b).
24 Section 1202(c)(1).
25 Section 1202(d)(1).
26 Section 1202(a)(1).
27 Section 1202(e).
28 Section 1202(e)(1)(A).
29 See section 1202(e)(3).
business create little risk of running afoul of the QSBS exclusion’s requirement that 80 percent of the corporation’s assets be invested in qualified trades or businesses. Second, and more significant, reinvesting in an ongoing business would appear to result in a sizeable tax advantage from using the corporate form when the investment tax on dividends replaces the individual-level ordinary income tax. That advantage is explained next.

Consider a business held through a passthrough entity. Assume that the business is profitable and that profits reinvested in the business will produce ordinary income. The income generated from reinvesting profits in the business is not taxed at 20 percent — the reduced tax rate that applies to most portfolio assets — but rather is taxed at the ordinary income tax rate, which is as high as 37 percent (not accounting for the Medicare tax). In contrast, if the same business is held through a C corporation, both the income generated by the business and the income generated by the profits reinvested in the business will be taxed at 21 percent, the corporate tax rate. The individual tax upon distribution will be assessed at 20 percent, but that tax is deferred.

As described earlier regarding the reinvestment of profits in portfolio assets, the deferral of the individual income tax on the corporation’s retained earnings is roughly equivalent to excluding the return on those earnings from the individual investment tax. Thus, the imposition of the corporate tax on the income generated by retaining profits in the corporation roughly compensates for the deferral of the individual investment tax. That is because the corporate tax and individual investment tax are nearly equal and because the corporate tax — as well as the investment tax — is imposed on the income from reinvestment only if reinvestment takes place through the corporation.

However, when profits are reinvested in a passthrough entity and produce ordinary income, both the original income and the income from reinvestment are taxed at 37 percent. In this case the tax benefit that would result from deferring the individual-level tax is equivalent to exempting the return on the reinvested profits from the individual tax on ordinary income. Thus, because the 21 percent corporate tax on the income from reinvestment does not fully offset the benefit of deferring the 37 percent ordinary tax on the income from reinvestment, incorporation can produce a tax saving over passthrough treatment when profits are reinvested in the business and produce ordinary income. This is illustrated in Table 4 (which includes the Medicare tax).

Table 4. Reinvestment Comparison for Conversion From a Passthrough Entity to a C Corporation

<table>
<thead>
<tr>
<th>Passthrough</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Section 199A</td>
<td>Section 199A</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Panel 1. Current Distribution; No Investment

| Entity tax | $210 |
| Distribution | $1,000 | $1,000 | $790 |
| Payment | | $1,000 | $1,000 |
| Individual tax | $408 | $334 | $188.02 | $408 | $408 |
| Net consumption | $592 | $666 | $601.98 | $592 | $592 |
| Percentage difference | 12.5% | 1.69% | 0 | 0 |

Panel 2. Reinvestment

| Entity tax | $210 |
| Payment | $210 | $210 | $210 |
The fourth and fifth columns of the last two panels of Table 4 show the large tax benefits potentially available from using a corporation rather than a passthrough entity (second column) when retained earnings are reinvested in the business and produce ordinary income. In the example, the magnitude of the tax advantage from choosing the corporate form when profits are reinvested in the business and produce ordinary income is similar to that from the section 199A deduction. Of course, the example is constructed, and other examples can yield different results. However, a 10-year holding period is relatively long, and a 10 percent annual rate of return is relatively high. Thus, the example suggests that the strongest case for using a corporation post-TCJA is not as a corporate pocketbook to reinvest earnings in portfolio
investments, but rather as a vehicle to reinvest earnings in the business when the business’s owners cannot take the section 199A deduction and the reinvestment produces ordinary income.

However, even here there might not be an advantage from incorporating. Implicit in the discussion of the tax benefit from reinvesting is that the reinvested proceeds generate some immediate tax liability, whether the reinvestment occurs through a corporation or a passthrough entity. As is widely recognized, an immediate deduction of the full amount invested is equivalent to exempting the return on that investment from tax — regardless of the tax rate — assuming that the tax rate is constant (and making some other common assumptions). Accordingly, for there to be a tax benefit from incorporating, the reinvested expenditures cannot be immediately deductible.

