Relative tax treatment of pass-throughs and C corporations

Prepared for the S Corporation Association

Robert Carroll, Quantitative economics and statistics (QUEST) group

June 6, 2023

EY
Building a better working world

Changes in 2026 present significant challenges for pass-though businesses

Key changes confronting pass-throughs

- Section 199A provision sunsets
- Top individual tax rate reverts to 39.6%
- SALT limitation sunsets
- “Pease” limit on itemized deductions for high income taxpayers returns

Key question: How do these changes affect the relative tax treatment of businesses organized as pass-throughs versus C corporations (parity)

EY

Objectives of study

Analysis builds on 2019 EY report that examined parity by taking a more expansive view of the tax policies affecting entity choice and revisiting key assumptions

Considers parity from several perspectives:

- What is the relative tax treatment between the pass-through versus C corporation form?
- Overall, within the economy, what is the relative taxation of pass-through businesses versus C corporations?
- Does the relative taxation depend on the size of the pass-through business: Large S corporations versus the average pass-through business

EY

Objectives of study (cont.)

Key assumptions revisited or refined:

- Fraction of corporate earnings received by tax-exempt/lightly taxed shareholders
- Fraction of corporate earnings paid as dividends versus retained
- Average holding period for corporate shares
- State pass-through entity (PTE) elections impact on the SALT cap
- Fraction of pass-through income that qualifies for Section 199A

EY

How parity is assessed

Evaluate relative tax treatment of pass-throughs and C corporations using two tax rate measures:

Effective tax rates (ETRs)

- Average tax rate for hypothetical business earnings received through a pass-through business and a C corporation; useful for comparing the relative burden on existing operations
- Plans, including choice of organizational form, often based on overall average taxes based on existing rules and changes can have significant impacts

Marginal effective tax rates (METRs)

- Measures taxes on the additional increment of income from a new breakeven investment
- Forward-looking measure that reflects the burden of taxes on a new investment; is a measure of the impact of the tax system on the incentive to undertake a new investment
- Include METRs for a business choosing between the pass-through versus C corporation business form and METRs that reflect the overall burden of taxation on the pass-through and C corporation business sectors

Compare tax rates under TCJA law in 2019 to those in 2026; also report tax rates under pre-TCJA law in 2016.

Key assumptions

Fraction of corporate earnings that is tax-exempt	Consider three scenarios: 1) All shareholders are fully taxable (e.g., a closely-held business) 2) 38% of corporate shareholders are tax-exempt (based on Congressional Budget Office (CBO) analysis*) 3) 75% of corporate shareholders are tax-exempt (based on Tax Policy Center (TPC) analysis*)
Fraction of corporate earnings paid as dividends versus retained	Assume that 62% paid out as dividends with remaining 38% retained and taxed as capital gains when realized (based on Department of Commerce data)
Average holding period for corporate assets	Assumed held for 8.5 years and discounted at a 5% rate, which implies the value of deferral reduces the effective capital gains tax rate by one-third
State pass-through entity (PTE) elections	Enactment of state PTE taxes are assumed to reduce the impact of the SALT cap by 50%
Fraction of pass-through income qualifying for Section 199A deduction	60% of pass-through income is assumed to qualify for the Section 199A deduction (consistent with US Treasury analysis)

* Congressional Budget Office, CapTax Model (GitHub - US-CBO/captax); Steve Rosenthal and Lydia Austin, "The Dwindling Taxable Share of U.S. Corporate Stock," *Tax Notes* Vol. 151, no. 6 , May 16, 2016; EY analysis.

EY

Comparison of simple effective tax rates

- Tax treatment of corporate shareholders matters:
  - In 2026, rough parity between pass-throughs and C corporations if corporate shareholders are fully taxable.
  - Large S corporations disadvantaged somewhat before 2026, but especially after the sunsets in 2026.
  - As the fraction of tax-exempt corporate shareholders rises, pass-through business fare relatively less well, especially under the TPC assumption.

Effective tax rates	Pre-TCJA (2016)	Post-TCJA (2019)	Post-TCJA (2026)
Large S corporations	41.2%	34.0%	41.2%
Pass-through businesses	32.9%	27.4%	32.9%
C corporations:			
Closely-held, fully taxable shareholders	43.7%	32.0%	31.6%
38% of corporate shareholders nontaxable (CBO)	42.5%	30.5%	30.1%
75% of corporate shareholders nontaxable (TPC)	38.0%	24.8%	24.7%

Note: Effective tax rates are for hypothetical business earnings received through an S corporation, pass-through business, and a C corporation. The ETR for the C corporation reflects both the corporate income tax and investor level shareholder taxes.

Source: EY analysis.

- What is the question: Is there parity for a business choosing between business forms? How do businesses in the pass-through sector generally compare to those in the C corporate sector? Do the results vary by ownership structure or industry?

EY

Comparison of marginal effective tax rates

- S corporations/pass-throughs versus fully taxable corporate shareholders reflects a business choosing between business forms.
- Tax advantage associated with S corporation / pass-through forms relative to a C corporation with fully taxable shareholders.
- Economy-wide, parity depends, in part, on the degree to which shareholders are tax-exempt:
  - Under the TPC assumption that 75% of corporate shareholders are tax exempt, pass-through business are disadvantaged.
  - And, large S corporations are very disadvantaged.

Economy-wide METRs	Pre-TCJA (2016)	Post-TCJA (2019)	Post-TCJA (2026)
Large S corporations	21.4%	14.6%	25.1%
Pass-through businesses	18.1%	12.8%	21.3%
C corporation: Fully taxable shareholders	37.6%	31.5%	34.7%
C corporation: Partially taxable shareholders:			
38% of corporate shareholders nontaxable (CBO)	28.5%	21.2%	24.9%
75% of corporate shareholders nontaxable (TPC)	19.2%	10.7%	15.0%

Note: The METR estimates reflect bonus depreciation (50% in 2016, 100% in 2019, and 20% in 2026). The economic characteristics of a corporate versus pass-through investment differ in economy-wide METRs. For example, there are different compositions of investment (e.g., share of equipment versus structures versus intangibles) in the corporate versus pass-through sector, as well as differences in the amount of debt versus equity used to fund an investment.

Source: EY analysis.

Appendix: Sunset/sunrise of key tax provisions

Provision	2021	2022	2023	2024	2025	2026	2027
Interest deduction based on EBITDA		EBIT					
R&D expensing		Five-year amortization					
Some tax extenders							
100% expensing			Phased down in 20% increments				
GILTI deduction at 50%						37.5%	
FDII deduction at 37.5%						21.875%	
BEAT rate: 10%/11% for banks/dealers						12.5%/13.5%	
TCJA individual rate cuts, other provisions							
20% pass-through deduction							
Cap on SALT deduction							
Tax extenders: CFC look-through rule, Work Opportunity Tax Credit (WOTC)							

In effect   Not in effect

EY