Illustration of tax treatment of C and S corporations under the TCJA

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July 31, 2018

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Overview

- Examples developed to illustrate the impact of the TCJA on business income taxed under C corporation and S corporation rules
- Effective tax rates (ETRs) developed to capture the major features of the TCJA: 1) 21% corporate tax rate, 2) 20% pass-through deduction for qualified business income (QBI), 3) limitations on deduction for QBI, 4) limitation on deductibility of state and local taxes, and 5) potential issues with aggregation of business entities
- ETRs for S corporations are compared to an average C corporation and to the ETR if the S corporation were instead taxed as a C corporation

Impacts depend on both the relative tax treatment and the characteristics of the S and C corporations

<u>C corporations</u>

- Earnings of C corporations generally subject to two layers of tax:

    1) 21% entity level tax, and

    2) shareholder level tax at top 23.8% tax on corporate earnings distributed to shareholders as dividends or retained and taxed as capital gains taxes upon disposition of shares (top 20% dividends/capital gains tax plus 3.8% Medicare investment tax).

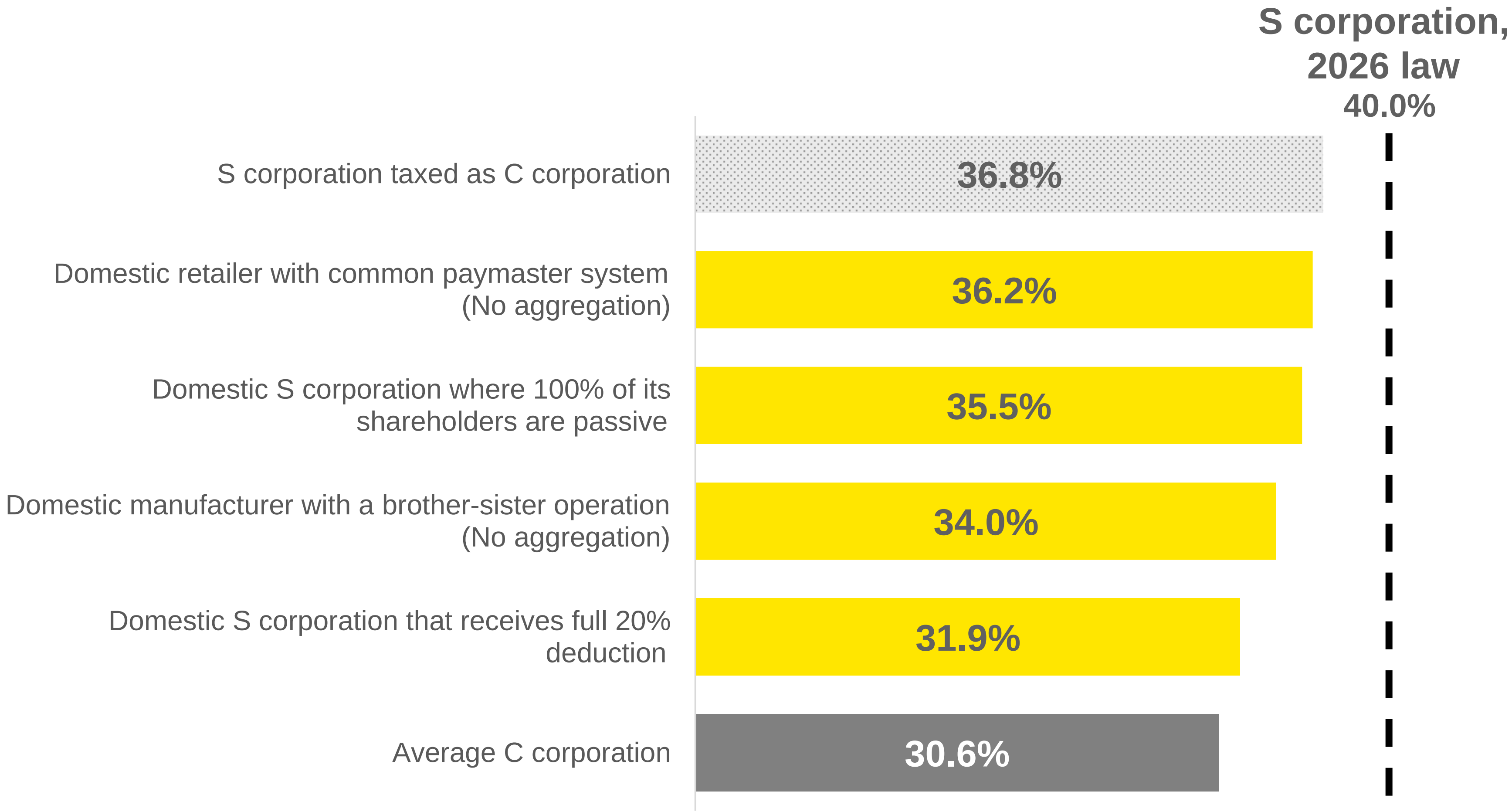
- Shareholders of C corporations may be tax-exempt or lightly taxed (e.g., pension funds, retirement accounts, university endowments, foreign investors).
- Capital gains tax deferred until disposition of shares.

