Tax Policy and Organizational Form: Assessing the Effects of the Tax Cuts and Jobs Act

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For presentation at the
National Tax Association 48th Annual Spring Symposium Program
Washington, D.C.

May 17, 2018

Abstract

We provide a historical context to assess the implications of the Tax Cuts and Jobs Act on organizational form decisions. We review the provisions and aftermath of the Tax Reform Act of 1986 to assess the extent of organizational form changes in response to changing tax incentives and the effects of those organizational form changes on business operations. We develop a simple analytic model to provide insight into the incentives created by the Tax Cuts and Jobs Act, and briefly summarize practitioner observations and guidance.

Keywords: organizational form, pass-through, corporate tax, tax rates

JEL Codes: H25, K34

We thank Caitlin Bokulic, Kelly Luttrell, and Marty Harris for their assistance and /or comments. Henry and Plesko also hold positions as economists with the Statistics of Income Division of the Internal Revenue Service, however the views expressed in this paper are solely those of the authors and do not represent those of the U.S. Department of the Treasury or the Internal Revenue Service. Any and all errors are our own.

I. Introduction

Although more than 30 years have passed since the enactment of the Tax Reform Act of 1986 (TRA86), its history continues to be written, and changes in the tax code over time allow researchers to better understand how taxpayers respond to tax reform. While a number of tax changes over the past thirty years could have incrementally influenced organizational form, the number and scope of changes in the tax code brought about recently by the Tax Cuts and Jobs Act of 2017 (TCJA), especially those affecting the tax rate structures, have the potential to significantly influence organizational form decisions to an extent not present since 1986.[1]

In this paper, we examine the implications of the TCJA for pass-through activities in three ways. First, we review and revisit the behavior of firms in response to enactment of the TRA86 to see what lessons and insight might be gained to inform our analysis of the TCJA. Second, we develop a simple analytic model of the changes in the tax structure affecting pass-through entities to estimate the magnitude of the changing incentives that could influence behavior. Third, we draw from the practitioner literature and conversions with tax advisors to gain a sense of how the law is currently influencing behavior.

In the next section, we highlight some of the relevant aspects of the TRA86 that affected organizational form choice and review the evidence of organizational change, and provide an analysis of some of the aggregate trends following TRA86. In Section III we present a stylized analytic model to examine the change in incentives following the enactment of the TCJA, emphasizing the array of operating characteristics that make the decision more difficult, and likely less predictable, than in 1986. Supporting those observations, Section IV provides a brief survey of the practitioner literature since the passage of the TCJA to evaluate the guidance provided to businesses as they evaluate their options. We present our conclusions in Section V.

[1] For technical reasons, the reform is officially named "Public Law No: 115-97, An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." For simplicity, in this paper we refer to the act formerly known as the Tax Cuts and Jobs Act using the unpronounceable acronym TCJA.

II. The Tax Reform Act of 1986

A. Provisions affecting organizational form

We first inform the debate surrounding potential effects of TCJA on fundamental business decisions using TRA86 to provide historical context. Specifically, we review prior literature on the organizational form responses to TRA86 and extend it by also examining the response of business decisions (e.g., payout policy) to organizational form changes. For closely held businesses, TRA86 dramatically affected organizational form decisions owing to a number of significant changes in the Internal Revenue Code (IRC). While both individuals and corporations saw their marginal tax rates fall, TRA86 inverted the maximum rates between individuals and corporations, with the maximum corporate rate set higher than the maximum individual rate (34 versus 28 percent). Further, dividend distributions from C corporations remained subjection to double taxation – at the individual level at ordinary income rates – increasing the effective rate on corporate income. This created strong incentives for eligible businesses to leave the double-taxed C corporation form, where earnings could previously be retained at a lower rate, and convert into an S corporation. Other changes affecting the organizational form decision were the elimination of preferential treatment for long-term capital gains, reducing the benefits of deferral, and the establishment of the Alternative Minimum Tax (AMT) for C corporations.

B. Changes in Organizational Form and Firm Characteristics after TRA86

Empirical evidence suggests that tax incentives, changed by TRA86, influenced organizational form choice. The reduction in the individual tax rate relative to the corporate tax rate resulted in both a larger number of pass-through entities and a larger share of economic activity held within pass-through entities.[2] In examining the effects of TRA86, Plesko (1994) documents a dramatic increase in S conversions in the months after the enactment. For subsequent years, Plesko (1995a) reports that S corporations sustained the largest growth rate of any organizational form, while the number of C

[2]Plesko (1995a), Plesko and Henry (2012), Plesko and Toder (2013), and Nelson (2016) examine the trends in both business organization and the economic activity within each organizational form prior to and following TRA86.

corporation returns declined, from 1986-1990. Further, the S corporation share of net income, deficits, and net income less deficits dramatically increased following TRA86.

Several studies also examine the determinants of organizational form choice, including the changing incentives arising from TRA86. Using a sample of C corporations prior to TRA86, Plesko (1995b) models the choice to operate as a C versus an S corporation following TRA86 as a function of various firm characteristics and generally finds that the organizational form choice is consistent with tax minimization incentives. Ayers et al. (1996) study a sample of firms in 1988 and 1989 to assess the extent to which tax and nontax factors jointly influence the organizational form choice. Their analysis suggests that nontax factors, such as business risk, ownership structure, firm size and firm age are salient to the organizational form choice. Finally, Omer, Plesko and Shelley (2000) examine the influence of tax considerations on conversions to S corporation status in the natural resource industry.

2. Using TRA86 to Inform the Analysis of TCJA

We build upon the literature above by descriptively examining changes in important firm decisions following a change in organizational form. We focus on firm decisions such as organizational form choice, financing and payout policy, and compensation mix. We utilize corporate tax return data from the Statistics of Income (SOI) corporation file from 1984 through 1990 to generate four subsamples: 1) C corporation entities prior to and following TRA86; 2) C corporation entities prior to TRA86 that switched to S corporation status following TRA86 ("conversions" or "converting corporations"); 3) S corporation entities prior to and following TRA86; and 4) S corporation entities prior to TRA86 that switched to C corporation status following TRA86.

Statistics of Income (SOI) does not collect data for the entire population of corporate tax returns. Rather, SOI collects return data for a subset of corporations using a stratified probability sampling procedure intended to increase the probability that the same firms are collected from year to year.[3] To

[3] See U.S. Internal Revenue Service, Statistics of Income – 2013 Corporation Income Tax Returns, SOI's complete report on corporation income tax returns for 2013 for further detail on the IRS's sampling and weighting procedures found here: https://www.irs.gov/pub/irs-soi/13coccr.pdf

generate our sample, we exclude from the SOI corporation file those firms filing 1120-RIC or 1120-REIT forms, and personal service corporations. We also exclude corporations unable to elect S status based on number of shareholders.[4] Finally, we drop firms that do not have at least one return observation present in each year's SOI corporation file to create a balanced sample of C and S corporation return observations spanning 1984-1990. To generate our tabulations, we rely on weighted SOI data to ensure that our disclosure of Federal tax return information (FTI) complies with IRC §6103(j).

Our sample, described in Table 1, represents a total of 604,500 corporations and 4,807,990 corporation-years. Approximately 15 percent of all pre-TRA86 C corporations in our sample switched to S corporation status following TRA86. Our data suggests that corporations' organizational form decisions were made quickly following passage of TRA86, as 70 percent of the C to S corporation conversions occurred in 1987 and 1988. We compare the economic magnitude of C corporations that remained C corporations to converting corporations by SOI major industry division in Figures 1 and 2. Consistent with prior literature (e.g., Plesko, 1995), we find that the largest corporations in terms of both average total assets and tax net income retained C corporation status after TRA86. The largest converting firms operate in manufacturing, transportation and public utilities, wholesale trade, and retail trade industries.

