Minimizing the Effective Tax Rate on Trade or Businesses Income

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This Article examines the effective tax rates (i.e., the amount of tax owed divided by taxable income) that apply to typical business owners. Many analyses of the effective tax rates following the Tax Cuts and Jobs Act of 2017 (TCJA) use the highest tax rates that could apply to taxable income to compute the effective tax rates of various business-ownership scenarios. Much of the taxable income recognized by business owners is not subject to the highest marginal rates. Even when taxable income is high enough to subject some of the income to the highest marginal rates, the effective tax rate is generally lower than the highest marginal rates. Thus, not all income of business owners is subject to the highest tax rates, and the effective tax rates on the business income of most taxpayers will be less than the highest tax rates.

This Article focuses on the effective tax rates that will apply to business income of the vast majority of the population—those with taxable income less than $1,000,000. The effective tax rates below that amount generally differ significantly from the highest marginal rates. Effective tax rates can also differ significantly from one business to another, depending on the type of business and the entity structure. The nuances created by the TCJA make choice-of-entity analyses situational. Rules of thumb regarding choice-of-entity may apply to businesses that

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come within a certain band of income or have a certain employment or entity structure, but those same rules may not apply to other situations.

A few changes in the TCJA in particular affect choice-of-entity. The TCJA reduces tax rates on corporate and individual income and provides a deduction under section 199A for passthrough income, i.e., income of partnerships, S corporations, and proprietorships. Business owners are takin these changes into account as they choose from several basic structures or combinations of basic structures to own and operate their businesses. The following are structures from which business owners may choose.

1. Corporation that pays reasonable owner compensation and distributes all of its after-tax income
2. Corporation that pays reasonable owner compensation and distributes a fraction of its after-tax income
3. S corporation that pays reasonable compensation to shareholders
4. Passthrough entity other than an S corporation
5. Some combination of basic ownership structures

The business structure that business owners choose can affect their federal income tax and other types of taxes. For instance, the structure may affect the tax rate that applies to noncompensatory income, e.g., the 21% rate that applies to corporate income versus the graduated rates that apply to individual income. The structure also may affect the amount of employment tax for which the business owners are liable and the tax on net investment income that applies to passive-type income. This Article first presents the effective tax rate for the basic business structures taking only income tax into account. After considering the effective income tax rates that apply to different business structures, the Article considers the effective tax rate that applies to those same structures, factoring in employment taxes and the tax on net investment income. The analysis adopts the following assumptions, unless stated otherwise.

1. The owners manage the business and pay sufficient wages to third parties to qualify for the section 199A deduction, if they otherwise qualify for it. The analysis assumes that the business owners pay wages equal to two-sevenths of the pre-wage income, to ensure that the section 199A deduction is not subject to the wage limit. Thus, taxable income is five-sevenths of the business pre-wage income.[1]
2. The computation of the effective tax rate on C corporation income does not deem the corporation to pay compensation to the owners, unless stated otherwise. The analysis assumes the shareholders withdraw earnings through taxable dividends. This is unrealistic because the owners manage the business, but the analysis that combines corporate ownership with other arrangements illustrates how business owners would be taxed if they operated the business in a C corporation and received reasonable compensation for their services.
3. S corporations pay reasonable compensation to their owners.

[1] Five-sevenths of pre-wage income derives from a fairly simple formula for computing the optimal amount of wages, as a percentage of pre-wage income. The section 199A deduction equals 20% of the a QTB's taxable income. Taxable income equals a QTB's pre-wage income (PWI) minus wages (W). The deduction is limited to 50% of wages. To qualify for the maximum amount of the deduction, 50% of the wages must equal 20% of the QTB's taxable income (PWI-W). The formula for that statement is $0.2(PWI - W) = 0.5W$. After simplifying, the formula becomes $0.2PWI = 0.7W$. Thus, wages must be at least two-sevenths of PWI for the QTB to qualify for the maximum 20% deduction. In such situations, taxable income would be five-sevenths of PWI.

4. Compensation paid to business owners (compensatory business income) does not qualify for the section 199A deduction.
5. The taxpayers are married filing jointly.
6. Any entity that has income also pays wages to third parties equal to two-sevenths of that income, unless stated otherwise.
7. Employment taxes on wages paid to third parties are disregarded to help simplify the analysis.

Calculating Effective Tax Rates

The analysis first computes effective income tax rates taking into account only the income tax. That analysis illustrates how the rates can vary depending upon type and amount of income. The analysis then computes the effective tax rates taking into account income, employment tax, and the tax on net investment income. The analysis uses models created in Microsoft Excel to compute the effective tax rate in the following manner.

Effective Tax Rates on Taxable Income—Considering Only Income Tax

The effective tax rate on corporate income derives from the tax paid at the corporate level and the tax paid at the shareholder level on distributions. All corporate income is taxed at 21%. [2] Qualified dividend income is taxed at favorable rates,[3] and this analysis assumes that all

[2] *See* I.R.C. § 11(b).
[3] *See* I.R.C. § 1(h)(1)(B), (C), (D), (3), (h)(11).

dividends are qualified dividend income. For individuals with no other income, the first $77,200 of dividends is taxed at 0%, the amount in excess of that amount up to $479,000 is taxed at 15%, and the amount above that limit is taxed at 20%.[4]

Non-corporate business income is subject to a single level of tax. If a qualified trade or business (QTB) recognizes the income and pays sufficient wages, then it qualifies for the 20% deduction on qualified business income (QBI deduction).[5] Specified trades and businesses (SSTBs) also qualify for the 20% QBI deduction on their first $315,000 of income (the threshold amount[6]), but the deduction phases out as an SSTB's income rises to $415,000 (the threshold-plus amount).[7] Because the analysis assumes that wages paid to third parties are two-sevenths pre-wage income (PWI), a business that has PWI of $1,400,000 would have taxable income of $1,000,000. The analysis computes the effective tax rate for passthroughs using the graduated-rate table, applied to $1,000,000 of taxable income. Table 1 presents the computation of tax and the effective tax rate on $1,000,000 of business taxable income that does not qualify for the 20% QBI.

Table 1: Computation of Tax and Effective Tax Rate on $1,000,000 of Business Income (no QBI Deduction)

Brackets	Income	Tax Rate	Tax	Effective Rate
	$19,050	10%	$1,905	
19,050	$58,350	12%	$7,002	
$77,400	$87,600	22%	$19,272	
$165,000	$150,000	24%	$36,000	
$315,000	$85,000	32%	$27,200	
$400,000	$200,000	35%	$70,000	

[4] *See* I.R.C. § 1(h)(1)(B)(i), (C)(ii)(I), (j)(5).
[5] *See* I.R.C. § 199A(a), (b)(2).
[6] *See* I.R.C. § 199A(e)(2).
[7] *See* I.R.C. § 199A(d).

$600,000	$400,000	37%	$148,000	
Total	$1,000,000		$309,379	30.94%

A business that is a QBI with sufficient wages, will qualify for the 20% QBI deduction. Its taxable income will become $800,000, but the analysis computes the effective tax rate with respect to the $1,000,000 of pre-QBI deduction to provide a consistent reference point for comparing the effective tax rates of the various situations. Table 2 presents the computation of the tax and effective tax rate on $1,000,000 of QBI.