Impacts depend on both the relative tax treatment and the characteristics of the S and C corporations

<u>S corporations</u>

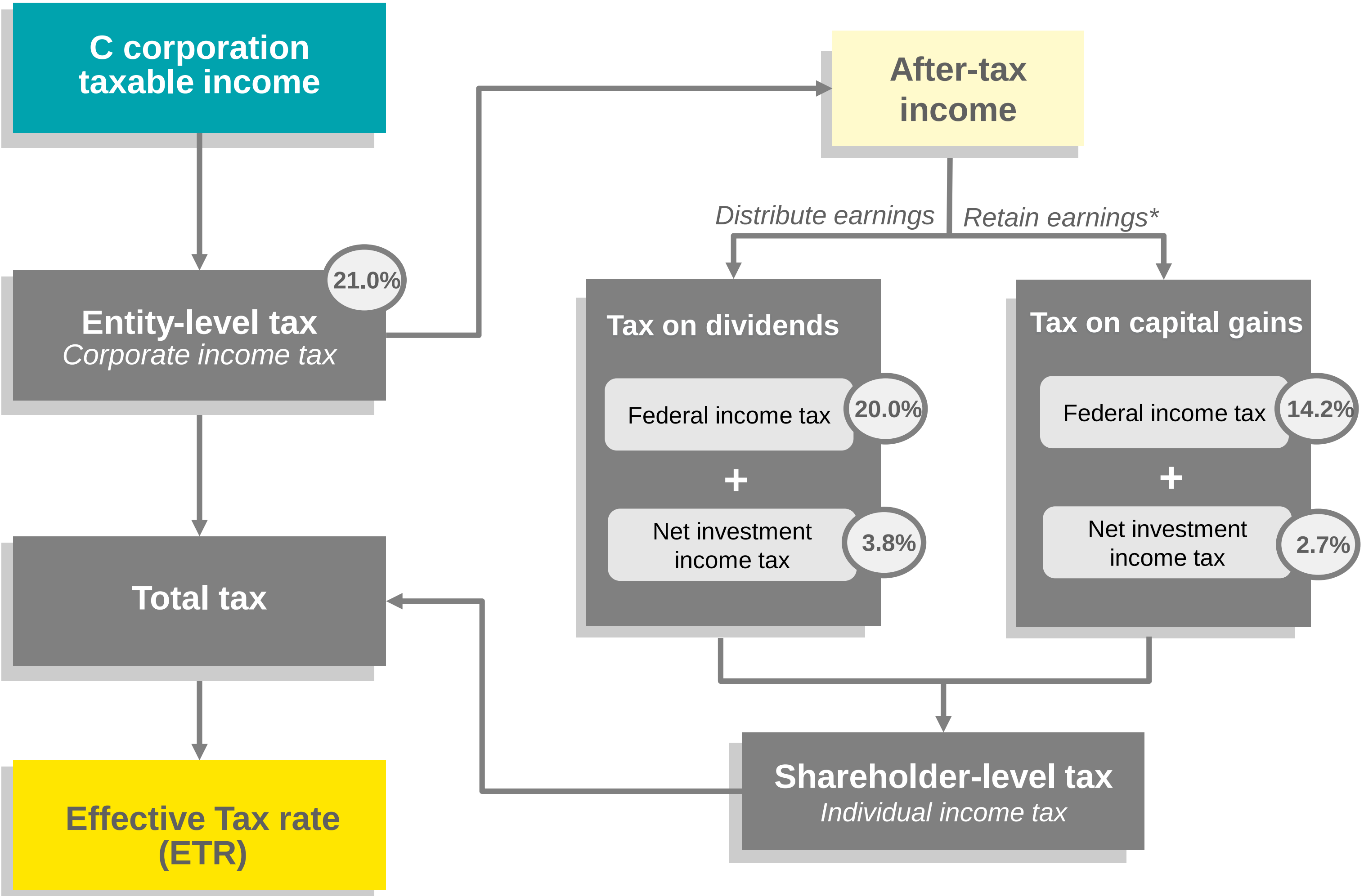
- Earnings of S corporations subject to one layer of tax on income passed-through to owners.
- Taxed at individual income tax rates with possible 20% deduction for qualified business income (QBI) (Section 199A deduction).
- 20% QBI deduction limited to the greater of:
  - 50% of the W-2 wages paid (“wage limitation”), or
  - Sum of 25% of the W-2 wages and 2.5% of the unadjusted depreciable tangible property (“capital limitation”).
- Limitation on deduction for state and local taxes also major change for owners of pass-through businesses.
- Section 199A does not describe how the 20% limitation would apply when multiple entities are operated under the same ownership (“aggregation/grouping”) – awaiting issuance of regulations to clarify aggregation rules.