We study the economic magnitude of corporate business activity for converting and non-converting corporations through total assets and tax net income (TNI). We also separately examine mean TNI for firms with positive versus negative TNI as individuals have incentives to shift negative TNI to an S corporation because losses, to the extent they are active rather than passive, pass through to the individual tax return to offset other sources of individual taxable income. This is in contrast to C corporation losses, which are carried back/forward to offset previous/future C corporation taxable income.

[4] Ideally, we would exclude firms unable to elect S status prior to TRA86. However, 1988 is the first year information on the number of shareholders was included on corporate returns. We make the assumption that the number of shareholders from a corporation's 1988 return approximates the number of shareholders in years prior to TRA86. At that time, S corporations were limited to 35 shareholders, with married couples counting as one.

We then examine how fundamental firm decisions change following TRA86 and organizational form change. We capture compensation mix by examining several line items from corporations' Form 1120: salaries and wages (line 13), compensation of officers (line 12), the deduction from pension and profit sharing plans (line 23) and the deduction for employee benefits (line 24).[5] All compensation-related variables are scaled by total deductions (line 27). We use total distributions to proxy for a corporation's payout policy and compute them as the sum of total cash and property distributions as reported on Schedule M-2 of a corporation's Form 1120, scaled by total assets from Schedule L. We capture related-party financing decisions with loans to and from shareholders, each as a percentage of firms' total debt from Schedule L of the Form 1120. Finally, we examine the debt to equity ratio. We winsorize all variables at 1 and 99 percent to mitigate the effect of outliers.

In Table 2, we present the weighted means of the various firm characteristics by year for converting C corporations and non-converting C and S corporations. The data in Table 2 suggests that firms' compensation mix remained relatively stable both pre- and post-TRA86 for both converting and non-converting corporations. However, we observe significant changes in the economic activity, payout policy, and financing decisions within converting firms relative to non-converting C corporations. The changes we observe are all consistent with firms using the S corporation organizational form after TRA86 to minimize personal taxes of individual business owners and distribute corporation capital to them in a tax efficient manner.

We present in Figure 3 the growth rates in both positive and negative TNI with 1984 as the base year. While growth rates in average positive TNI within converting and non-converting corporations was nearly identical throughout our sample period, Figure 3 suggests that average negative TNI significantly increased for converting firms, while average negative TNI significantly decreased for firms that

[5]This is a different measure than used by Nelson (2016), who provides a detailed analysis of S corporation compensation and wages over a long time period and multiple changes in the tax provisions affecting S corporations. She concludes that the ability of owners to change the characterization of payments to themselves has implications for quantifying the amount of income owners receive from S corporations.

remained C corporations. This suggests that C corporations with significant losses converted to S corporations in order to pass through taxable losses to shareholders.

Figure 4 presents growth rates in total distributions with 1984 as the base year. Distributions from non-converting C corporations to their shareholders remained fairly constant over our sample period. However, distributions sharply increased after TRA86 for firms that converted to S corporations. S corporation earnings are not taxed at the entity level; rather, S corporation owners pay tax on their respective share of S corporation earnings each year and are not subject to additional tax on distributions from the S corporation, provided distributions do not exceed the owner's basis in S corporation stock. C corporation earnings are taxed at the entity level each year and those earnings are taxed again at the individual level when distributed to owners. Thus, our results are consistent with the C corporation "double tax" discouraging dividend distributions to owners. When the double tax is removed by conversion to S status, the corporation's payout policy responds fairly dramatically.

To examine the role of related-party capital structure decisions, we plot growth rates in loans to and loans from stockholders in Figures 5 and 6. We find loans from stockholders for converting firms decreased relative to non-converting C corporations in the years surrounding TRA86. Prior to TRA86, C corporations had incentives to borrow from stockholders in order to both reduce pretax corporate income and return income to shareholders in the form of interest payments, thereby avoiding the double tax on shareholder distributions. Upon conversion, S corporations are able to distribute income without additional tax consequences for owners, thereby reducing the incentive for owners to issue loans to the corporation.

Our observations about TRA86 provide a baseline from which we can evaluate the potential organizational form response to TCJA. Overall, we find that the behavioral response to TRA86's significant change to corporate and individual tax rates was fairly dramatic. A large number of C corporations converted to pass-through form and the majority of converting firms did so in the years immediately following the enactment of TRA86. Our descriptive evidence also suggests that the

conversion to S corporation induced changes in firm behavior, with firms shifting to S corporations to pass through losses and distribute income without a double tax. The effects of the TCJA likely depend on the changes in relative tax rates across organizational forms and the importance of distributions to a given firm.

III. The Tax Cuts and Jobs Act of 2017 (TCJA)

In this section, we develop a stylized, basic model of the choice between C corporation, S corporation, and partnership organizational forms.[6] We use our model to evaluate organizational form choice both pre- and post-TRA86 to substantiate the conclusions presented in Section II. We then use our model to evaluate organizational form choice in response to TCJA. In our model, we assume the business entity is closely owned (e.g., by a sole owner, husband/wife, family, etc. where a group of related parties control major firm decisions) and the owners are actively engaged in the business. As a result, we assume owners are not subject to passive activity loss rules.[7] We also assume the personal service corporation rules and the accumulated earnings tax do not apply.

We begin with the simple model presented in prior literature where non-corporate or pass-through form (S corporation or partnership) is preferred over corporate form (C corporation) if the following inequality holds (e.g., Graham 2003; Scholes et al. 2015):

$$(1) \qquad (1-\tau_P) > (1-\tau_C)(1-\tau_E)$$

In equation (1), τ_P equals the personal (i.e., individual ordinary) income tax rate, τ_C the corporate income tax rate, and τ_E the preferential tax rate on income from equity ownership (e.g., dividends and capital gains). Effectively, this equation states that if the after-tax return from non-corporate (or pass-through) entities, which is only subject to the personal tax, exceeds the after-tax return on corporate entities subject

[6] Sullivan (2018a) describes the complicated rules of the section 199A passthrough deduction, and has made available a spreadsheet detailing his calculations.

[7] We analyze the taxes of the firm's owner-employees, as opposed to passive investors who would face a different tax burden.

to double taxation, businesses should organize as partnerships. If the inequality does not hold, businesses prefer corporate form.

The TCJA potentially changed the preferred organizational form by changing both τ_P (slight reduction) and τ_C (major reduction). At the simplest level, this makes corporate form more appealing under the TCJA relative to the treatment of corporate form under prior law.[8] However, our analysis of the response to TRA86 suggests that payout policy is an important component of organizational form choice.[9] The firm has a choice between returning earnings to owners as salary, subject to individual ordinary income tax rates, or dividends and retained earnings (which translate into long-term capital gains) subject to preferential tax rates. Second, and relatedly, certain methods of paying owners are subject to self-employment tax, while others are not. In order to better evaluate organizational form decisions under TCJA, we extend equation (1) by incorporating the tax effect of the form of distribution into the organizational form decision.