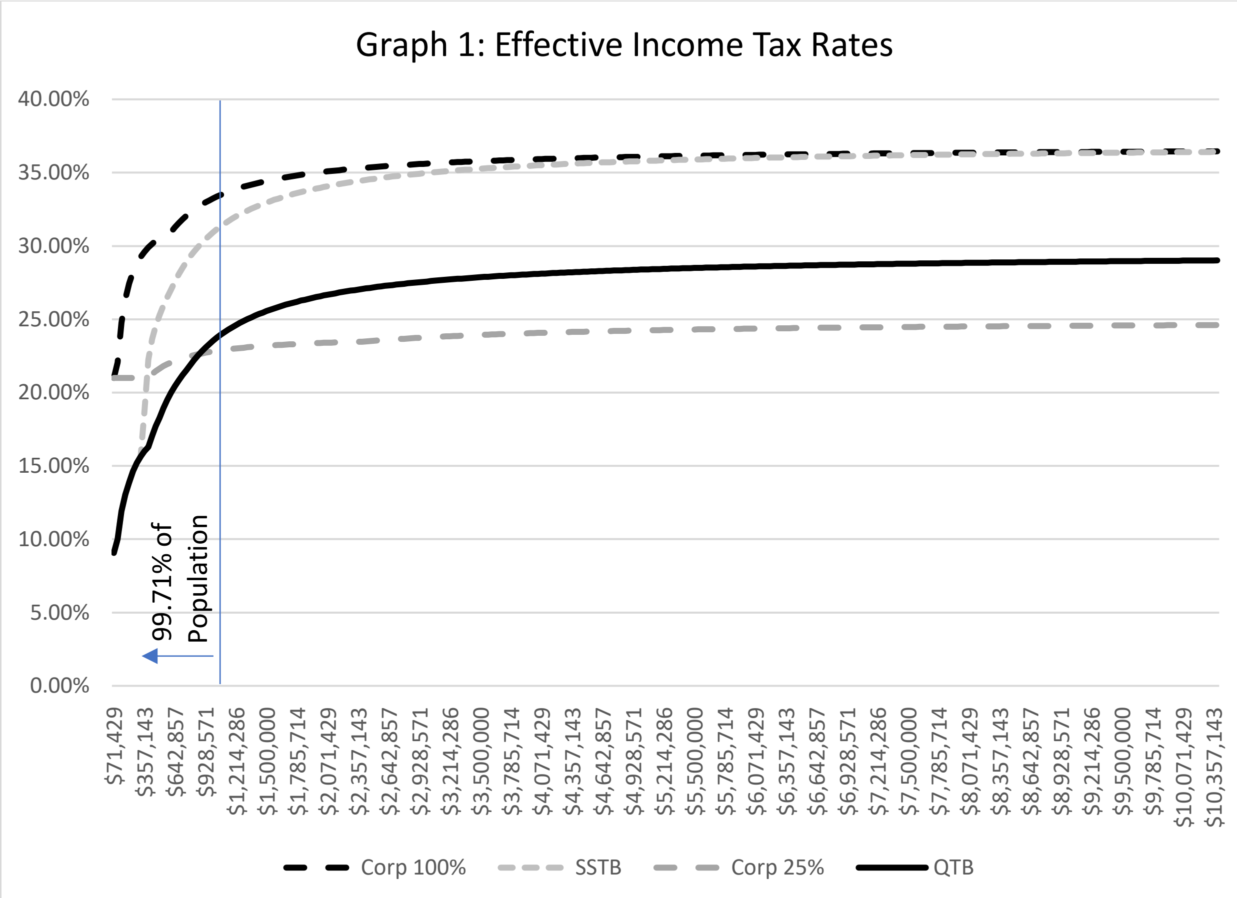
Table 2: Computation of Tax and Effective Tax Rate on $1,000,000 of Business Income (with QBI Deduction)

Brackets	Income	Tax Rate	Tax	Effective Rate
	$19,050	10%	$1,905	
19,050	$58,350	12%	$7,002	
$77,400	$87,600	22%	$19,272	
$165,000	$150,000	24%	$36,000	
$315,000	$85,000	32%	$27,200	
$400,000	$200,000	35%	$70,000	
$600,000	$200,000	37%	$74,000	
Total	$800,000		$235,379	23.54%

The analysis computes tax on corporate income as presented in Table 3, assuming the corporation distributes 100% of its after-tax income. The corporation's income is taxed at the corporate level. The corporation distributes the after-tax income, which is then subject to the graduated dividend rates. The effective tax rate on the $1,000,000 of corporate income is 33.25% when the corporation distributes all of it after-tax income.

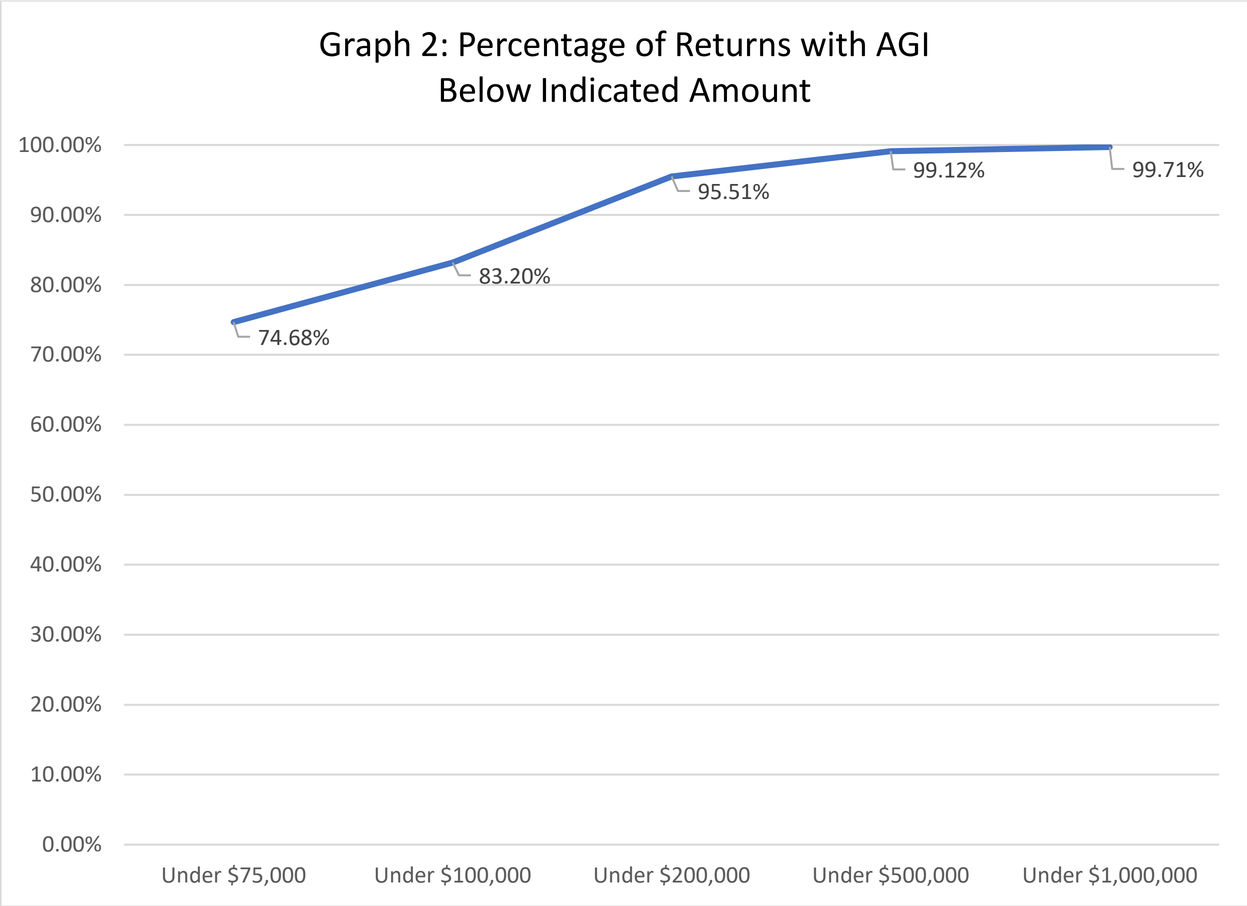
Table 3: Computation of Tax and Effective Tax Rate on $1,000,000 of Corporate Income			
Corporation	**Income**	**Rate**	**Tax**
	$1,000,000	21%	$210,000
Dividend-Payout Ratio*			100%
Tax at Individual Level			
Dividend			$790,000
0% Amount	$77,200	0%	$0
15% Amount	$401,800	15%	$60,270
20% Amount	$311,000	20%	$62,200
Total Tax on Dividend			$122,470
Effective Tax Rate on Dividend			15.50%
Total Tax on Corporate Income			$332,470
Effective Tax Rate Corp. Income			33.25%

Using those methods to calculate effective tax rates, the model creates several data tables to compute the effective tax rates on taxable income at $50,000 increments ranging from $100,000 to $14,000,000 of pre-wage business income. That information flows into Graph 1 to present the effective tax rates of income at the various levels of income. Notice that when taxable income becomes very large, the effective rates begin to approach the top marginal rates.