Effective tax rate comparison, 2018 law



Note: *S corporation taxed as C corporation* is identical to *Average C corporation* except it has 100% taxable shareholders. *S corporation, 2026 law* is assumed to have 10% passive and 90% non-passive shareholders.

Overview of C corporation tax calculation



*Statutory capital gains tax rates are adjusted to account for the benefit of deferral of tax.

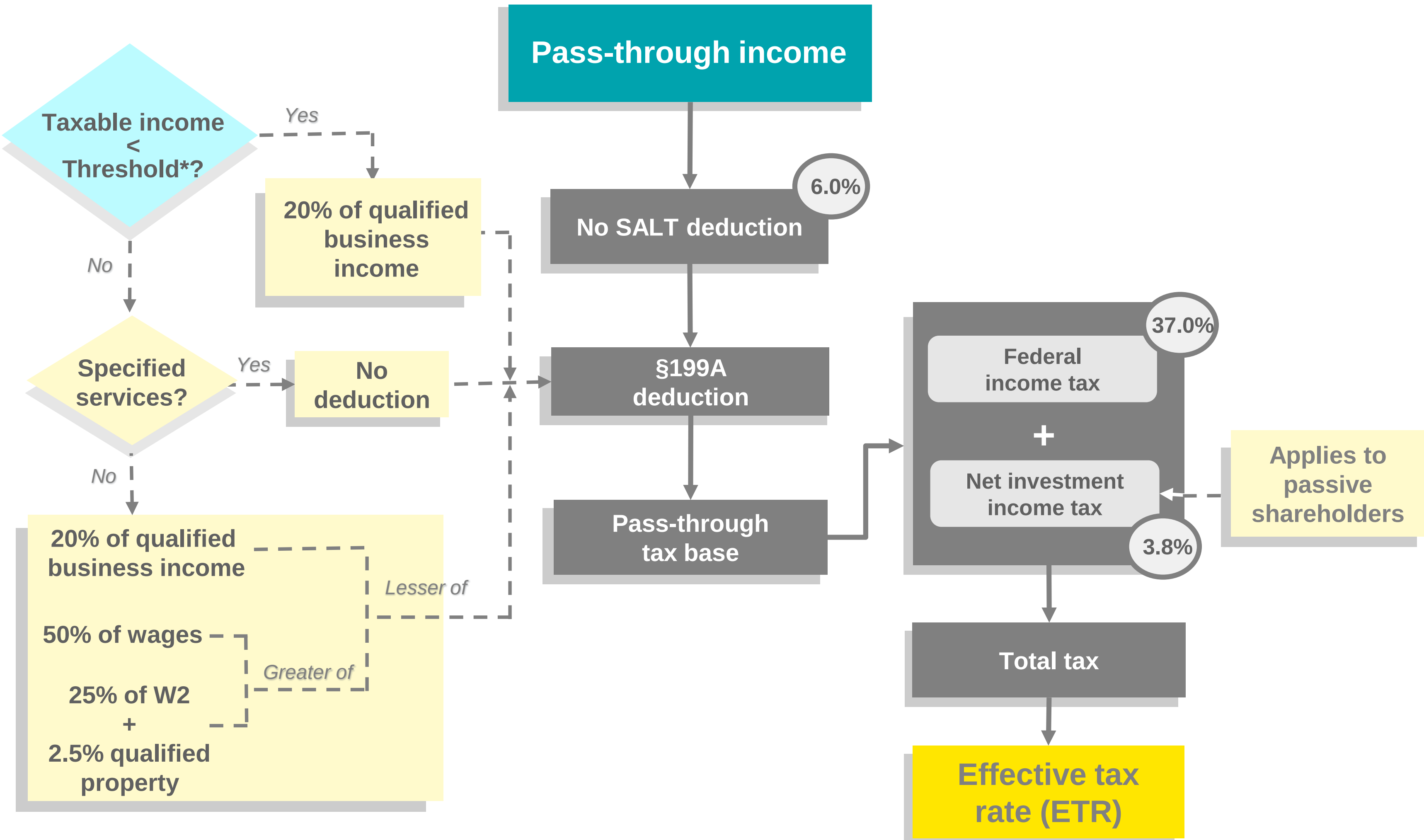
Average C corporation

	2018 law
Taxable income	$9,400
Entity-level tax	
Federal corporate income tax (21.0%)	$1,974
After-tax income	**$7,426**
Shareholder-level tax	
Tax on dividends	
Taxable income	$1,996
Federal income tax (23.8%)	$475
Tax on capital gains	
Taxable income	$2,541
Federal income tax (16.9%)*	$430
Total tax	**$2,879**
Effective tax rate (ETR)	**30.6%**

*Statutory capital gains tax rates are adjusted to account for the benefit of tax deferral (assuming a seven year holding period).

Note: Example assumes that 44% of corporate earnings are distributed to shareholders as dividends and the remaining 56% of corporate earnings are retained and eventually taxed as capital gains upon disposition. It is also assumed that 38.9% of C corporation shareholders are nontaxable. A C corporation with taxable income of $9,400 is comparable to a S