



The Tax Cuts and Jobs Act's Incorporation “Incentive”

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The Tax Cuts and Jobs Act (TCJA), hastily passed by Congress and signed into law by President Trump in December 2017, appears to have shifted business owners' incentives.¹

In particular, the TCJA seems to encourage owners of successful businesses structured as sole proprietorships or passthrough entities to incorporate their businesses.² The advantage of owning a business through corporation is said to stem from (1) the relatively low corporate tax rate (21 percent), as compared with the maximum personal tax rate on ordinary income (37 percent), and (2) the deferral of individual-level tax. According to its critics, the TCJA will drive wealthy business owners to restructure 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.³

As a result of the TCJA, the long-held wisdom that passthrough entities are tax advantaged relative to subchapter C corporations is being questioned. And business owners—encouraged by academics, commentators, and consultants—are seriously considering converting their passthrough entities to corporations. Recent articles that model choice of entity under the TCJA further support the view that there will be a large shift from the passthrough to the corporate form.⁴ The choice of entity decision is now more complicated and the consensus is that there are many

SUMMARY

- Many observers have asserted that the reduced corporate tax rate instituted by the 2017 Tax Cuts and Jobs Act will incentivize owners of businesses structured as sole proprietorships or passthrough entities to incorporate their businesses and use these new corporations as pocketbook investment vehicles to invest in and hold portfolio investments, substantially reducing wealthy individuals' tax obligations and Treasury's tax collections.
- This brief offers a different view, and discusses why predictions of widespread conversions to the corporate form at a substantial cost to the fiscal position of the U.S. are overstated.
- The brief explores the various purported tax advantages to incorporating, both when business owners are looking to invest substantial profits in portfolio assets, as well as when retained earnings are reinvested in the business and produce ordinary income.
- Ultimately, for most businesses, the tax benefits from switching from a passthrough entity to a C corporation are nonexistent, speculative, or small. Consequently, tax collections are not likely to change much from businesses switching to the corporate form—at least for now. If certain provisions of the TCJA are not extended by Congress in the coming years, the tax advantages of incorporation could increase.

situations in which the corporate form would be tax preferred relative to a passthrough structure.⁵

This Issue Brief—a synthesis of two *Tax Notes* articles—takes a different position. Put simply, and in the words of the Roman storyteller Phaedrus, “the first appearance deceives many.” For several reasons discussed in this brief, the general claim that there will be a mass conversion of passthrough entities into C corporations is, in fact, doubtful. Ultimately, predictions of widespread conversions to the corporate form at a substantial cost to the fiscal position of the U.S. are overstated.

THE TWO PRINCIPAL SOURCES OF PRESUMED ADVANTAGE FOR INCORPORATING

1. RATE CHANGES

Under pre-2018 tax law, business owners had little tax incentive to incorporate. The total tax on retained earnings eventually distributed to shareholders was 7.6 percentage points higher than the tax on income earned through passthrough entities. That difference was a large disadvan-

tage 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. The total tax rate on passthrough earnings is now 37 percent—the top individual tax rate—down from 39.6 percent. The total tax rate on corporate earnings distributed immediately as dividends is now 36.8 percent.⁶ Hence, when all income is used for current consumption, the total tax burden on income earned through corporate and passthrough entities is now almost equal, 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 con-

sumption for a recipient in the top tax bracket. When the taxpayer’s business is a passthrough entity, the taxpayer will be taxed on all \$1,000 of earned income. If the taxpayer receives a dividend, the corporation pays corporate income tax, and then the dividend is taxed to the individual recipient at 20 percent. The end result is that the taxpayer who received a dividend can spend only 0.31 percent more than the taxpayer who owns a passthrough entity. Alternatively, if the individual is paid a \$1,000 salary, the corporation has no income and hence no corporate income tax liability. The individual who receives the salary pays income tax and is left with the same amount to spend as an owner of a passthrough entity.