Under current law, most expenditures are immediately deductible for many businesses. The TCJA provides a general allowance of expenditures for businesses regardless of size. Small and medium-size businesses can deduct up to $1 million a year before having to capitalize and depreciate their investment expenditures. And through 2022, large businesses can take 100 percent bonus depreciation, which also produces an immediate deduction. Thus, at least for now, there is no tax advantage from using the corporation to reinvest profits in a business, even if that reinvestment produces ordinary income. This is illustrated in Table 5 (which includes the Medicare tax).

As the third row in Table 5 shows, the full $1,000 can be reinvested in the business regardless of how the business is organized. That is because there is no tax on reinvested profits as the full investment is immediately deductible. As the last two rows show, although there remains a substantial tax advantage when the owner can use the section 199A deduction, when that benefit is unavailable, there is little difference in consumption whether the business is organized as a passthrough entity or a corporation. Thus, what is commonly thought of as the strongest case for switching to a corporation isn’t that strong after all.

V. A Cautionary Note

Regardless of whether the various potential tax advantages described above are considered separately or together, it does not appear that business owners can substantially reduce their taxes by switching from a passthrough entity to a

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Table 5. Reinvestment With Immediate Expensing

<table>
<thead>
<tr>
<th></th>
<th>Passthrough</th>
<th>Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No Section 199A</td>
<td>Section 199A</td>
</tr>
<tr>
<td>Net investment</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Grows to</td>
<td>$2,593.74</td>
<td>$2,593.74</td>
</tr>
<tr>
<td>Corporate tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividend tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ordinary tax</td>
<td>$1,058.25</td>
<td>$866.31</td>
</tr>
<tr>
<td>Net consumption</td>
<td>$1,535.50</td>
<td>$1,727.43</td>
</tr>
<tr>
<td>Percentage difference</td>
<td>12.5%</td>
<td>1.69%</td>
</tr>
</tbody>
</table>

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30 Section 179 (the maximum immediate deduction is $1 million, and the deduction phases out dollar for dollar for annual expenditures above $2.5 million; both of these amounts are indexed for inflation).
31 Section 168(k).
32 Also, because all income is assumed to be reinvested over a 10-year period, there is no interim tax liability even if income is realized each year, because that income is offset by an immediate deduction.
33 What difference there is, illustrated by the fourth column, is mostly the result of the corporate tax being excluded from the Medicare tax base. The rest of the difference reflects the small difference in the total federal income tax rate on dividends (36.8 percent) and passthrough profits or salary (37 percent).
corporation. In this section, I describe a tax risk from incorporation that I have not seen discussed elsewhere. That risk can make switching from a passthrough entity to a corporation in response to the TCJA even less attractive than the prior discussion suggests.

Implicit in the discussion so far is an assumption that (1) the corporate payer can control whether it pays a dividend or instead pays compensation; and (2) if the corporation does pay compensation, it can deduct the full amount of the paid compensation against its current taxable income. That assumption may be wrong. If the payment is taxed as compensation (not as a distribution) and the corporation does not have taxable income that can be offset by the payment, the corporate form can be at a large tax disadvantage relative to the passthrough form (even if the section 199A deduction is unavailable).

That possibility is not unrealistic. A corporation and its shareholder-employee cannot simply decide whether a payment from the corporation to the shareholder-employee is taxable as a distribution or as salary. Rather, the payment’s tax treatment depends on the surrounding facts and circumstances. As suggested earlier, there is no problem if the payment is taxed as a distribution. That payment is a dividend, taxable to the recipient at a rate of 20 percent to the extent of the corporate payer’s E&P. If the corporation lacks sufficient E&P, the distribution is (untaxed) return of capital up to the shareholder’s basis, and thereafter it is capital gain, which is taxed at 20 percent if the taxpayer has held the shares for longer than one year.