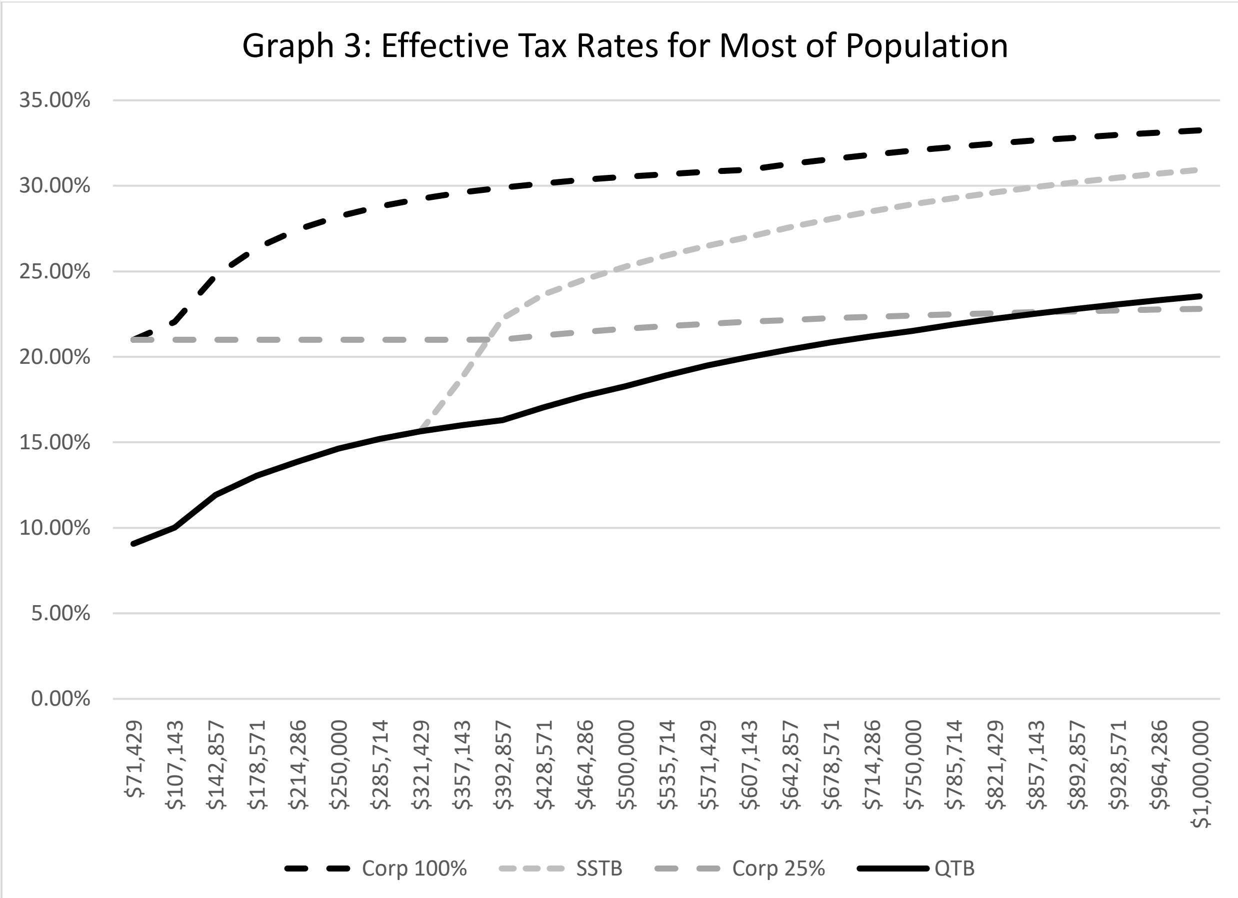


For most individual business owners, the most favorable tax rates apply to income from QTBs and SSTBs. Only as income gets fairly large the corporate rates become more attractive than the passthrough rates. For most taxpayers, however, the highest effective tax rates will be irrelevant. The vast majority of tax returns have adjusted gross income of less than $1,000,000, as presented in Graph 2.[8]

[8] Information used in this graph is derived from Internal Revenue Service, *SOI Tax Stats—Individual Statistical Tables by Size of Adjusted Gross Income. All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items* (2015).



Because the taxable income of almost all taxpayers is below $1,000,000, most taxpayers will be interested in looking more closely at the effective tax rates in that range. Graph 3 presents the effective tax rates for taxable income below $1,000,000. At these levels, the effective tax rates on pass through income are noticeably lower than the effective tax rates on distributed corporate income.



Effective Tax Rates on Taxable Income—Considering Income Tax, Employment Tax, and Net Investment Income Tax

Graphs 1 and 3 present an incomplete picture of effective tax rates because they do not account for employment tax and the tax on net investment income. Dividends in excess of $250,000 are subject to the 3.8% tax on net investment income.[9] Thus, undistributed corporate income is taxed at 21%, but qualified dividend income can be taxed at a rate as high as 23.8%. Compensation and earnings from self-employment are subject to the Social Security (Old-Age,

[9] *See* I.R.C. § 1411.

Survivors, and Disability Insurance—OASDI) and Medicare (hospital insurance) employment taxes.[10] In 2018, the wage base for the OASDI tax is $128,400, and wages and self-employment income above that amount are not subject to OASDI.[11] The total employment tax rate on compensation or earnings from self-employment up to the wage base is 15.3%.[12] The Medicare tax rate of 2.9% applies to all compensation or earnings from self-employment, including the amounts in excess of the wage base.[13] For employees, the employer pays half the tax and the employee pays the other half.[14] Shareholders who receive remuneration for services are employees, so the corporation would pay half of the employment tax owed on the shareholder's compensation, and the shareholder would pay the other half. Employers are allowed to deduct the share of employment taxes that they pay.[15] Self-employed taxpayers pay the entire amount of self-employment tax, and they are allowed to deduct half of the amount they pay.[16]

To incorporate the employment tax into the analysis, the model assumes that all passthrough income, other than S corporation income, is earnings from self-employment. The first $128,400 of that income is subject to both the 12.4% OASDI tax and the 2.9% Medicare tax, and amounts in excess of that are only subject to the Medicare tax. The model also deducts 50% of the resulting employment tax to compute taxable income and determine the amount of income tax owed.