Similar to Scholes et al. (2015), we assume owners of a firm invest capital, *$I*, which generates a return on capital of *R*. In our model, *R* represents return before salary paid to owners in order to allow firms to choose the salary paid.[10] In a one period model, we can write the tax due on the returns of the three alternative organizational forms as follows. The after-tax return to the owner of a C corporation, accounting for salary versus equity payouts equals:

$$(2) \qquad (R - S(1 + \tau_{SE}))(1 - \tau_C)[D(1 - \tau_D) + (1 - D)(1 - \tau_{CG})] + S(1 - \tau_P - \tau_{SE})$$

The first term represents the distributions of corporate profit, after the corporate income tax and tax on

[8] Considering only federal income taxes, immediately prior to TCJA's enactment, the after-tax return to the partnership (corporate) form equaled 60.4 (52) percent. TCJA results in an after-tax return to the partnership (corporate) form equal to 63 (63.2) percent, not including the §199A deduction for pass-through income.
[9] Prior research also identifies several additional factors, including salary/dividend mix, that warrant consideration (e.g., Plesko and Toder, 2013; Borden, 2018; Repetti 2018; and Williamson, Rivera and Staley, 2018).
[10] One complication not included in our model involves fringe benefits. For corporations, certain fringe benefits for owner-employees are excluded from personal income whereas they may be included for pass-through owner-employees. However, one of the largest of these fringe benefits, health insurance, is then deductible on pass-through owner-employees' personal tax return. As such, the net effect of these complications may not be substantial.

corporate payouts. *S* represents the salary paid to the owners.[11] *D* represents the portion of profits paid out currently as dividends, and (1 – *D*) represents the portion of profits retained and ultimately subject to long-term capital gains taxes. Although rates on long-term capital gains taxes and dividends are currently equal, we set them as two separate rates, τ_{CG} and τ_D, to allow for periods when the rates differ and to allow the capital gains rate (τ_{CG}) to account for deferral of the capital gains tax (e.g., Feldstein, Poterba, and Dicks-Mireaux 1983). The second term represents the after-tax salary received by the owners, where τ_{SE} equals the employee's or employer's share of self-employment tax.[12] As previously noted, τ_P equals the personal tax rate and τ_C equals the corporate tax rate.

Moving to the next organizational form, the after-tax return of an S corporation accounting for salary versus equity payouts equals:

$$(3) \qquad (R - S(1 + \tau_{SE}))(1 - \tau_{PT}) + S(1 - \tau_P - \tau_{SE})$$

Note that in this equation we include τ_{PT} to represent the tax on pass-through income, which in many cases is equal to the personal income tax rate. We allow for an alternative pass-through rate because TCJA allows certain taxpayers a deduction of up to 20% of their pass-through business income, subject to certain limitations. For simplicity, we treat this deduction as a direct reduction to the tax rate on this income and ignore the requirement that, in some cases, the business must pay a certain amount of salary and/or hold tangible depreciable property to qualify for the deduction. We highlight two important aspects of equation (3). First, the tax on profits is limited to the pass-through tax rate; there is no second layer of tax on distributions to owners as in equation (2). Second, profits are *not* subject to self-employment tax.

Finally, we turn to the after-tax equation for partnerships, which equals:

$$(4) \qquad (R - S(1 + \tau_{SE}))(1 - \tau_{PT} - 1.75\tau_{SE}) + S(1 - \tau_P - \tau_{SE})$$

[11] Technically, a salary paid to a partner in a partnership is known as a guaranteed payment (IRC 707(c)). For simplicity, we ignore this distinction and use the term salary across all organizational forms.

[12] Following the Affordable Care Act, an additional self-employment tax of 0.9% is levied on employees with income above certain thresholds, but not on employers. For simplicity, we assume that employers and employees face the same self-employment tax rate.

The partnership calculation is similar to the S corporation calculation, except that partnership profits are subject to self-employment tax. A particularly important aspect of this, overlooked in prior literature, is that for certain income ranges, the self-employment tax on partnership pass-through income and the preferential tax rates on C corporation dividend income are approximately equal. Therefore, differences between operating in C corporation versus partnership form may be smaller than previously believed in certain scenarios. Also note that the partnership profits are subject to both the employer's and employee's share of self-employment tax ($2*\tau_{SE}$). However, the employer's share is deductible against the partner's taxable income. Thus the effective self-employment tax rate is $\tau_{SE} + \tau_{SE}(1 - \tau_P)$. To avoid complications in our simple model, we assume a personal tax rate of 25% and ignore possible differences between the personal and pass-through rates, and thus include $1.75\tau_{SE}$ in the equation.

We use our models to estimate effective tax rates paid by representative taxpayers at different income levels operating businesses through different organizational forms. We assume: (1) the taxpayer is married filing jointly, (2) all taxpayers and types of income are subject to a flat state income tax rate of 6%, which we include in the personal, preferential, and corporate rate, and (3) taxpayers have itemized deductions, excluding state income taxes, exceeding the maximum standard deduction. We vary the firm's income (R) between low ($250,000) and high ($750,000) and use three alternative levels of distributions: 0%, 50%, and 100%. For the two scenarios with distributions, we vary the salary portion at three levels: 0%, 50%, and 100%, with dividends making up the remainder of the distribution in each case. We use the actual Federal corporate, preferential, and personal tax rate schedules in effect and compare the effects of the changes in after-tax return for each organizational form pre- and post- both TRA86 and TCJA.[13]

[13] Self-employment taxes consist of the employee's and employer's shares of Social Security and Medicare taxes. Because the 6.2% Social Security tax only applies up to a certain income level, we ignore this tax. As income increases, this tax rate effectively approaches zero. Thus, we focus on the 1.45% (2.35% for high income taxpayers) Medicare tax in our analyses.

TRA86 reduced the maximum corporate (personal) rate from 46% (50%) to 34% (28%). In untabulated analyses, we generally find the corporate form, prior to TRA86, produced similar tax rates to other organizational forms when dividend distributions are relatively low. As dividend distributions increase, the cost of double taxation increases, putting C corporations at a disadvantage. Following TRA86, C corporations are tax disadvantaged in almost every setting, consistent with the massive increase in S corporations and other pass-through businesses following TRA86. The one exception to this is the case where the firm pays all profits out as salary because salary is treated the same across all organizational forms. Finally, we note that in virtually all cases, the S corporation is preferred over the partnership because of the ability to avoid a portion of self-employment tax.

Next we address the changes to the organizational form choice as a result of TCJA. Consistent with the period after TRA86, in the period prior to TCJA, C corporation form is generally disadvantaged relative to other forms, and this disadvantage is increasing in dividend distributions. By contrast, following the TCJA, the gap between tax rates of operating as a C corporation versus a pass-through narrow significantly, in some cases reversing so that C corporation form is preferable. We tabulate two of our scenarios for both high and low income firms to illustrate.

Table 3, Panel A presents the results for a low-income firm with zero distributions. The C corporation is disfavored prior to TCJA. This is true after TCJA, but the difference between C corporation and pass-through rates narrows. Panel B shows the case where the 20% pass-through deduction is phased out for a high-income firm. It is clear that an entity planning to retain earnings is better off in C corporation form following TCJA. Firms not involved in professional services (e.g., manufacturers) do not phase-out of the 20% deduction. Panel C presents results for a high-income firm in this type of business and shows that even with the pass-through deduction, C corporation form is preferable after

TCJA.[14] In untabulated analysis, we find a similar result for firms distributing 50% of income where the distribution is split as half salary and half dividend.

Table 4, Panel A presents the results for a low income firm that distributes 100% of income, where half of the distribution is salary and half of the distribution is dividends. For the low-income firm, we find little change in the incentives to choose C corporation form. Tax rates decrease, but the relative gap between C corporation and pass-through form changes very little. Panel B presents results for a high-income firm not eligible for the pass-through deduction. At this income range and distribution style, pass-through firms received no tax rate cut from TCJA, while corporations received a small tax rate cut. Panel C presents the results for a high-income firm that remains eligible for the pass through deduction. Similar to Panel A, we find that firms receive a small tax cut, but the gap between C corporation and pass-through form shows little change. In general, results in Table 4 suggest a preference for pass-through form in terms of tax rates both before and after TCJA, though that preference is sometimes small.

To summarize our analytical results, the TRA86 change provided a clear incentive for many businesses to organize as S corporations, and, to a lesser extent, partnerships, a result consistent with prior analytical and empirical studies. However, this incentive was lower for C corporations planning to retain earnings. By contrast, the results of TCJA are significantly less clear. Depending on the specific circumstances of the firm (business type, distribution policy, etc.) either C corporation or pass-through form may be beneficial.