For a payment to be taxed as a dividend, the payment must be made “with respect to stock.” That, in turn, requires that the distribution be made to all holders of the same class of stock on the same terms — which can present a challenge when earnings are retained and invested in nonbusiness assets. Shareholders can differ in their preferences for current consumption versus savings. Even among savers, parties can differ in their investment horizon and their risk tolerance (and hence in their preferred investment portfolio of assets). Those differences in preferences cannot be easily accommodated when the company has multiple owners but is not publicly traded. For deferred payments to be taxed as dividends in their entirety, all shareholders must be willing to reduce current payments (of salary or dividends) in proportion to their share ownership and to make the same investments. If that is not so, future payments on deferred earnings will not match share ownership and thus will be treated — at least in part — as compensation rather than dividends.

Moreover, even if shareholders reduce their payments in proportion to their shareholdings, the shareholder-employees are still not entirely in the clear. Under long-standing doctrine, the compensation paid to shareholder-employees must reflect the reasonable value of their services. If salary payments are too low relative to value, the IRS might challenge treating even pro rata payments as dividends and argue that they should be taxed as salary.

If a payment from a corporation to its shareholder-employee is salary, and the corporate payer has sufficient income to deduct the full payment currently, again there is no problem. A problem arises only if the payment is salary and the corporation cannot use the full deduction to offset current income. If the corporation cannot use any of the deduction, there is no corporate tax saving from the payment.

When some or all of the deduction from a salary payment cannot be used to offset current income, the corporation receives a net operating loss, which it can carry forward and use to offset their liabilities.

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34 If the corporation lacks sufficient E&P, the distribution is (untaxed) return of capital up to the shareholder’s basis, and thereafter it is capital gain, which is taxed at 20 percent if the taxpayer has held the shares for longer than one year.

35 See section 301(a) (referring to “distributions of property made by a corporation to a shareholder with respect to its stock”).

36 Non-pro rata payments are likely to be taxed as redemptions instead of as dividends if they are accompanied by corresponding changes in share ownership. Those payments are not deductible by the corporate payer and are taxable to the payee as capital gain. Long-term capital gains are taxed at the same rate as dividends. However, the taxpayer can offset some of the payment received by her basis in the tendered shares. The resulting tax deferral can be beneficial to the taxpayer.

37 Providing additional securities or claims to shareholder-employees who choose to invest more today and hence are later entitled to a larger share of the corporation’s profits will not be effective in avoiding salary treatment because the tax treatment of such securities or claims resembles the treatment of deferred salary for both parties.
future income.\textsuperscript{39} If, however, the business is winding down and there is likely to be little or no future income, the NOL will likely have little or no value.\textsuperscript{40} In that situation, the corporation will in effect be taxed on more than its long-term income. Such a situation seems likely for a small corporation with one or only a few owners of the same generation that is winding down. If the business is larger and it is being passed across generations, the problem is less likely, but if the business ever does wind down, the last generation in or the last generation to retire can be left holding the bag from a tax deduction that can’t be used.

The last column in tables 2, 3, and 4 illustrates the situation when the payment is of deferred salary and the corporate payer has no income against which to offset the payment.\textsuperscript{41} In each case, there is a substantial decline in net consumption relative to treating the payment as a dividend.\textsuperscript{42} In those situations, the corporate form can be much less tax efficient than the alternative of a passthrough entity. The risk that a corporate payment of deferred salary is not deductible must be considered and taken seriously.

VI. The Newly Incorporated

So what kinds of businesses are most likely to be converted into C corporations, and with how large of an impact on tax collections? Although prominent commentators have predicted that many business owners will choose to incorporate their businesses, and that those conversions will have a substantial effect on tax collections, the analysis in this report suggests that relatively few businesses would be taxed far more favorably as C corporations than as passthrough entities.

As a start, business owners who can take the section 199A deduction will probably pay substantially higher taxes if they incorporate. So the candidates for switching likely consist mostly of businesses whose owners cannot take that deduction.