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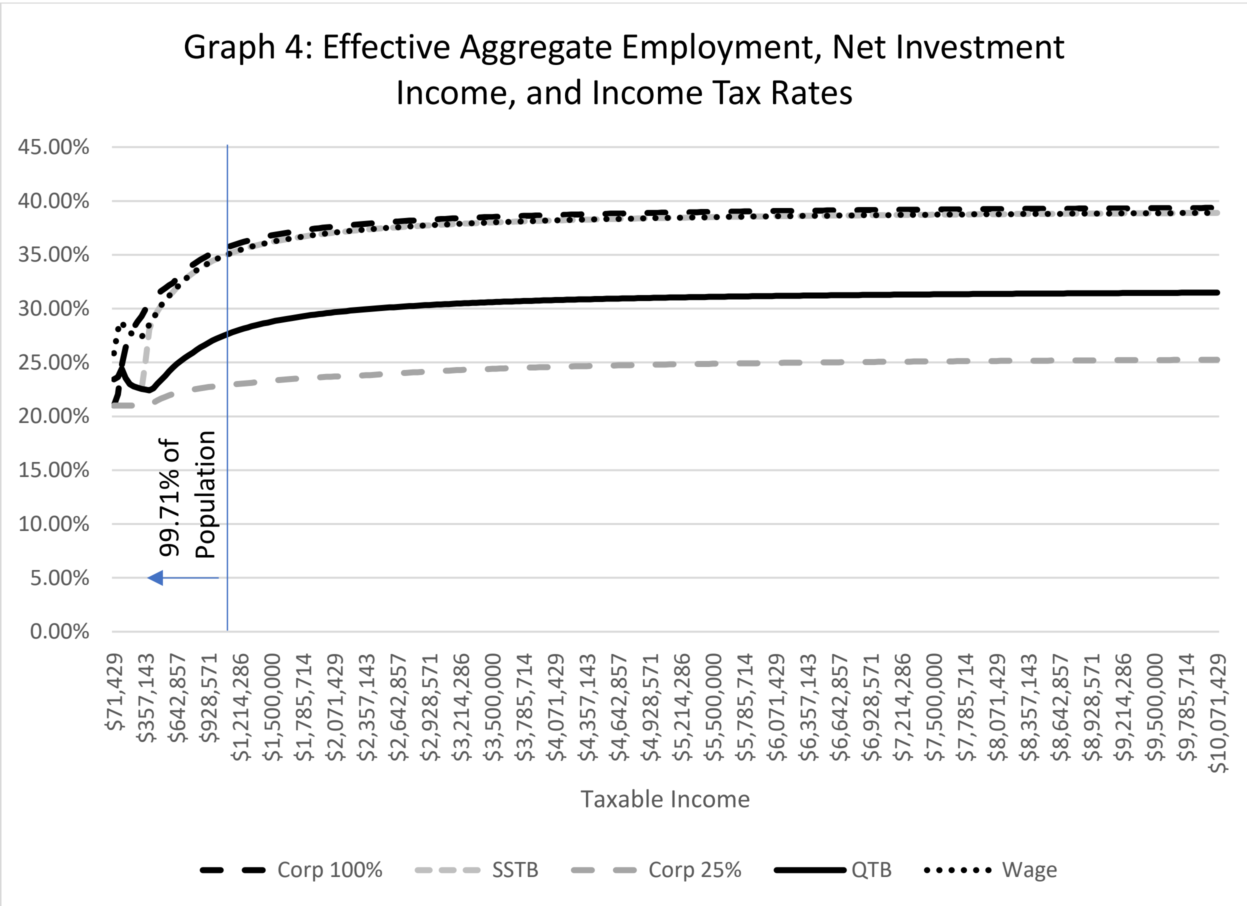
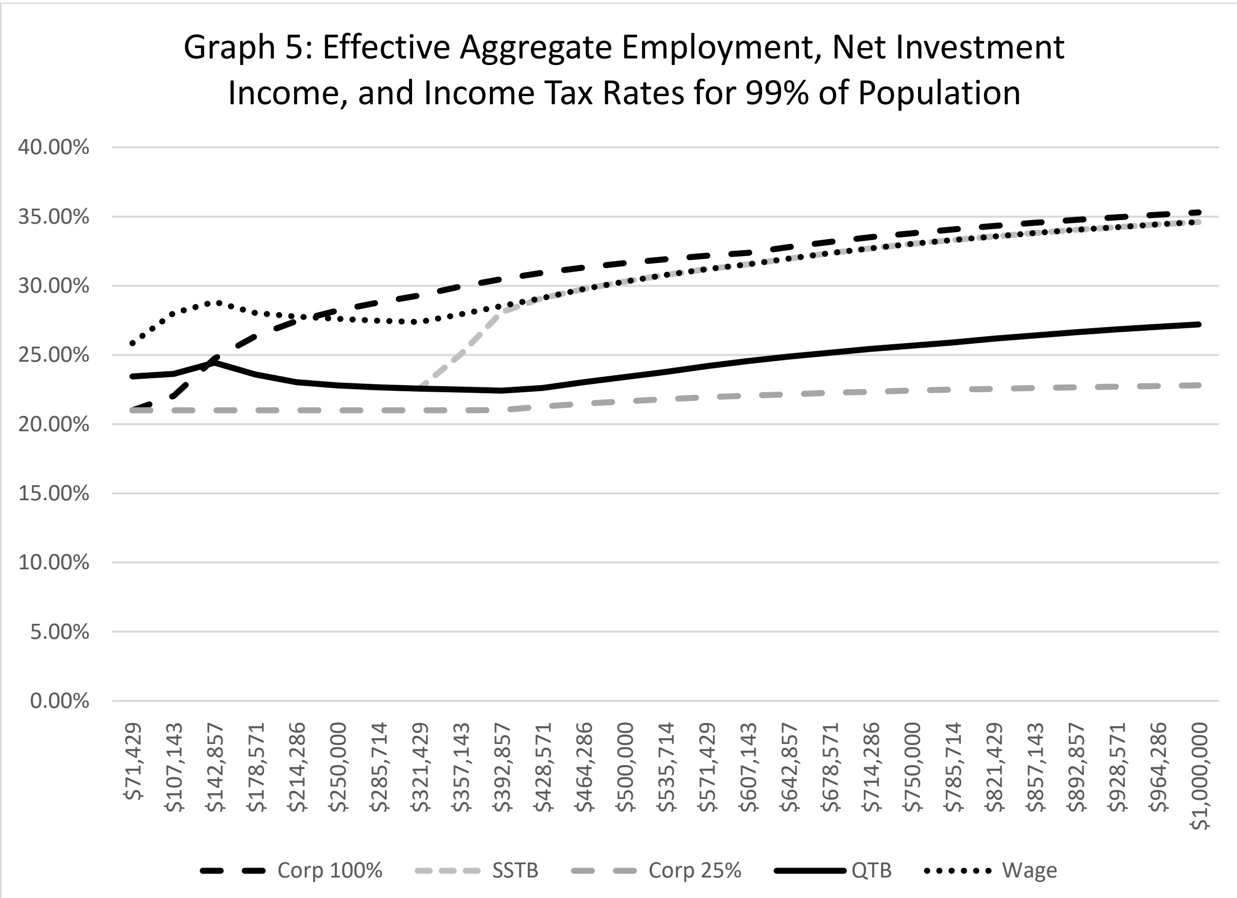
[10] *See* I.R.C. § 1401(a), (b) (imposing Social Security and Medicare tax on self-employment income); I.R.C. § 3101(a), (b) (imposing one-half of the Social Security and Medicare taxes on wages of individuals); I.R.C. § 3111(a), (b) (imposing one-half of the Social Security and Medicare taxes on wages paid by employers); https://www.ssa.gov/policy/docs/quickfacts/prog_highlights/index.html.
[11] *See* https://www.ssa.gov/policy/docs/quickfacts/prog_highlights/index.html.
[12] *See* I.R.C. § 1401(a).
[13] *See* I.R.C. § 1401(b). An additional tax equal to 0.9% of self-employment income and wages is imposed on the amount of such income that exceeds $250,000 for married individuals. *See* I.R.C. §§ 1401(b)(2); 3101(b)(2).
[14] *See* I.R.C. §§ 3101, 3111. The employer withholds the employee's portion of the tax from the wages paid to the employee. *See* I.R.C. § 3102.
[15] *See* I.R.C. § 162.
[16] *See* I.R.C. § 164(f).

Income from a QTB or SSTB that is not an S corporation will be subject to employment tax and dividends will be subject to the net investment income. Those additional taxes shift up the effective tax rates on corporate and passthrough income. The imposition of the employment tax causes the effective tax rate on SSTB income above the threshold-plus amount to equal the effective tax rate on wage income. Graph 4 presents the effective tax rates, accounting for income tax, employment tax, and tax on net investment income.



Graph 5 presents the effective tax rates that apply to income below $1,000,000, providing a clearer picture of the effective tax rates that most business owners should consider.



Notice that the effective tax rate on SSTB income is the same as the effective tax rate on QBI, if taxable income is less than the threshold amount. For income above the threshold-plus amount, the effective tax rate on SSTB income is the same as the effective tax on wage income. This result obtains if the business owners are able to deduct employment tax owed on wages at the entity level at the same rate that would apply to self-employment tax deductions, e.g., an S corporation pays wages to the owners. The shift of the rate is due to the phase-out of the QBI deduction on SSTB income when that income exceeds the threshold amount. Thus, the QBI deduction and employment taxes affect effective tax rates and will most likely change choice-of-entity preferences in some situations.

The new tax rates may make the S corporation less attractive than partnerships under the current assumptions (i.e., QBI pays wages to third parties equal two-sevenths of pre-wage income) because S corporations must pay reasonable compensation to shareholders who manage the S corporation. Owners of businesses have used S corporations to reduce employment taxes by causing their S corporations to pay the shareholders reasonable compensation, which is subject to employment tax, and distributing the remaining income, which is not subject to employment tax. By contrast, all income allocated to general partners and members of some LLCs is subject to self-employment income, so some business owners preferred S corporations over partnerships for employment-tax planning purposes.

The QBI deduction may alter some of those planning strategies. Compensation, even that paid to shareholders, does not come within the definition of QBI.[17] Thus, reasonable compensation paid to shareholders does not qualify for the QBI deduction. The loss of the 20% deduction on that income may offset the benefit of using the S corporation to minimize the employment taxes. Because of the QBI deduction, business owners may have a lower effective tax rate on income that passes through a partnership, even if they pay self-employment tax on the entire amount of that income. Business owners may now look for business structures that reduce their income tax through the QBI deduction while also reducing their employment taxes. Such

[17] *See* I.R.C. § 199A(c)(4)(C).

possibilities will motivate business owners to look at various entity choices and consider combining entities to find structures that provide the lowest possible effective rate.