corporation with $10,000 of pass-through income that includes $600 of disallowed state and local taxes (assuming a 6% average state corporate income tax rate). ETR calculated with income prior to federal taxes.

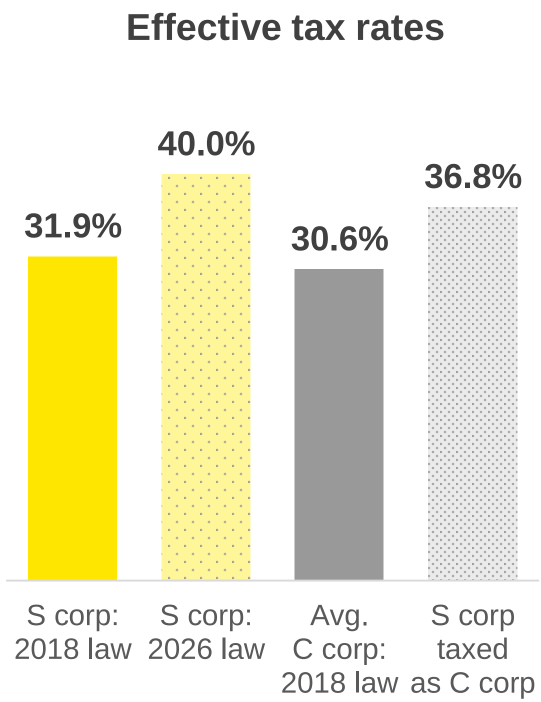
Overview of S corporation tax calculation



*The threshold is $157,500 for single and $315,000 for married filing jointly. The phase-in is not shown in the flow chart.

Example 1. Domestic S corporation that receives full 20% deduction

	2018 law	2026 law
Pass-through income*	$9,400	$9,400
Plus: SALT deduction	$600	$0
Pass-through income excl. §199A	**$10,000**	**$9,400**
Less: §199A deduction	-$2,000	$0
Taxable income	**$8,000**	**$9,400**
Non-passive shareholders (% of total)	90%	90%
Federal individual income tax rate (active)	37.0%	39.6%
Federal individual income tax rate (passive)	40.8%	43.4%
Federal individual income tax rate (weighted)	**37.5%**	**40.0%**
Federal income tax liability	**$2,998**	**$3,758**
Total tax liability	**$2,998**	**$3,758**
Effective tax rate (ETR)	**31.9%**	**40.0%**



*Pass-through income includes the SALT deduction and excludes the §199A deduction.
Note: *S corp taxed as C corp* is identical to *Avg. C corporation* except it has 100% taxable shareholders. ETR calculated with income prior to federal taxes.