One caveat to this analysis is that we have focused on profitable firms. In general, because both TRA86 and TCJA reduced the corporate tax rate, reducing the value of losses generated in C corporation form, and we examine active businesses not subject to passive activity losses, loss entities have strong incentives to shift to non-corporate form to enable immediate use of losses, consistent with results in

[14] The phase-out is based on income thresholds. The low income firm falls below these thresholds so faces no phase-out, regardless of its type of business activity (e.g., services versus manufacturing).

Figure 3.[15] Thus, the TCJA appears to provide clear incentives for loss firms to change organizational form, similar to TRA86 but in contrast to the TCJA effect for profitable firms.

IV. Practitioner Guidance on Organizational Form Choice after TCJA

At its simplest, TCJA's inversion of the corporate and top individual ordinary income tax rate suggests that C corporations will become attractive to individuals to shelter income. However, our extension of the simple analytic model suggests that even the inclusion of one additional factor, e.g., distribution policy, suggests that organizational form decisions following TCJA will be significantly more nuanced than those following TRA86. Consistent with our conclusions, there is little anecdotal evidence to date of substantial tax-induced organizational form changes currently underway.

Our conversations with practitioners, coupled with a review of popular and practitioner press articles suggest the reasons for a slower response to TCJA reduce to the temporary nature of certain aspects of the TCJA, the uncertainty in pending administrative guidance, and concerns over the time horizon that the Act's provisions may remain in place. For example, the pass-through deduction is currently set to expire at the end of 2025, while the corporate income tax rate cut is permanent. Also, a significant amount of uncertainty remains with respect to the staying power of many of TCJA's relevant provisions, including the pass-through deduction, because of the speed with which the bill was written and the criticisms levied against it (Shaviro, 2018; Kamin et al., 2018). Business owners also face uncertainty with respect to the application of TCJA's provisions in the years immediately following its passage, as currently there is little IRS or Treasury guidance on the new laws (Kamin et al, 2018; Nitti, 2018). Business owners, and their advisors, are hesitant to make hasty organizational form decisions given such a high degree of uncertainty surrounding TCJA and the fact that some organizational form choices cannot be quickly reversed.[16] Finally, questions have been raised about whether fundamental

[15] We note that the TCJA limits the amount of allowable flow-through losses to $500,000 for married filers, providing a cap on the benefits of operating loss firms as flow through entities.

[16] For example, an S corporation that converts to a C corporation has a 5 year waiting period before it is able to elect S status again (IRC § 1362(g)). Previous empirical studies also show that individuals are not always responsive to tax incentives to shelter income in C corporation form (e.g., Romanov 2006; Tazhitdinova 2016).

changes to the tax structure will need to be considered as part of any legislative approach to addressing the current budget situation (CBO, 2018, Sullivan, 2018b).

Even if the provisions of TCJA are likely to remain intact for the foreseeable future, our analysis and practitioner advice suggests the organizational form choice moving forward depends on a myriad of individual facts and circumstances, any of which could "turn the dial" just enough to prefer one form over the other.[17] In other words, there is no "one size fits all" approach for a particular organizational form in the post-TCJA era. Guidance issued by both KPMG and BDO, some of the largest accounting firms in the world, even advise taxpayers not to dismiss outright a corporate-to-partnership conversion (KPMG, 2018; BDO, 2018). For example, businesses which expect to reinvest rather than distribute profits would benefit from C corporation status, while businesses that intend to distribute profits to owners may benefit from pass-through status under some circumstances (but not others, further complicating the matter).

Anecdotal evidence of firms' initial behavioral responses to the TCJA suggests the reduction in the tax cost of choosing one organizational form over the other will increase the relevance of *non-tax* costs to the decision. For example, two major publicly traded partnerships in the alternative asset management industry, Ares Management LP and KKR & Co LP, recently announced their conversion to C corporation status. KKR reported the conversion will result in a higher tax burden, but that TCJA "made the tax hit less painful" and, in turn, the firm gained increased access to potential capital providers via the C corporation form (Franklin, 2018). Thus, it is possible the non-tax benefit of greater access to capital markets for some partnerships now outweighs the tax cost (now drastically reduced by TCJA) of using the C corporation form.[18]

[17] The tax treatment of several individual factors also changed under TCJA, such as the cap on or elimination of certain itemized deductions (e.g., state and local tax deduction), making them now salient to the organizational form decision.

[18] Specifically, Merton (1987) suggests capital market benefits to expanding a firm's shareholder base. Thus, the non-tax benefits of drawing in more institutional investors, who face additional tax and non-tax burdens from partnership ownership (e.g., Utke 2018), given the increase in institutional ownership over time (e.g., Gompers and Metrick 2001) outweigh the additional tax costs for some firms. In fact, non-tax factors were driving these types of conversions before TCJA reduced the tax costs (e.g., Sider and Chen 2015). Though beyond the scope of this paper, TCJA increased the tax burdens of partnership versus C corporation ownership for certain institutional investors.

V. Conclusion

Similar to the TRA86, enactment of the TCJA has provided a significant change in the U.S. tax structure, causing many businesses to reassess fundamental decisions about their structure and operations. With respect to organizational form, comparisons with the TRA86 are useful to gauge the extent of potential behavioral responses. Our analyses suggest that while changes in the factors affecting organizational form are nearly as dramatic as those not seen since 1986, the net effect on organizational form in the aggregate is not likely to be as large as those in 1986. Further, to the extent that businesses as a whole make changes in their form, the decisions will likely take place over a longer period of time than in 1986. Further, our analysis suggests that predictions by political, media, and academic commentators related to the incentives to changes organizational form created by the 20% pass through deduction may not be as significant as suggested, at least in the short-run. Similar to the TRA86, the changes brought about by the TCJA provide an opportunity for researchers to reexamine a broad range of tax-related research questions, and can serve as a foundation for research that will provide additional insight into the role of taxes in individual and business decisions.