The effective-rate graphs reveal that the type and amount of income can significantly affect tax rates. The most favorable rates apply to undistributed corporate income. For two reasons, most small-business owners cannot leave all a corporation's income in the corporation. First, owners of small businesses generally participate in the management of the business, and corporations must pay reasonable compensation for the owners' services. Second, small businesses are a source of discretionary income for the business owners, so the owners must withdraw money from the corporation for their personal expenses.

Taxpayers who can afford tax advice and the fees required to create the legal structures might combine the different types of entities to get the best tax results. To identify a structure that might provide the optimal tax situation, taxpayers, with the assistance of their advisors, would undoubtedly consider various alternative structures. Consider how a married couple with $1,400,000 of pre-wage business income might analyze various business structures to find one that provides the lowest effective tax rate. Assume the business pays $400,000 of wages (two-sevenths of the $1,400,000 pre-wage income) to third parties, so its taxable income is $1,000,000. The couple wishes to withdraw $315,000 of taxable income from the business for personal consumption. The couple believes that reasonable compensation for the services that they provide to the entity is between $300,000 and $441,000. Consider the following several different structures they may adopt for their business and how the structures will affect the effective tax rate on that income.

<u>Business in C Corporation with $315,000 Compensation</u>

The owners of the business could simply form a C corporation for the business and pay themselves $315,000 of compensation. Under this scenario, the corporation would have $685,000 of taxable income ($1,400,000 income before wages - $400,000 compensation paid to non-owners - $315,000 compensation paid to owners) before the deduction for employment taxes. The total tax on the compensation paid to the owners would be $89,236 (consisting of $64,179 of income tax and $25,057 of employment tax), which would be an effective rate of 27.38% on that income. Assuming the corporation is allowed to deduct to 50% of the employment tax, it would have a deduction of $12,529 ($25,057 ÷ 2), and a resulting corporate taxable income of $672,471 ($685,000 - $12,529). Based upon the 21% corporate rate, the tax on the corporate income would be $141,219 ($672,471 x 21%). Thus, the total tax paid on the $1,000,000 of taxable income would be $230,455 ($89,236 + $141,219), for an effective tax rate of 23.05%.

Business in S Corporation with $315,000 Compensation

The owners could also form an S corporation and pay themselves $315,000 of compensation with the corporation’s taxable income flowing through to the members. After paying $315,000 of compensation to the owners, the S corporation would have $1,085,000 of income. The tax on the $315,000 of compensation should be the same $86,262 (consisting of $61,168 of income tax and $25,094 of employment tax) that it was on the compensation received from the C corporation, and the effective tax rate on that amount should be 27.38%.

Assuming $400,000 of wages to non-owners and an employment tax deduction of $12,547, $672,453 ($1,400,000 - $315,000 compensation to owners - $400,000 wages to third parties - $12,547 employment tax deduction) of taxable income would pass through to the owners. The tax rate on that income would depend upon whether the business is a QTB or and SSTB. The tax on the $672,453 that flows through will not be subject to employment tax. If the business is a QTB, then the tax on that income will be $139,666, and the effective tax rate on the passthrough income would be 20.77%. The total tax would be $225,928 ($86,262 + $139,666), which results in an effective tax rate of 22.59%.

If the business is an SSTB, then the $685,000 of passthrough income would not qualify for the QBI deduction, and the tax on that income would be $188,187, which results in an effective tax rate on the passthrough income of 27.99%. The total tax would be $274,449 ($86,262 + $188,187), which is an effective tax rate of 27.44%.

<u>Business in QTB</u>

If the business is a QTB in a member-managed LLC, the $1,000,000 of taxable income will pass through to the owners, qualify for the QBI deduction, and be subject to the self-employment tax. The owners' total tax, accounting for income tax, employment tax, and the deduction for one-half of the employment tax, will be $272,012, for an effective tax rate of 27.20%.

<u>Business in SSTB</u>

If the business is an SSTB in a member-managed LLC, then the $1,000,000 of taxable income that passes through to the owners, will not qualify for the QBI deduction and will be subject to self-employment tax. The owners' total tax, accounting for income tax, employment tax, and the deduction for one-half of the employment tax, will be $346,021, for an effective tax rate of 34.60%.

Business in C Corporation with Management Payment to QTB or SSTB

The business owners may consider running the business through a C corporation with a passthrough under contract with the corporation to manage the business. With this structure, the corporation would pay $315,000 of management fees to the manager partnership. The corporation will have $685,000 of income ($1,400,000 - $400,000 paid to third parties - $315,000 paid to the management partnership) taxed at 21%, with a resulting tax of $143,850. Assuming the management company is a tax partnership and the income is below $315,000, it qualifies for the QBI deduction, whether the management company is a QTB or an SSTB. The management fee will pass through to the owners, and the tax on that amount will be about $71,109 ($46,052 of income tax and $25,057 of employment tax), for an effective tax rate of about 22.57%. The total tax on the $1,000,000 of taxable income will be $214,959 ($143,850 corporate tax + $71,109 on the amount paid to the management company), for an effective tax rate of 21.50%.

Business in C Corporation with Management Payment to S Corporation

If the management company is an S corporation, the S corporation will pay the entire $315,000 to the owners as reasonable compensation, so the payment will not qualify for the QBI deduction.[18] The effective tax rate under this assumption will be similar to the effective tax rate when the corporation paid compensation directly to the owners, but the deductions for employment tax will apply at the owners' individual tax rate, not the corporation's 21% tax rate. The deduction by the S corporation will reduce the amount of tax the business owners pay on the $315,000. The total tax owed on the $315,000 that flows through the S corporation will be $86,229 ($61,172 income tax + $25,057 employment tax),[19] so the total tax would be $230,079 ($143,850 corporate tax + $86,229 on the amount paid to the management company), for an effective tax rate of 23.01%, which is slightly lower than the 23.05% rate that applied when the corporation paid compensation directly to the owners.

<u>Business in QTB Limited Partnership</u>

If a QTB is in a limited partnership, then the owners can be both limited partners and general partners. The income allocated to them as limited partners will not be earnings from self-employment,[20] but the income allocated to them as general partners will be earnings from self-employment.[21] The amounts allocated are not guaranteed payments or paid to the business owners for acting in a non-partner capacity, so they can come within the definition of QBI.[22] Assuming the amount allocated to the members as general partners remains QBI, then all income

[18] *See* I.R.C. § 199A(c)(4)(A).
[19] Compared to $89,236 of tax when the corporation paid compensation directly to the owners.
[20] *See* I.R.C. §1402(a)(13).
[21] *See* I.R.C. § 1402(a).
[22] *See* 199A(c)(4).

allocated to the owners will qualify for the QBI deduction. Assume the limited partnership would allocate and distribute $315,000 to owners in their general-partner capacities, and the remaining $685,000 of income would pass through to them as QBI that is not subject to employment taxes. Tax on the $315,000 treated as earnings from self-employment would be $71,109 ($46,052 of income tax and $25,057 of employment tax).[23] Tax on the remaining $685,000 would be $189,331 ($235,379 tax on $1,000,000 of QBI - $46,048 of income tax on the $315,000). Thus, the total tax on the $1,000,000 of taxable income is $260,440 ($71,109 of tax on income allocated to the owners in their general-partner capacity + $189,331 of tax on the remaining income), for an effective rate of 26.04%.

C Corporation with Optimal Payment to QTB Limited Partnership

Based upon the representations in Graph 3, the effective tax rate on QBI income is below the 21% corporate rate until taxable income reaches about $679,000. Thus, the business owners may believe they could minimize their tax liability, if they can structure $679,000 of taxable income to pass through a QTB with the remaining $321,000 being taxed in the corporation. To ensure that the QTB qualifies for the QBI deduction, the management company will have to have sufficient wages, so the analysis assumes the management company pays wages to third parties equal to two-sevenths of the amount the management company receives from the corporation. The grossed-up amount of the payment is therefore $950,600.[24]

[23] The $315,000 is net of the $414,000 of income allocated, which qualifies for a QBI deduction of $63,000.
[24] The grossed-up amount equals the $679,000 of taxable income divided by five-sevenths because the taxable income, after deducting the two-sevenths of wages, equals five-sevenths of the pre-wage income.