That doesn’t exhaust all possi-

TABLE 1: CONSUMPTION WITH DIFFERENT ENTITIES

	Passthrough Entity		C Corporation	
	No Section 199A	Section 199A	Dividend	Salary
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		11.75%	0.31%	0

NOTES

¹ See, e.g., Reuven S. Avi-Yonah et al., “The Games They Will Play: Tax Games, Roadblocks and Glitches Under the House and Senate Tax Bills” (Dec. 7, 2017).
² Some commentators emphasize that the post-TCJA balance between passthrough entities and C corporations depends on a party’s circumstances. A list of references is available in footnote 3 of Michael S. Knoll (2019), “The TCJA and the Questionable Incentive to Incorporate,” *Tax Notes*, Vol. 162, No. 9, pp. 977-986. That paper is the basis of this Issue Brief, along with Michael S. Knoll (2019), “The TCJA and the Questionable Incentive to Incorporate, Part

2,” *Tax Notes*, Vol. 162, No. 12, pp. 1447-1461.
³ See, e.g., Avi-Yonah et al., *supra* note 1.
⁴ Penn Wharton Budget Model, (2018), “Projecting the Mass Conversion from Pass-Through Entities to C-Corporations.”
⁵ *Supra* note 2.
⁶ This 36.8 percent figure is 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.
⁷ Section 199A(a). The provision is temporary through the

end of 2025.
⁸ A QTBS 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.
⁹ Section 1411 provides for a 3.8 percent surtax on net investment income of certain high earners with substantial investment income.
¹⁰ Knoll, “Part 2,” *supra* note 2 (Table 3).
¹¹ Section 243 provides corporations with a 50 percent dividends received deduction for dividends received from

bilities, however, because the TCJA created a new category of income for tax purposes under the so-called passthrough provision of section 199A. 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).⁷ 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 and corporations, but it is available to sole proprietorships and owners of passthrough entities that are qualified trades or businesses (QTBs).⁸

For taxpayers who can take advantage of the section 199A deduction, a passthrough entity can deliver substantially more consumption than can a corporation. In Table 1, a top-bracket owner of a successful passthrough entity who can take full advantage of section 199A can consume 11.75 percent more than can a passthrough entity without the deduction.

2. DEFERRAL

Because it can be quite valuable, deferral drives the most preva-

lent argument for incorporation. When a portion of income is saved and invested, the corporate form appears more tax-friendly than the passthrough form, since the personal tax on long-term capital gains and qualified dividends can be deferred, possibly indefinitely, within 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.

However, there is actually a small disadvantage to using a corporation rather than a passthrough entity (without a section 199A deduction) as a vehicle to invest in portfolio assets, as illustrated in Table 2. Table 2 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. It assumes that all investment income is taxed at the end of 10 years when the investment will be liquidated.

This small disadvantage is an important and surprising point. Despite a relatively long holding

period and a relatively high rate of return, the initial larger investment fund with a C corporation still 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.

The explanation, however, is simple. The imposition of the 21 percent corporate tax on investment income almost exactly offsets the benefit of the deferred 20 percent individual-level tax when investment income is earned through the corporation. With earnings taxed twice—once at the corporate level and then later at the individual level—the deferral benefit disappears.

At current tax rates, there are (roughly) no differences in the tax burdens of different organizational forms, 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.

NOTES

- firms where the recipient has an ownership share below 20 percent.
- ¹² 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.
- ¹³ Section 1014 provides as a general rule that the basis of property received from a decedent is the fair market value of the property at the time of the decedent's death (or the alternate valuation date).

- ¹⁴ Section 1202.
- ¹⁵ Knoll, "Part 2," *supra* note 2.
- ¹⁶ *Ibid.* For the full analysis, see section IV.
- ¹⁷ The TCJA provides a general allowance of expenditures for businesses regardless of size. Under section 179, 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, section 168(k) allows all businesses to take 100 percent bonus depreciation on most investments other than real estate, which also produces an immediate deduction.