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Figure 1

Average Assets (weighted): Converting v Non-Converting Firms

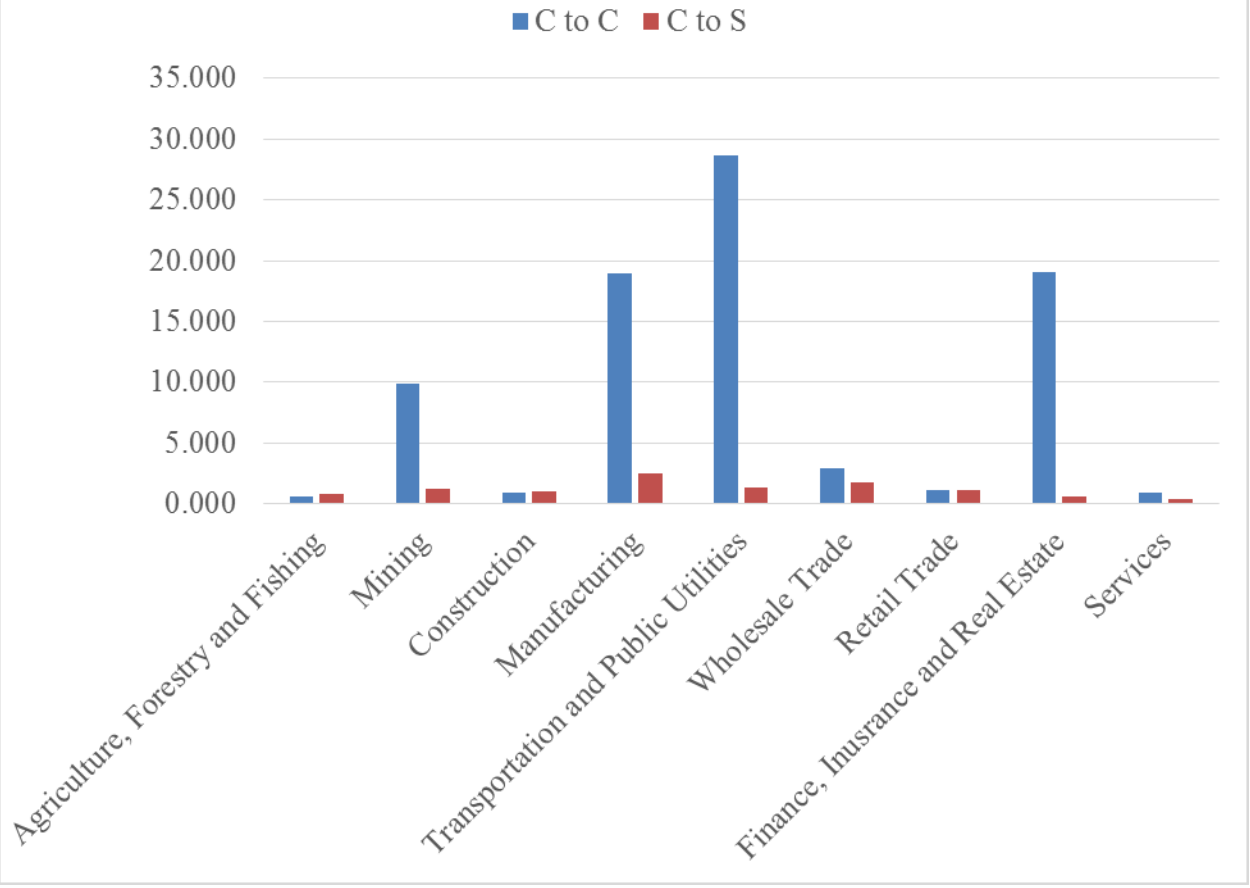

Figure 2

Average TNI (weighted): Converting v Non-Converting Frims

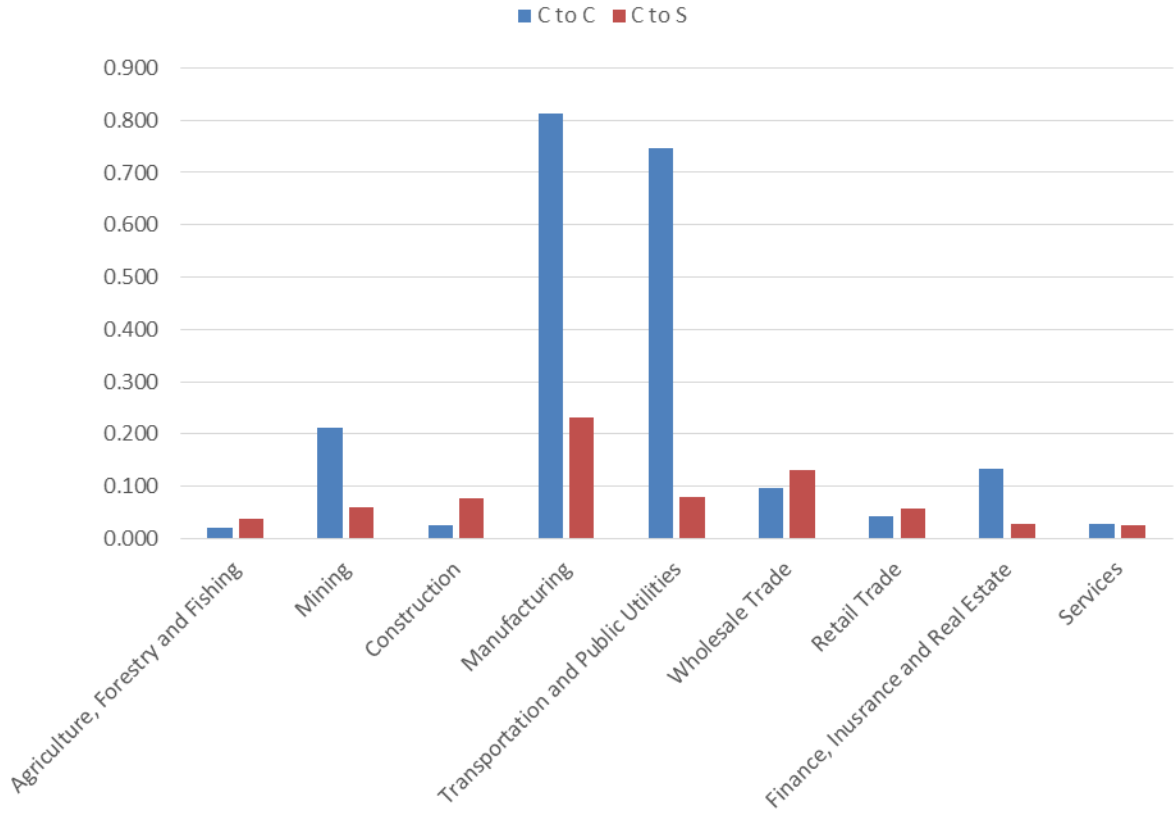

Figure 3
Positive and Negative TNI: Change from 1984 Base

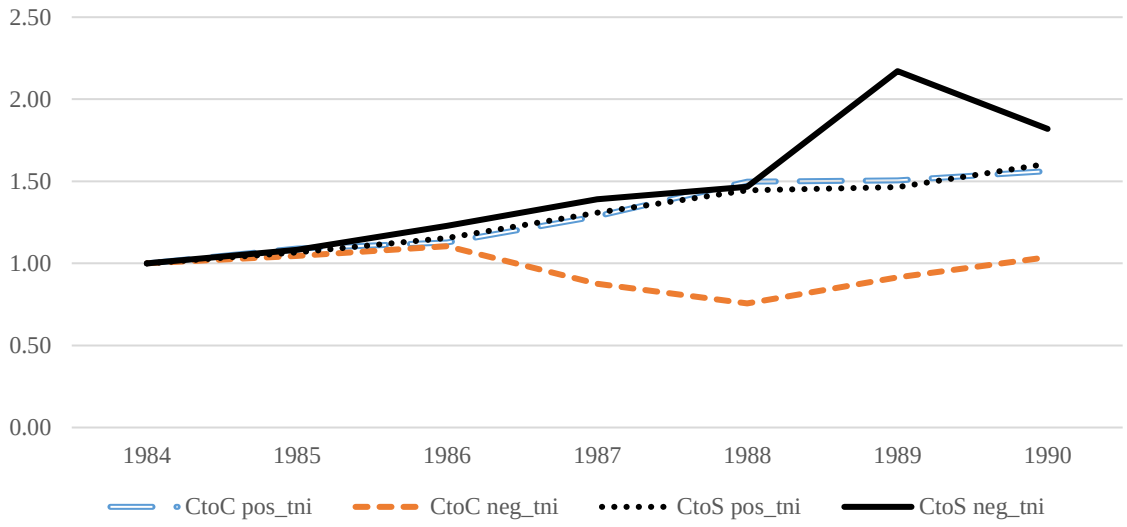

Figure 4
Total Distributions: Change from 1984 Base

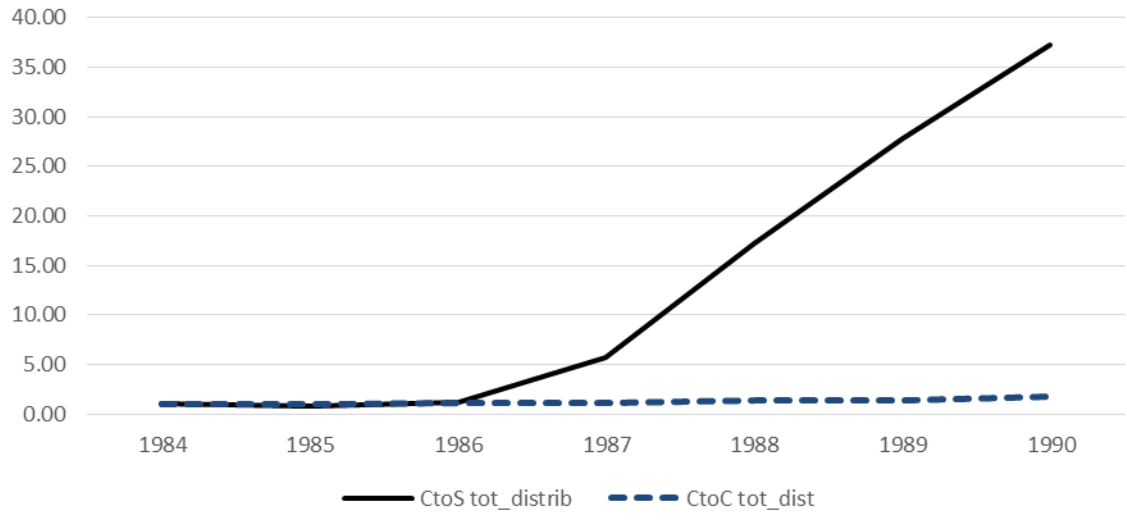

Figure 5
Loans to Stockholders: Change from 1984 Base

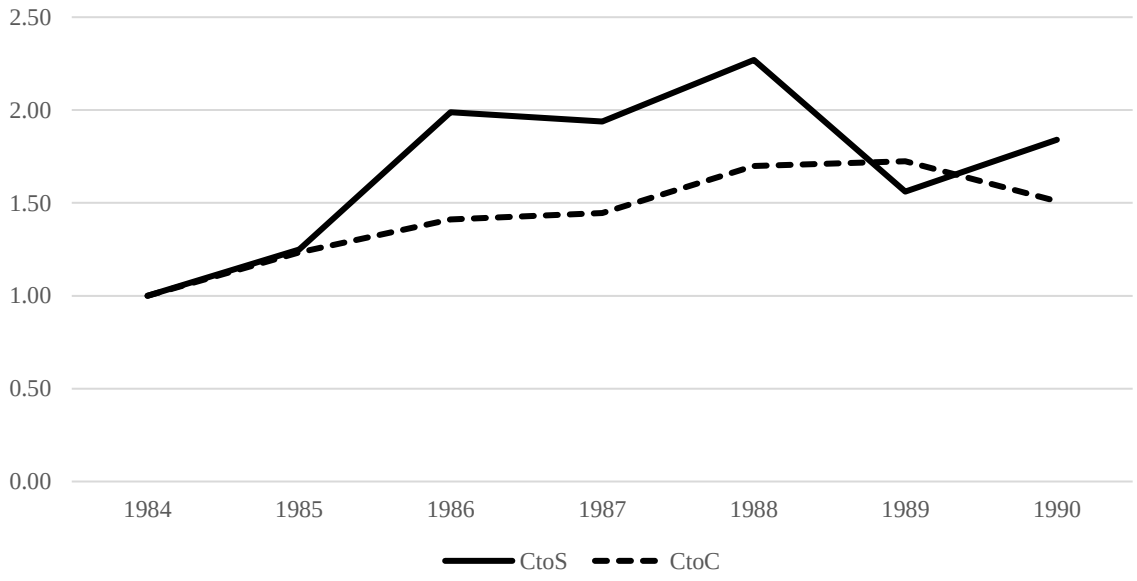

Figure 6
Loans from Stockholders: Change from 1984 Base

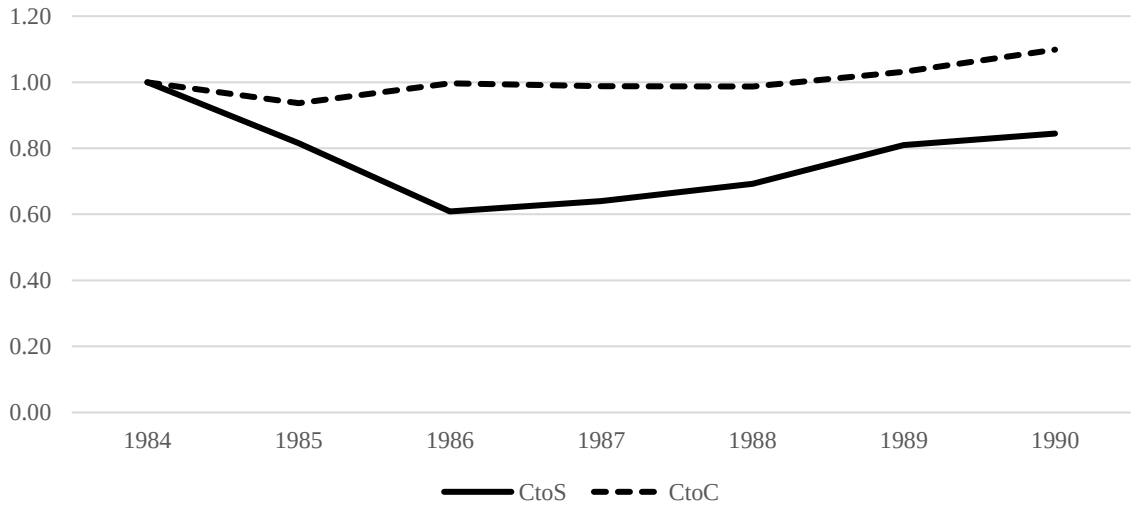

Table 1
Number of C and S Corporations 1984 – 1990

Panel A: Number of Corporations by Entity Type Pre- and Post-TRA 86

Pre-TRA 86	Post-TRA 86	Weighted N
C Corporation	C Corporation	400,045
C Corporation	S Corporation	70,613
S Corporation	S Corporation	129,945
S Corporation	C Corporation	3,897

Panel B: C Corporation to S Corporation Conversions by Year Post TRA 86

	Weighted N
1987	33,388
1988	21,865
1989	17,593
1990	6,080
Total	**78,926**

In this table, we present weighted counts for the four subsamples that comprise our full sample of corporation observations: 1) C corporation entities prior to and following TRA86; 2) C corporation entities prior to TRA 86 that switched to S corporation status following TRA86; 3) S corporation entities prior to and following TRA 86; and 4) S corporation entities prior to TRA 86 that switched to C corporation status