The owners may attempt to minimize the tax by forming a QTB limited partnership to perform management services for the corporation. Because the limited partnership is a QTB, it will qualify for the 20% QBI deduction. The corporation could pay the limited partnership $950,600 for management services ($679,000 grossed up by 7/5). The limited partnership would pay $271,600 of wages on the $950, 600 of income ($950,600 × 2/7). Both the $950,600 of the limited partnership's pre-wage income and the $271,600 of wages would passthrough to the owners,[25] so the wage limit would not affect the application of the QBI deduction. The limited partnership could allocate $441,000 of its pre-wage income and $126,000 of wages to the owners in their general-partner capacities for a net of $315,000 of taxable income that will also be earnings from self-employment. The limited partnership will allocate the remaining $509,600 of pre-wage income and $145,600 of its wages to the owners in their limited-partner capacities for a net taxable income of $364,000.

Business owners may attempt to compute the effective tax rate under this scenario using the values presented in the graphs in the following manner. The tax on the $321,000 of taxable income that remains in the corporation will be $67,410 ($321,000 × 21%). The tax on the $315,000 taxable income that will be allocated to the members in their general-partner capacities will be earnings from self-employment and be subject to $25,094 of employment tax and $46,048 of income tax. The remaining $364,000 of the limited partnership's taxable income will be subject only to $95,431 income tax ($141,499 of income tax on the full $679,000[26] - $46,048 paid on the $315,000). The total tax would be $233,983 ($67,410 + $25,094 + $46,048 + 95,431), for an effective tax rate of 23.40%.

[25] *See* I.R.C. § 199A(f)(1).
[26] Computed based upon a pre-wage income of $950,600 = $679,000 × 7/5.

This computation illustrates the complexity of identifying the optimal entity structure and the shortcomings of using the values presented in one model for all situations. The graph of QTB income subject to employment tax and the graph of QTB income that is not subject to employment tax suggest that the effective tax rate on QTB income that is not subject to employment tax will be less than 21% as long as the pre-wage income of the QTB is less than $950,600. The problem with that application of the graphical representations is that neither graph provides a blended approach, one that subjects a portion of the QTB income to employment taxes and subjects the balance to income tax. Thus, the computation of the effective tax rate of QTB income where only a portion is subject to employment tax requires a different model that considers the income subject to the employment tax and the income that is not subject to the employment tax. Because of the employment tax, the effective tax rate of the QBI will not be lower than the corporation's 21% rate. Consequently, if business owners do not plan to withdraw income from a corporation, they are better off leaving it in the entity. Business owners would, therefore, seek to know the optimal amount they should withdraw from the corporation to obtain the most favorable tax result.

The search for the optimal payment from a corporation to business owners therefore must use a hybrid computation of effective tax rates to find the amount that the corporation should pay the management company. The hybrid approach computes the effective tax rate on a QTB limited partnership's taxable income by applying employment taxes to the amount that comes within the definition of earnings from self-employment. For instance, in this example, the approach would deem $315,000 of taxable income to be earnings from self-employment and the remainder of the limited partnership's taxable income to not be earnings from self-employment. Running the model to determine the lowest possible effective tax rate on such income suggests that the point at which the tax rate is the lowest on such income is when it equals about $416,250. To reach that level, the grossed-up management fee paid to the limited partnership would need to be about $582,750,[27] and the corporation would retain $817,250 of the income. The corporation will use two-sevenths of the amount that it retains to pay wages to third parties, so its taxable income will be $583,750. The corporation's tax on that amount will be $122,588 ($583,750 × 21%). Assuming the limited partnership management company allocates $315,000 of the taxable income to the owners in their general-partner capacities, it would allocate the remaining $101,250 to the owners in their limited-partner capacities. The total tax on that the limited partners will owe on the allocated income will be $91,018 ($65,924 of income tax + $25,094 of employment tax). The total tax paid on the $1,000,000 of taxable income will be $213,606, for an effect tax rate of 21.36%. This generates the lowest effective rate for $1,000,000 of taxable income under these assumptions.

Situation	**Amount Withdrawn**	**Total Tax**	**Effective Rate**
C Corporation with hybrid-rate-determined payment to QTB LP	$416,250	$213,606	21.36%
C Corporation with $315,000 payment to QTB or SSTB	$315,000	$214,959	21.50%
S Corporation with $315,000 of compensation (QTB)	$315,000	$225,928	22.59%
C Corporation with $315,000 payment to S Corporation	$315,000	$230,079	23.01%
C Corporation with $315,000 compensation paid to owners	$315,000	$230,455	23.05%
C Corporation with graph-determined payment to QTB LP	$679,000	$232,093	23.21%
QTB in a limited partnership	$1,000,000	$260,444	26.04%
QTB	$1,000,000	$272,012	27.20%
S Corporation with $315,000 of compensation (SSTB)	$1,000,000	$274,449	27.44%
S Corporation with $315,000 of compensation (SSTB)	$315,000	$279,091	27.91%
SSTB	$1,000,000	$346,021	34.60%

[27] $416,250 × 7/5 = $582,750.

<u>Observations</u>

The analysis of the effective tax rates on $1,000,000 of taxable income raises several issues. The following discussion presents a few takeaways from the analysis.

Type of Business Entity Matters

This analysis demonstrates that the type of business and type of entity affect the effective tax rate that might apply to business income. It also demonstrates that the way to achieve the lowest effective tax rate under the prescribed assumptions is to form a C corporation to conduct the business and form a QTB to provide management services to the corporation. The QTB as a manager generates the lowest effective tax rate because the income of a QTB qualifies for the QBI deduction. If the corporation pays the owners compensation or pays an S corporation to manage the corporation, which requires the S corporation to compensate the owners, the amount that the owners receive as compensation will not qualify for the QBI deduction.

Optimal Payment to QTB Limited Partnership can Reduce the Effective Tax Rate

Payment of more than the owners' reasonable compensation from the operating corporation to the QTB limited partnership helps drive down the effective tax rate, because the effective tax rate of income may decrease as income increases, after income passes the OASDI wage base. As income continues to increase, however, the effective tax rate will reach an inflection point and then begin to increase. Thus, some business owners may reduce the effective tax rate that applies to the business income by causing a C corporation to pay a management QTB limited partnership more than the owners' reasonable compensation. The optimal management fee therefor is the amount that results in the lowest possible effective tax rate on the management fee. That amount is the amount at which the effective-rate inflection point occurs. The amount will vary depending upon various factors.

Compensation can be Worse than QBI

Even though the 21% corporate rate is lower than the effective rate of QBI subject to employment tax, operating a business that has less than $1,000,000 of taxable income solely in a corporation probably will not result in the lowest effective tax rate. Because corporations must pay their active shareholders reasonable compensation, the portion of the corporate income paid as compensation would be subject to employment tax and not qualify for the QBI deduction. This analysis demonstrates that business owners can achieve the lowest effective tax rates by utilizing a C corporation with a management component. The problem with C corporations is that contributions to and distributions from such entities often are taxable, so business owners generally prefer not to operate capital-intensive businesses in corporations. Consequently, business owners typically try to structure ownership of assets outside the corporate structure.

Income Levels May Affect Choice-of-Entity

A business's amount of income may affect the choice-of-entity analysis. Taxpayers with income below the threshold amount will qualify for the QBI deduction, even if their business is an SSTB. But if income of an SSTB exceeds the threshold amount, the QBI deduction phases out. As income rises, effective tax rates on non-corporate QTB and SSTB income also increase. Owners of high-income businesses may, therefore, prefer to retain as much income as possible within the corporation.