- ¹⁸ E.g., Joseph Bankman, "Silicon Valley Start-Ups," 41 *UCLA L. Rev.* 1737 (1994); Victor Fleischer, "The Rational Exuberance of Structuring Venture Capital Start-Ups," 57 *Tax L. Rev.* 137 (2003); Larry Ribstein, *The Rise of the Uncorporation* 13 (2010); and Gregg D. Polsky and Adam Rosenzweig, "The Up-C Revolution," 71 *Tax L. Rev.* 415 (2018).
- ¹⁹ The incorporations of private equity companies KKR and Ares Capital post-TCJA are prominent examples of passthrough businesses incorporating not to reduce their taxes, but rather doing so to better access capital because

TABLE 2: ALL INVESTMENT INCOME IS TAX DEFERRED

	Passthrough Entity		C Corporation	
	No Section 199A	Section 199A	Dividend	Salary
Investment grows to	\$1,634.06	\$1,825.99	\$2,049.06	\$2,049.06
Corporate tax			\$264.40	
Payment (not grossed up)	\$1,634.06	\$1,825.99	\$1,784.64	\$1,000
Payment (grossed up)				\$2,259.06
Dividend/investment tax	\$200.81	\$224	\$365.93	
Ordinary tax				\$835.85
Net consumption	\$1,433.25	\$1,601.60	\$1,427.72	\$1,423.21

and is made through a corporation.¹⁰

2. INTEREST AND DIVIDENDS

Corporations are taxed at lower rates than individuals 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 of up to 50 percent.¹¹ Regarding interest income, however, corporations and high-bracket investors are rarely the proper tax clientele for taxable bonds. And as for the dividends received deduction, dividends have accounted for only a small portion of the total return from holding stocks in recent years,¹² thereby reducing the tax benefit from investing in stocks through a corporation.

3. STEP-UP IN BASIS

The step-up in basis at death can eliminate the individual-level tax on both business profits and investment income.¹³ The effect of the step-up is to wipe out the decedent's accumulated capital gain upon her death. But in general, it is not clear whether the tax benefit from the step-up in basis

FOUR OTHER (POTENTIAL) TAX ADVANTAGES OF INCORPORATING

Other tax provisions could still make the corporate form more tax efficient when business owners are looking to invest substantial proceeds in portfolio investments. Although none of these provisions are likely to yield large tax advantages from incorporation, here are four possible sources of advantage:

1. THE MEDICARE TAX

Corporations—unlike high-bracket taxpayers—are not subject to the 3.8 percent Medicare tax.⁹ The Medicare tax is imposed on a corporation only when it pays wages to its employees or dividends to its

shareholders (or when shareholders sell their shares and realize capital gains). Unlike the previous result with income taxes—in which the tax benefit from deferring the individual income tax was almost exactly 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 modest tax benefit from incorporation and investing retained earnings, and it is quantifiable. The amount that 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 earns 10 percent annually

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the tax costs of converting are minimal, if any. Joshua Franklin, "Private equity firm KKR opts to become C-Corp after U.S. tax reform," *Reuters*, May 3, 2018.

²⁰ 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.

at death is greater with passthrough entities or with C corporations. The value of the step-up on *unrealized* income is greater with passthrough entities than with corporations. Conversely, the potential tax saving on *realized* income is greater with corporations than with passthrough entities. The answer in any specific case likely depends on the party's circumstances.

4. QSBS EXCLUSION

A final 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.¹⁴ However, because the exclusion and the incorporation incentive it creates precede the TCJA businesses seeking to take advantage of the deduction were likely already C corporations before the TCJA was enacted. Moreover, the QSBS exclusion does not make a corporation an effective vehicle for portfolio investments; it actually has the opposite effect.¹⁵

REINVESTING IN THE BUSINESS

The discussion thus far has focused on situations in which business owners invest some of their profits in portfolio assets. 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. This is because the 20 percent investment tax on dividends replaces the

individual-level ordinary income tax with rates as high as 37 percent.