following TRA86. Sample weights applied to an individual corporation observation change from year to year in the Statistics of Income data. In Panel A we apply sample weights from 1984, the first year of our sample, to obtained the weighted number of firms represented by our sample. In Panel B, we use sample weights corresponding to each year presented.

Table 2
Weighted Means of Firm Characteristics for Converting versus Non-Converting Corporations

Panel A: Firms that Converted from C to S Corporation Status After TRA 86

	Full	**1984**	**1985**	**1986**	**1987**	**1988**	**1999**	**1990**
Total Assets	1.0944	0.8899	1.0248	1.0975	1.0880	1.1202	1.1995	1.1849
Tax Net Income (TNI)	0.0767	0.0710	0.0757	0.0863	0.0853	0.0840	0.0707	0.0651
Positive TNI	0.1326	0.1026	0.1095	0.1184	0.1342	0.1482	0.1503	0.1648
Negative TNI	-0.0495	-0.0316	-0.0342	-0.0388	-0.0439	-0.0463	-0.0686	-0.0575
Salaries and Wages	0.1856	0.1748	0.1744	0.1760	0.1844	0.1891	0.2003	0.1950
Compensation of Officers	0.1808	0.1688	0.1785	0.1801	0.1780	0.1851	0.1939	0.1784
Pension, profit-sharing, etc. plans	0.0149	0.0186	0.0177	0.0160	0.0150	0.0149	0.0125	0.0111
Employee Benefit Programs	0.0131	0.0136	0.0129	0.0122	0.0122	0.0124	0.0142	0.0143
Total Distributions	0.0175	0.0012	0.0010	0.0014	0.0070	0.0214	0.0345	0.0462
Loans to Shareholders	0.1577	0.0922	0.1151	0.1833	0.1786	0.2092	0.1439	0.1696
Loans fr Shareholders	0.1265	0.1637	0.1335	0.0997	0.1048	0.1134	0.1325	0.1383
Debt to Equity Ratio	2.5941	4.0009	2.7753	2.3168	2.2632	2.4501	2.1950	2.3509