Amount Owners Withdraw Affects Effective Rate

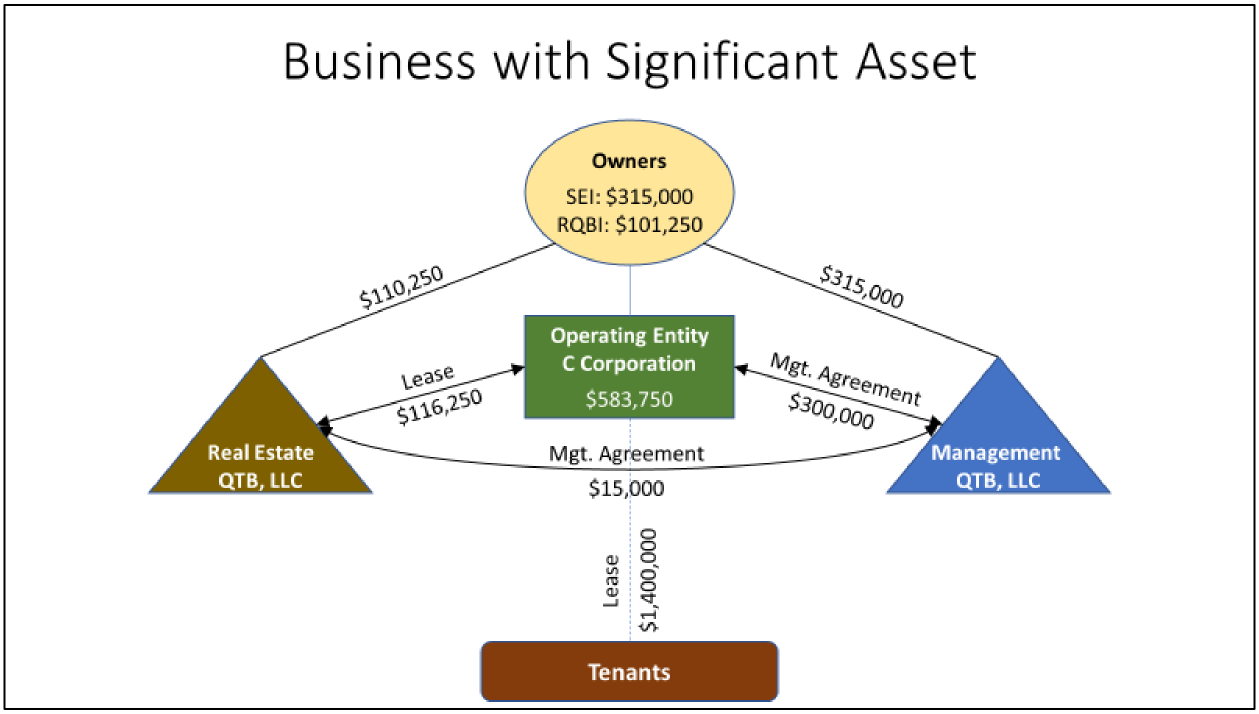
The amount of income that owners withdraw from a business will affect the effective tax rates. Tax rates on dividends increases as the amount of dividends increase, so the amount of dividends affect the effective rates in that manner. Distributions can also expose corporate income to a second level of income, increasing the effective rate on the income. Compensation corporations pay to their shareholders is not subject to double taxation, but it is subject to income tax and employment tax. Thus, business owners who can limit the amount of income they withdraw from a corporation can keep their effective tax rate in check.

Structure Matters

Choice-of-entity has been a significant part of any business owners' business planning. After the TCJA, the choice is more complicated because the new act changed rates and created the QBI deduction. Now business owners must do more sophisticated analyses to identify the entity that provides the best tax and other results. In addition to considering the tax on operating income, business owners should consider how tax law will apply to transactional aspects of their choice of entity. Moving assets into and out of a corporation can be taxable, but the same transactions may occur tax-free with a partnership. Thus, some business owners may consider a more complex business structure that separates business assets from business operations.

Structuring Asset Location for a QTB

The analysis to this point has not considered the possibility that the business might have significant assets. For instance, the business asset might be an apartment building. Most tax advisors know that holding assets in a corporation can result in negative tax consequences at some point because distributions from corporations are taxable events. Consequently, the owners of such businesses will generally prefer to hold real estate in a tax partnership. The owners of such a business may use a multiple-entity structure to keep some operating income in a corporation and ensure that the business assets are held in an entity that is not a corporation. If a business is a QTB with significant assets, perhaps it will form an entity to hold the assets, an entity to operate the business, and an entity to manage the other two entities. With such a structure, the operating entity will be a corporation, and the other entities would be partnerships. The following diagram illustrates such an arrangement.



Business Without Employees[28]

The analysis above assumes that the business pays wages to third parties. Some businesses pay little or no wages and may have nominal assets. The wage limit in section 199A applies to income above the threshold amount. For any QTB with income in excess of the threshold-plus amount (the $315,000 threshold amount for joint filers + $100,000), the QBI deduction will be available only if the QTB pays wages. If the QTB has no third-party employees, the owners will most likely benefit from a structure that allows them to cause the business to pay themselves reasonable compensation.

[28] The discussion in this portion of the Article is from a forthcoming article by the author titled *Reasonable Compensation versus Passthrough in Choice-of-Entity Considerations*.

Section 199A provides a deduction equal to 20% of an individual's qualified business income (QBI). The QBI deduction is subject to a wage limit equal to 50% of the wages paid with respect to the qualified trade or business (QTB).[29] QBI does not, however, include (1) reasonable compensation paid to a business owner, (2) guaranteed payments from partnerships to partners, or (3) payments to partners for services provided in a non-partner capacity.[30] This analysis refers to these three types of income as compensatory business income. The exclusion of compensatory business income from QBI means that such income does not qualify for the QBI deduction. That disqualification and the wage limit may affect business owners' choice of entity. As with other choice-of-entity decisions related to section 199A, the choice regarding compensatory business income will most likely be situational. After a quick review of the relevant aspects of the QBI deduction, consider how different situations may lead to different choices.

The QBI deduction applies to all business income below the threshold amount ($315,000 for married individuals filing jointly).[31] Self-employment income is subject to the Social Security and Medicare employment taxes,[32] as is wage income.[33] Corporations must pay reasonable compensation to their shareholders who participate in management of the corporation.[34] Income allocated to general partners comes within the definition of self-employment income, but income allocated to limited partners, if not a guaranteed payment for services, does not come within the definition of self-employment income.[35] Allocations to members of LLCs may or may not come

[29] *See* I.R.C. § 199A(b)(2)(B).
[30] *See* I.R.C. § 199A(c)(4), (e)(2).
[31] *See* I.R.C. § 199A(c)(3)(A) (eliminating the wage limit if a taxpayer's taxable income is below the threshold amount); I.R.C. § 199A(d)(3) (including specified service trades or businesses (SSTBs) in the definition of qualified trade or business (QTB) and allowing the full QBI deduction, if the taxpayer's income is below the threshold amount).
[32] *See* I.R.C. § 1402.
[33] *See* I.R.C. §§ 3101, 3111.
[34] *See, e.g.*, David E. Watson, P.C. v. United States, 757 F.Supp. 2d 877 (2010).
[35] *See* I.R.C. § 1402(a), (a)(13).

within the definition of self-employment income, depending on members' management authority.[36] Three situations illustrate how business owners might prefer compensatory business income in some situations, but not others.

Situation 1: Income is less than Threshold Amount

If taxpayers' taxable income is less than the threshold amount, business income will qualify for the QBI deduction. Compensatory business income does not qualify for the QBI deduction, regardless of income level. Thus, business owners who have taxable income below the threshold amount will want to ensure that the income is not compensatory business income. Because corporations must pay their shareholders reasonable compensation, the owners would have compensatory business income, if they operate the business in a corporation. They would lose the QBI deduction on the portion of the business income paid to them from the corporation as compensation. To avoid receiving compensation and losing the QBI deduction on that portion of their income, the owners may consider operating the business as a sole proprietorship, or through a partnership.

Moving away from S corporations may be difficult for some business owners. For years, without additional planning, such income would be subject to employment taxes, but would qualify for the QBI deduction. Business owners have used S corporations to reduce employment taxes. They reduce employment taxes by causing the S corporation to pay reasonable compensation to the members that is less than the S corporation's taxable income. The amount

[36] *See, e.g.*, Castigliola v. Commissioner, T.C. Memo 2017-62 (Apr. 12, 2017); Hardy v. Commissioner, T.C. Memo 2017-16 (Jan. 17, 2017).

paid as compensation is subject to employment tax, but the corporation's residual taxable income flows through to the members free of employment taxes. The residual income would come within the definition QBI and qualify for the QBI deduction in this situation, but the reasonable compensation would not. For business owners who have taxable income below the threshold amount, they would lose the QBI deduction with respect to the reasonable compensation paid by the corporation. They could, however, retain the employment-tax benefits of an S corporation without losing the QBI deduction, if they operate the business in a limited partnership.