Within that group of business owners, those who consume all income as it is earned will see only a small decrease in their taxes from incorporating, most of which will come from the corporate tax being excluded from the Medicare tax base. Business owners who invest a portion of their income in portfolio assets will likely be only slightly better off by incorporating. They might expect to see a decrease in their taxes from the dividends received deduction, the possibility (at times) of somewhat lower taxes on interest income, and the deferral of Medicare taxes. However, the deferral of the individual tax from investing retained profits in portfolio assets will not generate any tax savings. That is because the tax benefit from the deferral is (slightly more than) offset by the imposition of the corporate tax on investment earnings as a second level of taxation.

Nor are the owners of profitable businesses that reinvest in the business and produce ordinary income substantially better off owning their businesses through corporations. Because of the current widespread availability of immediate expensing for business investments, taxation is deferred — regardless of the form of ownership — until distribution (or reinvestment in portfolio assets, which is not a source of advantage).

Perhaps the increase in the QSBS exclusion to 100 percent would encourage some taxpayers to incorporate businesses that they would have otherwise structured as passthrough entities. However, for the past 25 years, academics have

\textsuperscript{39} Section 172.

\textsuperscript{40} Under current law, there are no loss carrybacks, so the corporate payer cannot get a refund for prior taxes paid. Until 2018 a corporation with a current NOL could use it to receive a refund of taxes paid during the prior two years. If there were not sufficient income and taxes in the prior two years to use the current NOL, the taxpayer could carry it forward for 20 years before it expired.

\textsuperscript{41} In calculating the payment in the last column of tables 2, 3, and 4, I assume that the corporation has no taxable income other than any income from the investment. That is why there is no corresponding “No Gross-Up” column in Table 5, when reinvestment is immediately deductible. In that case, the income from the reinvestment in the 10th year is entirely equal to the proceeds from reinvestment.

\textsuperscript{42} Moreover, the only circumstance in which consumption when the payment is salary and the corporation does not have taxable income from its business operations that can be offset by the salary payment is above consumption with a passthrough is in Table 4, when the proceeds are reinvested in the business and produce ordinary income. However, the calculations in that case (Table 3, Panel 4) assume that the reinvested expenditures are not immediately deductible. If they are immediately deductible, as is largely the case today, that benefit disappears, as illustrated in Table 5.
argued that businesses tend to adopt the corporate form even when a passthrough entity is more tax efficient. That tendency appears to be especially strong for businesses that are looking to raise venture capital funding or rely heavily on equity-based compensation. In other words, businesses with ambitious growth goals tend to be incorporated even if there is a substantial tax cost for doing so. For these businesses, the TCJA likely lowers the tax disadvantage. However, because many of these companies are already incorporated, it is not clear that many businesses that would have remained (or started) as passthrough entities if the old tax law had remained in place will incorporate. In these circumstances, because incorporation is suboptimal, tax collections are likely to rise, not fall, from businesses switching to the corporate form.

Ultimately, for most businesses the tax benefits from switching from a passthrough entity to a C corporation are nonexistent, speculative, or small. Moreover, those benefits would come with the risk that a later payment to a shareholder-employee is salary that cannot be deducted by the payer corporation. And for businesses with multiple owners, there would be pressure for all the owners to save through the corporation in proportion to their share ownership and for all shareholders to have the same investment portfolio. Although I have no numerical estimates to offer, it is hard to see the TCJA causing a rush to incorporate and a substantial loss of tax revenue — at least for now.

In 1897, reports were circulating that Mark Twain had died in London. A reporter from the New York Journal reached Twain and received the now-famous response that Twain considered the report of his death “an exaggeration.” Like the 1897 report of Twain’s death, claims of a stampede to incorporate are an exaggeration. As of today, the potential tax benefits from incorporation are likely to be modest for many passthrough owners. Yet, there are changes scheduled in the tax law that could in the years to come tip the balance in favor of incorporation for many passthrough owners.