Panel B: Non-Converting C Corporations

	Full	**1984**	**1985**	**1986**	**1987**	**1988**	**1999**	**1990**
Total Assets	7.4545	6.2634	7.3331	7.5128	7.8041	7.3388	7.7676	7.9513
Tax Net Income (TNI)	0.1693	0.1258	0.1378	0.1409	0.1764	0.2044	0.1946	0.1845
Positive TNI	0.3501	0.2669	0.2909	0.3007	0.3435	0.4000	0.4020	0.4169
Negative TNI	-0.1354	-0.1417	-0.1483	-0.1566	-0.1242	-0.1072	-0.1296	-0.1471
Salaries and Wages	0.1585	0.1586	0.1586	0.1615	0.1601	0.1585	0.1559	0.1573
Compensation of Officers	0.1409	0.1410	0.1387	0.1390	0.1426	0.1459	0.1410	0.1372
Pension, profit-sharing, etc. plans	0.0075	0.0092	0.0086	0.0086	0.0085	0.0069	0.0063	0.0052
Employee Benefit Programs	0.0119	0.0114	0.0098	0.0103	0.0116	0.0115	0.0134	0.0146
Total Distributions	0.0026	0.0020	0.0020	0.0023	0.0023	0.0028	0.0028	0.0037
Loans to Shareholders	0.1142	0.0786	0.0969	0.1109	0.1137	0.1336	0.1355	0.1187
Loans fr Shareholders	0.1510	0.1498	0.1403	0.1493	0.1481	0.1478	0.1546	0.1646
Debt to Equity Ratio	4.1558	5.2241	4.1208	4.2079	4.1668	3.5271	3.9409	4.1191

Panel C: Non-Converting S Corporations

	Full Sample	**1984**	**1985**	**1986**	**1987**	**1988**	**1999**	**1990**
Total Assets	0.3109	0.2769	0.3055	0.3151	0.3185	0.3072	0.3238	0.3207
Tax Net Income (TNI)	0.0232	0.0209	0.0226	0.0231	0.0239	0.0253	0.0233	0.0223
Positive TNI	0.0605	0.0607	0.0606	0.0588	0.0600	0.0603	0.0580	0.0654
Negative TNI	-0.0252	-0.0223	-0.0245	-0.0253	-0.0259	-0.0270	-0.0264	-0.0248
Salaries and Wages	0.1403	0.1294	0.1387	0.1361	0.1373	0.1462	0.1453	0.1451
Compensation of Officers	0.1177	0.1119	0.1117	0.1192	0.1183	0.1176	0.1178	0.1250
Pension, profit-sharing, etc. plans	0.0038	0.0027	0.0045	0.0042	0.0049	0.0041	0.0035	0.0026
Employee Benefit Programs	0.0075	0.0074	0.0066	0.0072	0.0068	0.0079	0.0077	0.0085
Total Distributions	0.0465	0.0069	0.0198	0.0376	0.0341	0.0459	0.0785	0.0831
Loans to Shareholders	0.0850	0.0739	0.0892	0.0659	0.0772	0.1229	0.0936	0.0647
Loans fr Shareholders	0.3214	0.3190	0.3123	0.3144	0.3350	0.3083	0.3325	0.3264
Debt to Equity Ratio	7.1429	11.4664	7.2345	8.9430	8.8316	5.7023	5.3557	4.0671

This table presents weighted means of various firm characteristics for converting and non-converting corporate entities for both the full sample of firms and by year from 1984 to 1990. Firm data is obtained from the SOI yearly corporate income tax return datasets. Each annual SOI file contains selected items from approximately 90,000 corporate income tax returns. From the SOI corporate files, we exclude personal holding and personal service corporations and any corporation ineligible to elect S status (greater than 35 shareholders in accounting year ended in 1988). Firm characteristics include total assets from Schedule L of Form 1120 and Tax Net Income (TNI) from Line 28 of page 1 of Form 1120. We present means separately for observations with positive TNI and negative TNI. Salaries and wages (Line 13 from page 1 of Form 1120), compensation of officers (Line 12), the deduction from pension and profit sharing plans (Line 23), and the deduction for employee benefits (Line 24) are all presented as a share of firms' total deductions (Line 27 from page 1of Form 1120). Total distributions, computed as the sum of total cash and property distributions listed in Schedule M-2, are scaled by total assets. The debt to equity ratio is computed by summing individual debt and equity components on Schedule L. We winsorize variables at the 1st and 99th percentile each year to mitigate the influence of outliers.

Table 3
0% Distribution
Panel A – Low-Income Firm ($250,000)

	C-Corporation		S-Corporation		Partnership	
	Pre	**Post**	**Pre**	**Post**	**Pre**	**Post**
Effective Corporate Rate, including state taxes	37.96%	25.74%	n/a	n/a	n/a	n/a
Effective Personal Rate, including state taxes	20.10%	18.00%	32.32%	30.00%	32.32%	30.00%
Self-Employment Tax Rate	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%
Effective Pass Through Rate, including state taxes	n/a	n/a	32.32%	25.20%	32.32%	25.20%
Effective Dividend Tax Rate, including State Taxes	20.10%	21.00%	n/a	n/a	n/a	n/a
Effective Capital Gains Rate, Including State Taxes	20.10%	21.00%	n/a	n/a	n/a	n/a
Capital Gains Assumed Realized	25%	25%	n/a	n/a	n/a	n/a
Effective Capital Gains Rate	5.0%	5.3%	n/a	n/a	n/a	n/a
After-Tax Income from Firm (1st term of model)	147,306	175,903	169,200	187,000	162,856	180,656
After-Tax Income from Salary (2nd term of model)	0	0	0	0	0	0
Total Income Available	147,306	175,903	169,200	187,000	162,856	180,656
Total Taxes Paid	102,694	74,097	80,800	63,000	87,144	69,344
Effective Tax Rate	41%	30%	32%	25%	35%	28%

We assume a 6% state tax rate. This is deductible before TCJA, but not deductible after for pass-through income taxed at the personal level. It remains deductible for corporations. Post TCJA pass through income is eligible for the 20% IRC 199A deduction. Following Feldstein et al. (1983) and Plesko and Toder (2013), we assume that 25% of capital gains are realized in the current period.

Table 3 (Continued)
0% Distribution
Panel B – High-Income Firm ($750,000) – Service Business

	C-Corporation		S-Corporation		Partnership	
	Pre	**Post**	**Pre**	**Post**	**Pre**	**Post**
Effective Corporate Rate, including state taxes	37.96%	25.74%	n/a	n/a	n/a	n/a
Effective Personal Rate, including state taxes	29.50%	28.00%	43.22%	43.00%	43.22%	43.00%
Self-Employment Tax Rate	1.45%	1.45%	1.45%	1.45%	2.35%	2.35%
Effective Pass Through Rate, including state taxes	n/a	n/a	43.22%	43.00%	43.22%	43.00%
Effective Dividend Tax Rate, including State Taxes	19.50%	21.00%	n/a	n/a	n/a	n/a
Effective Capital Gains Rate, Including State Taxes	19.50%	21.00%	n/a	n/a	n/a	n/a
Capital Gains Assumed Realized	25%	25%	n/a	n/a	n/a	n/a
Effective Capital Gains Rate	4.9%	5.3%	n/a	n/a	n/a	n/a
After-Tax Income from Firm (1st term of model)	442,617	527,710	425,820	427,500	394,976	396,656
After-Tax Income from Salary (2nd term of model)	0	0	0	0	0	0
Total Income Available	442,617	527,710	425,820	427,500	394,976	396,656
Total Taxes Paid	307,383	222,290	324,180	322,500	355,024	353,344
Effective Tax Rate	41%	30%	43%	43%	47%	47%

We assume a 6% state tax rate. This is deductible before TCJA, but not deductible after for pass-through income taxed at the personal level. It remains deductible for corporations. Post TCJA pass through income is not eligible for the 20% IRC 199A deduction; we assume this is a service business where the IRC 199A deduction fully phases out. Following Feldstein et al. (1983) and Plesko and Toder (2013), we assume that 25% of capital gains are realized in the current period.