Example 2. Domestic retailer with common paymaster system (Aggregation)

Entities A, B, C

Pass-through income excl. §199A	**$10,000**
QBI (100%)	**$10,000**
Qualified W2 wages	**$5,000**
Depreciable assets	**$15,000**

$2,500 (*50% of wages*) > Greater of $1,625 (*25% of W2 + 2.5% qualified property*) → $2,500

$2,000 (*20% of QBI*) < Lesser of $2,500 → **$2,000**

§199A deduction

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Entity A
Common paymaster

Pass-through income excl. §199A	**$3,333**
QBI (100%)	**$3,333**
Qualified W2 wages	**$5,000**
Depreciable assets	**$5,000**

$2,500 (*50% of wages*) > Greater of $1,375 (*25% of W2 + 2.5% qualified property*) → $2,500

$667 (*20% of QBI*) < Lesser of $2,500 → **$667**

§199A deduction

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Entities B, C
Retailers

Pass-through income excl. §199A	**$3,333**
QBI (100%)	**$3,333**
Qualified W2 wages	**$0**
Depreciable assets	**$5,000**

$0 (*50% of wages*) < Greater of $125 (*25% of W2 + 2.5% qualified property*) → $125

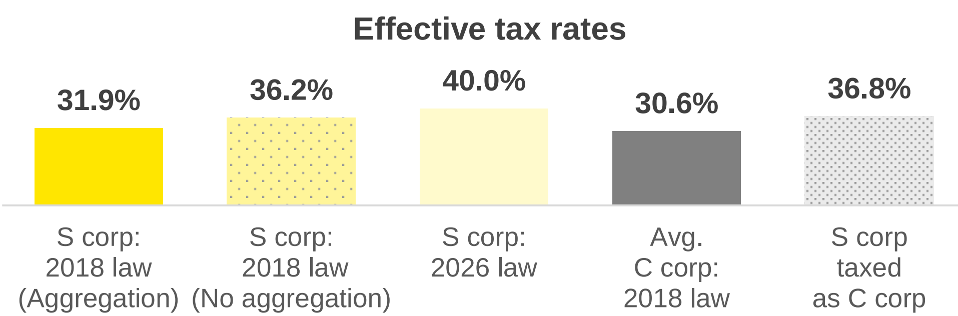
$667 (*20% of QBI*) > Lesser of $125 → **$125** ***x 2***

§199A deduction

Total loss of §199A deduction → ***54%***

Example 2. Domestic retailer with common paymaster system (Aggregation)

	2018 law, Aggregate	2018 law, Entity A	2018 law, Entities B, C	2026 law, Aggregate
Pass-through income*	$9,400	$3,133	$3,133	$9,400
Plus: SALT deduction	$600	$200	$200	$0
Pass-through income excl. §199A	**$10,000**	**$3,333**	**$3,333**	**$9,400**
Less: §199A deduction	-$2,000	-$667	-$125	$0
Taxable income	**$8,000**	**$2,667**	**$3,208**	**$9,400**
Non-passive shareholders (% of total)	90%	90%	90%	90%
Federal individual income tax rate (active)	37.0%	37.0%	37.0%	39.6%
Federal individual income tax rate (passive)	40.8%	40.8%	40.8%	43.4%
Federal individual income tax rate (weighted)	**37.5%**	**37.5%**	**37.4%**	**40.0%**
Federal income tax liability	**$2,998**	**$999**	**$1,200**	**$3,758**
Total tax liability	**$2,998**	**$999**	**$1,200**	**$3,758**
Effective tax rate (ETR)	**31.9%**	**31.9%**	**38.3%**	**40.0%**



36.2% **Combined ETR**

*Pass-through income includes the SALT deduction and excludes the §199A deduction.
Note: *S corp taxed as C corp* is identical to *Avg. C corporation* except it has 100% taxable shareholders. ETR calculated with income prior to federal taxes.
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Example 3. Domestic manufacturer with a brother-sister operation (Aggregation)

Entities A, B

Pass-through income excl. §199A	**$10,000**
QBI (100%)	**$10,000**
Qualified W2 wages	**$5,000**
Depreciable assets	**$15,000**

$2,500 (50% of wages) > $1,625 (25% of W2 + 2.5% qualified property) — Greater of: $2,500

$2,000 (20% of QBI) < $2,500 — Lesser of: **$2,000**

§199A deduction: **$2,000**

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Entity A
Real estate

Pass-through income excl. §199A	**$5,000**
QBI (100%)	**$5,000**
Qualified W2 wages	**$500**
Depreciable assets	**$13,500**

$250 (50% of wages) < $463 (25% of W2 + 2.5% qualified property) — Greater of: $463

$1,000 (20% of QBI) > $463 — Lesser of: **$463**

§199A deduction: **$463**

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Entity B
Manufacturer

Pass-through income excl. §199A	**$5,000**
QBI (100%)	**$5,000**
Qualified W2 wages	**$4,500**
Depreciable assets	**$1,500**