Whereas the corporate tax rate is set at 21 percent and the individual long-term capital gain and qualified dividend tax rate is set at 20 percent, the top individual ordinary income tax rate is scheduled to return to 39.6 percent in 2026. Unless Congress intervenes and extends the current 37 percent top tax rate, for top-bracket taxpayers, the benefit of incorporation and taking current income as dividends would rise from 0.2 percent to 2.8 percent (without taking into account the Medicare tax). In addition, more taxpayers would stand to benefit from incorporation if the section 199A deduction disappears at the end of 2025.

Assuming those changes go into effect as scheduled, there would still be no incremental incentive tax benefit from using corporations to hold portfolio investments. That is because the corporate tax rate will still exceed the personal investment tax rate. In contrast, the incentive to incorporate profitable businesses that reinvest earnings and produce ordinary income will increase when the TCJA’s personal tax provisions expire. In addition, the phasing out of bonus depreciation, which runs from 2023 through 2026, could provide a strong incentive to incorporate, especially when the horizon is long.

The old saying is nothing is true, but death and taxes. Taxes do not disappear, but they are not static either. They change over time, often in unexpected ways. And so there might or might not be a strong incentive in the future to incorporate. It is difficult to predict what the tax law will look like in the future. That uncertainty creates an additional reason for passthrough owners to wait. It is more difficult and more expensive to take assets out of corporate solution than to put them into corporate solution. Accordingly, the owners of a business that is structured as a passthrough have an option to convert their business into a corporation if doing so would be desirable. However, once they convert, they lose that option as they cannot easily and inexpensively convert back to a passthrough entity. Thus, at a time when there is much uncertainty surrounding the future of the tax

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43 Only in special circumstances (such as owners planning to hold large amounts of high-dividend, high-interest, low-capital gains assets until death) will switching from a passthrough entity to a C corporation likely lead to a large reduction in taxes.
system it is understandable for passthrough business owners to wait and keep their options open even if there appears to be a current benefit from incorporation.\footnote{There is also uncertainty surrounding the details of the current law relevant to making choice of entity decisions today. And that uncertainty appears to be further discouraging the conversion of passthrough entities into C corporations. See Henry, Plesko, and Utke, \textit{supra} note 3, at 656 (noting how the temporary nature of many TCJA provisions and the uncertainty surrounding how the law will be interpreted and administered are factors that are slowing the process of changing entity forms).}

\section*{VII. Conclusion}

The TCJA’s tax rates were the result of substantial negotiation, debate, tinkering, and compromise. The bill’s authors were determined to lower personal and corporate tax rates as much as they could within their budgetary constraints. As far as I am aware, achieving neutrality in the relative tax treatments of passthrough entities and corporations was not an important driver.\footnote{Oddly, neutrality between corporations and passthrough entities seems to have provided a justification for section 199A, where it does not tend to level the playing field between C corporations and passthrough entities but instead yields a tax advantage for passthrough entities. See Scott Greenberg and Nicole Kaeding, “Reforming the Pass-Through Deduction,” Tax Foundation (June 21, 2018) (“Supporters of the deduction argue that it delivers much-needed tax relief to American businesses and helps put the pass-through sector on an equal footing with the largest multinational corporations.”).} Yet, whether by design or by accident, the top statutory individual and corporate tax rates create very close to a level playing field between passthrough and corporate entities (at least for individuals in the top tax bracket who cannot take advantage of the section 199A deduction).

Accordingly, many other factors — both tax and nontax — can tip the scales in favor of either passthrough entities or C corporations. Many of those factors predate the TCJA.\footnote{For a lengthy (but still partial) list of tax and nontax factors that affect entity choice, see Repetti, \textit{supra} note 3, at 688 n.4.} As a result, choosing the most tax-efficient entity can require careful parsing of a wide range of tax and nontax considerations, and serious reflection about a business’s prospects and its owners’ personal plans.\footnote{\textit{See sources cited supra note 3, almost all of which concur with this point.}}

Yet it is not clear that many passthrough businesses would substantially reduce their tax burdens by incorporating. Accordingly, the sharp uptick in incorporations that some commentators are predicting seems unlikely to occur — especially if business owners understand and consider the full range of likely current and future tax consequences. And even if there are massive conversions by wealthy business owners, their tax savings would likely be modest.