Table 3 (Continued)
0% Distribution
Panel C – High-Income Firm ($750,000) – Manufacturing Business

	C-Corporation		S-Corporation		Partnership	
	Pre	**Post**	**Pre**	**Post**	**Pre**	**Post**
Effective Corporate Rate, including state taxes	37.96%	25.74%	n/a	n/a	n/a	n/a
Effective Personal Rate, including state taxes	29.50%	28.00%	43.22%	43.00%	43.22%	43.00%
Self-Employment Tax Rate	1.45%	1.45%	1.45%	1.45%	2.35%	2.35%
Effective Pass Through Rate, including state taxes	n/a	n/a	43.22%	35.60%	43.22%	34.00%
Effective Dividend Tax Rate, including State Taxes	19.50%	21.00%	n/a	n/a	n/a	n/a
Effective Capital Gains Rate, Including State Taxes	19.50%	21.00%	n/a	n/a	n/a	n/a
Capital Gains Assumed Realized	25%	25%	n/a	n/a	n/a	n/a
Effective Capital Gains Rate	4.9%	5.3%	n/a	n/a	n/a	n/a
After-Tax Income from Firm (1st term of model)	442,617	527,710	425,820	483,000	394,976	464,156
After-Tax Income from Salary (2nd term of model)	0	0	0	0	0	0
Total Income Available	442,617	527,710	425,820	483,000	394,976	464,156
Total Taxes Paid	307,383	222,290	324,180	267,000	355,024	285,844
Effective Tax Rate	41%	30%	43%	36%	47%	38%

We assume a 6% state tax rate. This is deductible before TCJA, but not deductible after for pass-through income taxed at the personal level. It remains deductible for corporations. Post TCJA pass through income is eligible for the 20% IRC 199A deduction. Following Feldstein et al. (1983) and Plesko and Toder (2013), we assume that 25% of capital gains are realized in the current period.

Table 4
100% Distribution - 50% Dividend, 50% Salary
Panel A – Low-Income Firm ($250,000)

	C-Corporation		S-Corporation		Partnership	
	Pre	**Post**	**Pre**	**Post**	**Pre**	**Post**
Effective Corporate Rate, including state taxes	37.96%	25.74%	n/a	n/a	n/a	n/a
Effective Personal Rate, including state taxes	32.32%	30.00%	32.32%	30.00%	32.32%	30.00%
Self-Employment Tax Rate	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%
Effective Pass Through Rate, including state taxes	n/a	n/a	32.32%	25.20%	32.32%	25.20%
Effective Dividend Tax Rate, including State Taxes	19.32%	21.00%	n/a	n/a	n/a	n/a
Effective Capital Gains Rate, Including State Taxes	19.32%	21.00%	n/a	n/a	n/a	n/a
Capital Gains Assumed Realized	25%	25%	n/a	n/a	n/a	n/a
Effective Capital Gains Rate	4.8%	5.3%	n/a	n/a	n/a	n/a
After-Tax Income from Firm (1st term of model)	61,660	72,268	83,373	92,144	80,247	89,018
After-Tax Income from Salary (2nd term of model)	82,788	85,688	82,788	85,688	82,788	85,688
Total Income Available	144,448	157,956	166,161	177,832	163,035	174,706
Total Taxes Paid	105,552	92,044	83,839	72,168	86,965	75,294
Effective Tax Rate	42%	37%	34%	29%	35%	30%

We assume a 6% state tax rate. This is deductible before TCJA, but not deductible after for pass-through income taxed at the personal level. It remains deductible for corporations. Post TCJA pass through income is eligible for the 20% IRC 199A deduction. Following Feldstein et al. (1983) and Plesko and Toder (2013), we assume that 25% of capital gains are realized in the current period.

Table 4 (Continued)
100% Distribution - 50% Dividend, 50% Salary
Panel B – High-Income Firm ($750,000) – Service Business

	C-Corporation		S-Corporation		Partnership	
	Pre	**Post**	**Pre**	**Post**	**Pre**	**Post**
Effective Corporate Rate, including state taxes	37.96%	25.74%	n/a	n/a	n/a	n/a
Effective Personal Rate, including state taxes	43.22%	43.00%	43.22%	43.00%	43.22%	43.00%
Self-Employment Tax Rate	1.45%	1.45%	1.45%	1.45%	2.35%	2.35%
Effective Pass Through Rate, including state taxes	n/a	n/a	43.22%	43.00%	43.22%	43.00%
Effective Dividend Tax Rate, including State Taxes	27.42%	29.80%	n/a	n/a	n/a	n/a
Effective Capital Gains Rate, Including State Taxes	27.42%	29.80%	n/a	n/a	n/a	n/a
Capital Gains Assumed Realized	25%	25%	n/a	n/a	n/a	n/a
Effective Capital Gains Rate	6.9%	7.5%	n/a	n/a	n/a	n/a
After-Tax Income from Firm (1st term of model)	166,400	192,655	209,823	210,651	194,625	195,452
After-Tax Income from Salary (2nd term of model)	207,473	208,313	207,473	208,313	204,098	204,938
Total Income Available	373,872	400,967	417,295	418,963	398,722	400,390
Total Taxes Paid	376,128	349,033	332,705	331,037	351,278	349,610
Effective Tax Rate	50%	47%	44%	44%	47%	47%

We assume a 6% state tax rate. This is deductible before TCJA, but not deductible after for pass-through income taxed at the personal level. It remains deductible for corporations. Post TCJA pass through income is not eligible for the 20% IRC 199A deduction; we assume this is a service business where the IRC 199A deduction fully phases out. Following Feldstein et al. (1983) and Plesko and Toder (2013), we assume that 25% of capital gains are realized in the current period.

Table 4 (Continued)
100% Distribution - 50% Dividend, 50% Salary
Panel C – High-Income Firm ($750,000) – Manufacturing Business

	C-Corporation		S-Corporation		Partnership	
	Pre	**Post**	**Pre**	**Post**	**Pre**	**Post**
Effective Corporate Rate, including state taxes	37.96%	25.74%	n/a	n/a	n/a	n/a
Effective Personal Rate, including state taxes	43.22%	43.00%	43.22%	43.00%	43.22%	43.00%
Self-Employment Tax Rate	1.45%	1.45%	1.45%	1.45%	2.35%	2.35%
Effective Pass Through Rate, including state taxes	n/a	n/a	43.22%	35.60%	43.22%	35.60%
Effective Dividend Tax Rate, including State Taxes	27.42%	29.80%	n/a	n/a	n/a	n/a
Effective Capital Gains Rate, Including State Taxes	27.42%	29.80%	n/a	n/a	n/a	n/a
Capital Gains Assumed Realized	25%	25%	n/a	n/a	n/a	n/a
Effective Capital Gains Rate	6.9%	7.5%	n/a	n/a	n/a	n/a
After-Tax Income from Firm (1st term of model)	166,400	192,655	209,823	237,998	194,625	222,800
After-Tax Income from Salary (2nd term of model)	207,473	208,313	207,473	208,313	204,098	204,938
Total Income Available	373,872	400,967	417,295	446,311	398,722	427,737
Total Taxes Paid	376,128	349,033	332,705	303,689	351,278	322,263
Effective Tax Rate	50%	47%	44%	40%	47%	43%

We assume a 6% state tax rate. This is deductible before TCJA, but not deductible after for pass-through income taxed at the personal level. It remains deductible for corporations. Post TCJA pass through income is eligible for the 20% IRC 199A deduction. Following Feldstein et al. (1983) and Plesko and Toder (2013), we assume that 25% of capital gains are realized in the current period.