$2,250 (50% of wages) > $1,163 (25% of W2 + 2.5% qualified property) — Greater of: $2,250

$1,000 (20% of QBI) < $2,250 — Lesser of: **$1,000**

§199A deduction: **$1,000**

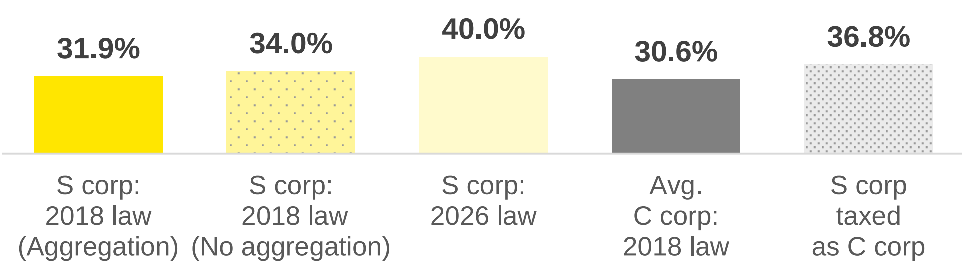
Total loss of §199A deduction → ***27%***

Example 3. Domestic manufacturer with a brother-sister operation (Aggregation)

	2018 law, Aggregate	2018 law, Entity A	2018 law, Entity B	2026 law, Aggregate
Pass-through income*	$9,400	$4,700	$4,700	$9,400
Plus: SALT deduction	$600	$300	$300	$0
Pass-through income excl. §199A	**$10,000**	**$5,000**	**$5,000**	**$9,400**
Less: §199A deduction	-$2,000	-$463	-$1,000	$0
Taxable income	**$8,000**	**$4,538**	**$4,000**	**$9,400**
Non-passive shareholders (% of total)	90%	90%	90%	90%
Federal individual income tax rate (active)	37.0%	37.0%	37.0%	39.6%
Federal individual income tax rate (passive)	40.8%	40.8%	40.8%	43.4%
Federal individual income tax rate (weighted)	**37.5%**	**37.4%**	**37.5%**	**40.0%**
Federal income tax liability	**$2,998**	**$1,698**	**$1,499**	**$3,758**
Total tax liability	**$2,998**	**$1,698**	**$1,499**	**$3,758**
Effective tax rate (ETR)	**31.9%**	**36.1%**	**31.9%**	**40.0%**

34.0% Combined ETR

Effective tax rates



*Pass-through income includes the SALT deduction and excludes the §199A deduction.
Note: *S corp taxed as C corp* is identical to *Avg. C corporation* except it has 100% taxable shareholders. ETR calculated with income prior to federal taxes.
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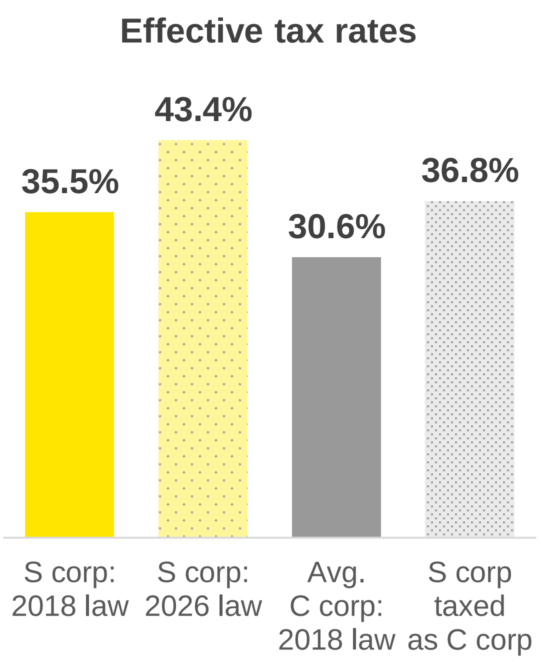
Example 4. Domestic S corporation where 100% of its shareholders are passive