The owners of a limited partnership who structure to minimize employment tax and maximize the QBI deduction would hold both limited partner and general partner interests in the limited partnership.[37] Income allocated to the owners in their general partner capacities will come within the definition of self-employment income and be subject to the employment tax.[38] The income allocated to them in their limited partner capacities will not come within the definition of self-employment income, so it will not be subject to the employment tax.[39] To ensure that the allocated income qualifies for the QBI deduction, the owners must ensure that the allocations are not compensatory business income, i.e., not guaranteed payments or payments for services the owner provides in a non-partner capacity. If the allocations are a percentage of the partnership's income, they would not be guaranteed payments.[40] The legal distinction between partner and non-partner capacity is not clear,[41] so the business owners must study the

[37] State law allows a single person to hold both limited partner and general partner interests in a limited partnership. *See* UNIF. LTD. P'SHIP ACT § 109 (2001, as amended in 2013).
[38] *See* I.R.C. § 1402(a).
[39] *See* I.R.C. § 1402(a)(13).
[40] *See* I.R.C. § 707(c) (defining guaranteed payment as one that is determined without regard to the partnership's income).
[41] *See, e.g.*, Pratt v. Commissioner, 550 F.2d 1023 (5th Cir. 1977); Rev. Rul. 81-301, 1981-2 C.B. 144; Prop. Reg. 1.707-2.

existing law to ensure that the allocations of income and any payments received from the partnership are not for non-partner services. If the IRS respects the allocations, the limited partnership's income should be QBI and qualify for the 20% deduction, and only a portion of it would be subject to employment taxes. The owners can avoid liability related to the general partner interests by forming an LLC to be the general partner.

Situation 1 Takeaway: If taxable income is below threshold amount, do not run business income through an S corporation.

Situation 2: Income Greater Than Threshold Amount, No Employees

Now consider a choice-of-entity analysis for business owners whose taxable income exceeds the threshold amount plus $100,000 for joint filers (threshold-plus amount) and who have no employees. In this situation, the nature of the business will affect the application of the QBI deduction. If the business is a specified services trade or business (SSBT), it will not qualify for the QBI deduction.[42] The income of the SSBT will be taxed to the owners like compensation (i.e., be subject to employment tax and not qualify for the QBI deduction). If the business is a QTB, it will qualify for the QBI only if the business owners can clear the wage limit. When business owners' taxable income exceeds the threshold-plus amount, the QBI deduction cannot exceed 50% of the wages the QTB pays or the sum of the 25% of the QBI's wages and 2.5% of the unadjusted basis of its assets.[43] Assume the QTB has assets with nominal unadjusted basis.

[42] *See* I.R.C. § 199A(d)(2), (3). SSTBs include service businesses in areas such as health, law, accounting, performing arts, and finance. *See* I.R.C. §§ 199A(d)(2)(A), 1202(e)(3)(A).
[43] *See* I.R.C. § 199A(b)(2).

In this situation, the QTB has no employees, so the business owners can only qualify for the QBI deduction through entity restructuring that creates wages for the QTB. Partners are not considered employees, so amounts allocated or paid to them are not wages.[44] Notice that although guaranteed payments and payments for non-partner services are excluded from the definition of QBI, they do not come within the definition of wages for purposes of determining the QBI wage limit.[45] Consequently, business owners cannot create wages by operating a QTB through a partnership and paying themselves guaranteed payments. Furthermore, if they run the business through a partnership, at least a portion of the income will be subject to employment taxes, and all of the income could be subject to employment tax, if they choose an LLC.

In this situation, the business owners should be able to qualify for at least a portion of the QBI deduction running the QBT through an S corporation and causing the S corporation to pay them reasonable compensation. The compensation will be subject to employment tax, but it can free up the deduction for the portion of the business income that is not compensation. The compensation paid must be reasonable. If the amount of compensation that is reasonable comes within a range, then the business owners should do an analysis to determine the amount of compensation that will result in the lowest effective tax rate. Assuming reasonable compensation covers a range of values, the business owners should seek a value within that range that minimizes their tax liability.

Finding the optimal amount of wages to pay the owners will be a challenge. Every dollar of compensation that the S corporation pays to the owners frees up fifty cents of QBI deduction, until 50% of the deduction equals 20% of the income minus the compensation. That equation

[44] *See* I.R.C. § 199A(b)(4) (defining wages); Rev. Rul. 69-184, 1969-1 C.B. 256.
[45] *See* I.R.C. § 199A(b)(4) (defining wages).

reveals that the inflection point for compensation is two-sevenths of QBI prior to compensation.[46] An example illustrates the trade-off of paying compensation to business owners in the current situation. Assume the business owners have $700,000 of QBI and pay no wages in a member-managed LLC that the owners manage. The wage limit will prevent the business from claiming the QBI deduction, the entire $700,000 of QBI will be taxable income under these facts. Because the income passes through a member-managed LLC, it will also be subject to employment tax. To obtain the optimal QBI deduction, the owners should run the business through an S corporation and pay $200,000 of wages ($700,000 × 2/7 = $200,000). Only the $200,000 of wages will be subject to employment tax, providing a tax savings over the LLC form under which all $700,000 of income was subject to employment tax. Even though the $200,00 of wages will not be QBI, they will free up $100,000 ($200,000 × 50%) of QBI deduction. Setting compensation at two-sevenths of the pre-wage income appears to provide the optimal tax situation. The wages paid to shareholders must, however, be reasonable. If wages equal to two-sevenths of the pre-wage income is not reasonable the business owners will lose some of the tax benefits for which they would otherwise qualify.

[46] To recognize that two-sevenths is the inflection point, imagine that the QBI is $700,000. If wages were $100,000 (i.e., one-seventh of pre-wage income), QBI would be $600,000 ($700,000 - $100,000). The QBI deduction could be $120,000 ($600,000 × 20%), but $50,000 wage limit ($100,000 × 50%) caps the deduction at $50,000. If wages were $300,000 (i.e., three-sevenths of pre-wage income), QBI would be $400,000 ($700,000 - $300,000). Thus, when wages are less than two-sevenths, the wage limit prevents business owners from taking the maximum QBI deduction, even though they pay employment tax on relatively small amount of wages.

The QBI deduction would be $80,000 ($400,000 × 20%), and the $150,000 wage limit ($300,000 × 50%) would not affect the amount of the deduction. Thus, when wages exceed the two-sevenths threshold, the wage limit does not affect the QBI deduction, but business owners may be paying employment tax on income that could otherwise qualify for the QBI deduction.

If the compensation paid to the owners is $200,000 (i.e., two sevenths of pre-wage income), QBI would be $5000,000 x ($700,000 - $200,00). The QBI deduction would be $100,000 ($500,000 x 20%), and the $100,000 wage limit ($200,000 x 50%) would not affect the amount of the deduction. Thus, two-sevenths is the target for the amount of compensatory business income as percentage of pre-wage income.

Situation 2 Takeaway: If a QTB pays no wages to third parties and its income exceeds the threshold-plus amount, the owners should be able to minimize their effective tax rates by forming an S corporation to pay the owners reasonable compensation. If reasonable compensation equals two-thirds of the business's pre-wage income, the owners should cause the S corporation to pay that amount of wages.

Situation 3: Income Greater Than Threshold Amount, Compensation Paid to Third Parties

If a QTB has third-party employees, the optimal business structure might be a limited partnership. As with wages paid to owners, a QTB maximizes the benefit of its QBI deduction if wages paid to third parties equal two-sevenths of the QTB's pre-wage income. Assuming third-party wages are at that target, owners would not want to create wages for themselves, but would want to minimize employment taxes they pay on their income from the business.

If the owners operate the business as a general partnership, the entire amount of QBI would be subject to employment tax. If they operate the business through an S corporation and cause the S corporation to pay them reasonable compensation, the reasonable compensation will be excluded from the definition of QBI and not qualify for the QBI deduction. Thus, the owners should consider operating the business in a limited partnership with the owners holding both limited partner and general partner interests. Income allocated to the members in their general partner capacities should be subject to employment tax, but income allocated to them in their limited partner capacities should not be subject to employment tax. All income allocated to them by the limited partnership should be QBI and qualify for the QBI deduction.

Situation 3 Takeaway: If a QTB's income exceeds the threshold amount and the QTB pays wages to third parties, the business owners may prefer operating the business in a limited partnership to avoid wage income and reduce their employment taxes.