Assuming, again, a 10-year holding period and a 10 percent annual rate of return, the benefits potentially available from using a corporation rather than a passthrough entity when retained earnings are reinvested in the business and produce ordinary income are large—as high as 16.4 to 22.4 percent.¹⁶ This 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.

But under current law, most expenditures are immediately deductible for many businesses.¹⁷ Therefore, at least for now, there is only a very small (1.69 percent) tax advantage

from using the corporation to reinvest profits in a business, even if that reinvestment produces ordinary income. This is illustrated in Table 3 (which includes the Medicare tax).

WHICH BUSINESSES WILL CONVERT?

The two most salient questions remain: what kinds of businesses are most likely to be converted into C corporations, and how large of an impact will those conversions have on tax collections? As for the first question:

- Business owners who can take the section 199A deduction will probably pay substantially higher taxes if they incorporate.
- 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. However, the deferral of the individual tax from investing retained profits in portfolio assets will not generate any tax savings. Again, the advantage comes from the Medicare tax. 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.
- Similarly, the owners of profitable businesses that reinvest in the

business and produce ordinary income are only slightly better off owning their businesses through corporations because of the current widespread availability of immediate expensing for busi-

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

more taxpayers would stand to benefit from incorporation if the section 199A deduction disappears at the end of 2025 and as bonus depreciation phases out, unless those provisions are extended.

TABLE 3: REINVESTMENT WITH IMMEDIATE EXPENSING

	Passthrough Entity		Corporation	
	No Section 199A	Section 199A	Dividend	Salary
Net investment	\$1,000	\$1,000	\$1,000	\$1,000
Grows to	\$2,593.74	\$2,593.74	\$2,593.74	\$2,593.74
Corporate tax			\$544.69	
Dividend tax			\$487.68	
Ordinary tax	\$1,058.25	\$866.31		\$1,058.25
Net consumption	\$1,535.50	\$1,727.43	\$1,561.38	\$1,535.50
Percentage difference		12.50%	1.69%	0%

ness investments, which defers taxation until distribution. However, as 100 percent bonus depreciation—a feature that is equivalent to immediate expensing—phases out and is eliminated, the potential benefits from incorporation to businesses that reinvest their earnings in the business increase.

- Finally, there is a tax risk from incorporation that must also be considered. If a corporate 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. That is because the ordinary tax on the payment is not partially offset by the corporation's deduction.

Despite these findings, businesses historically have had a tendency to adopt the corporate form even when a passthrough entity is more tax efficient.¹⁸ That tendency appears to be especially strong for businesses that are looking to raise venture capital funding

businesses, the TCJA likely lowers the tax disadvantage. Since many of these companies are already incorporated, however, it is not clear that many businesses that would have continued (or started) as passthrough entities if the old tax law had remained in place will incorporate.¹⁹ Under these circumstances, and in response to the second question, tax collections are not likely to change much 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.²⁰ Accordingly, despite being unable to offer numerical estimates, it is hard to see the TCJA causing a rush to incorporate and a substantial loss of tax revenue—at least for now. If, however, Congress does not extend the current 37 percent top tax rate for top-bracket taxpayers, the benefit of incorporation would rise from 0.2 percent to 2.8 percent (without taking into account the Medicare tax) in 2026. In addition,

FINAL THOUGHTS

In the current tax environment, which was created by the TCJA, small differences can shift the balance in favor of one form of entity over another. Accordingly, business owners seeking to choose the most tax-efficient entity need to know more than ever before; they cannot simply fixate on one or two factors. They are compelled to try to predict the future, too. The challenge in making the incorporation decision stems from the fact that the corporate tax benefits are quantifiable, while the tax benefits of a sole proprietorship, for example, are based on difficult-to-model anticipations of future realities—both in terms of the owners' income and investment opportunities and changes in the tax law.

As a result of the TCJA, which brought the tax consequences of passthrough entities and corporations closer together, the game of identifying the most tax-efficient structure to use for a successful business is afoot. However, given the modest tax benefits potentially available to many firms in a wide range of circumstances, the game might not be worth the candle.

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