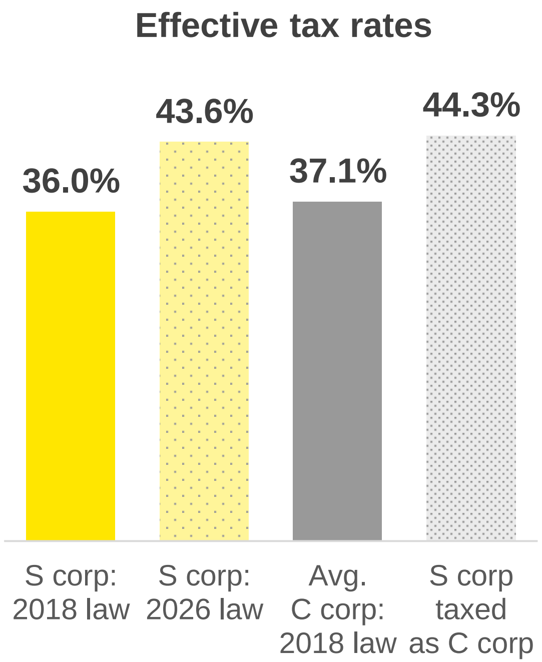
	2018 law	2026 law
Pass-through income*	$9,400	$9,400
Plus: SALT deduction	$600	$0
Pass-through income excl. §199A	**$10,000**	**$9,400**
Less: §199A deduction	-$2,000	$0
Taxable income	**$8,000**	**$9,400**
Non-passive shareholders (% of total)	0%	0%
Federal individual income tax rate (active)	37.0%	39.6%
Federal individual income tax rate (passive)	40.8%	43.4%
Federal individual income tax rate (weighted)	**41.8%**	**43.4%**
Federal income tax liability	**$3,340**	**$4,080**
Total tax liability	**$3,340**	**$4,080**
Effective tax rate (ETR)	**35.5%**	**43.4%**



*Pass-through income includes the SALT deduction and excludes the §199A deduction.
Note: *S corp taxed as C corp* is identical to *Avg. C corporation* except it has 100% taxable shareholders. ETR calculated with income prior to federal taxes.

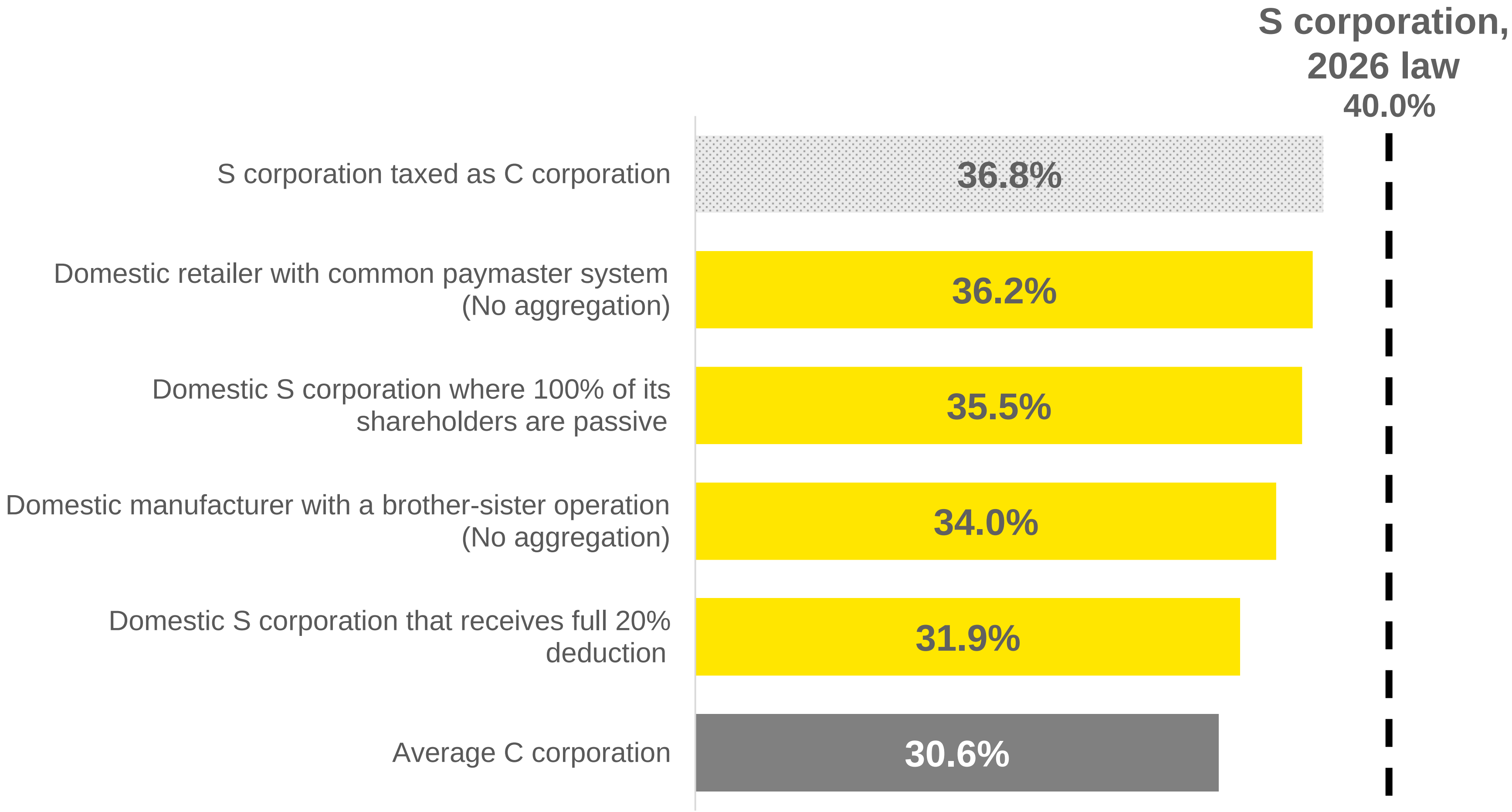
Example 5. Illustrative C and S corporations including state income tax

	2018 law	2026 law
Pass-through income*	$9,400	$9,400
Plus: SALT deduction	$600	$0
Pass-through income excl. §199A	**$10,000**	**$9,400**
Less: §199A deduction	-$2,000	$0
Taxable income	**$8,000**	**$9,400**
Non-passive shareholders (% of total)	90%	90%
Federal individual income tax rate (active)	37.0%	39.6%
Federal individual income tax rate (passive)	40.8%	43.4%
Federal individual income tax rate (weighted)	**37.5%**	**40.0%**
Federal income tax liability	**$2,998**	**$3,758**
State and local tax rate	6.0%	6.0%
State and local tax liability	**$600**	**$600**
Total tax liability	**$3,598**	**$4,358**
Effective tax rate (ETR)	**36.0%**	**43.6%**



*Pass-through income includes the SALT deduction and excludes the §199A deduction.
Note: *S corp taxed as C corp* is identical to *Avg. C corporation* except it has 100% taxable shareholders. ETR calculated with income prior to federal and state taxes.

Effective tax rate comparison, 2018 law



Note: *S corporation taxed as C corporation* is identical to *Average C corporation* except it has 100% taxable shareholders. *S corporation, 2026 law* is assumed to have 10% passive and 90% non-passive shareholders.

Appendix. Key assumptions

This presentation analyzes the federal income tax liability and the resultant effective tax rates for stylized examples of C and S corporations to illustrate key issues in their tax treatment. Although various assumptions might be listed, the following are particularly noteworthy:

- **Federal income tax rate.** The examples assume that income is subject to the top marginal income tax rate plus, when applicable, the 3.8% Medicare surtax on investment income.
- **State and local income tax rate.** The examples assume that the state and local income tax rate applicable at the individual level is 6.0%. This is based on a weighted average of top state individual income tax rates (weighted by total partnership and S corporation income). Data on S corporation income by state is not available from the Internal Revenue Service. Additionally, it is assumed in the examples that, for years in which the state and local tax deduction is capped, all income is after individuals have reached this cap (i.e., from real estate taxes, taxes on other income, etc).
- **Nontaxable shareholders.** Following a recent CBO analysis, the examples assume that all owners of S corporations are fully taxable and that 38.9% of C corporation shareholders are nontaxable.
- **Dividend payout rate.** The examples follow a recent CBO analysis that estimates that, on average, 44% of corporate earnings are distributed to shareholders as dividends.
- **Average holding period of corporate stock**. An analysis of Internal Revenue Service data indicates that the average holding period of corporate stock is 7 years. This is used to calculate an “accrued capital gains tax rate” that is the present value of the realized capital gains tax from 7 years in the future. That is, the capital gains tax rate is adjusted to reflect the benefit of tax deferral (assuming a 5% discount rate).
- **Passive/non-passive income.** For S corporations the examples assume that (unless otherwise stated) 90% of owners receive non-passive income and 10% of owners receive passive income. This is based on an analysis of Internal Revenue Service data on S corporation income (as reported on Schedule E).

Source: Congressional Budget Office, *Taxing Capital Income: Effective Marginal Tax Rates Under 2014 Law and Selected Policy Options*, December 2014; Internal Revenue Service; Federation of Tax Administrators; and EY analysis.