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The Spurious Allure of Pass-Through Parity

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In 2017, Congress reduced tax rates on both corporate and noncorporate income. The drafters invoked the concept of pass-through parity to justify lower rates on noncorporate business income, resulting in a new and highly controversial deduction for pass-through owners under § 199A. The concept of pass-through parity conflates equitable treatment of different entity forms with equitable distribution of the ultimate tax burden among labor and capital. The flawed rationale for § 199A may be viewed as an attempt to preserve the pre-2017 preference for pass-through income; conceptually, the advantage of lower corporate rates is limited to the availability of a higher after-tax rate of return on reinvested corporate earnings, obviating concerns about mass conversions. Despite the stated goal of distinguishing labor income from capital income in noncorporate businesses, the purported guardrails under § 199A provide a substantial subsidy for active pass-through owners by offering a lower tax rate on commingled labor and capital returns. Notwithstanding the rhetoric of parity, the reduced corporate tax rate seems unlikely to significantly alter the choice of organizational form, at least in the near term, given the inherent instability of the 2017 legislation. More significantly, the altered rate structure enhances the ability of owners of close corporations and pass-through businesses to recharacterize labor income as capital income and to avoid employment taxes. The pass-through deduction benefits primarily high-income owner-managers and undermines the equity and efficiency of the tax system. In light of growing concern over inequality and unsustainable deficits, the case for outright repeal of § 199A is even more urgent.

I. INTRODUCTION

In the 2017 Act, Congress radically reduced the tax rates on both corporate and noncorporate business income.[1] Following the 1986 Act, the pass-through sector (partnerships, S corporations, and sole proprietorships) dramatically increased their share of business income, greatly complicating any fundamental reform of the U.S. corporate tax system.[2] During the hasty 2017 legislative process, noncorporate businesses demanded a lower rate on pass-through business income—taxed at the individual level—to compensate for the 21% corporate rate.[3] The compromise, § 199A, provides a 20% deduction for qualifying business income earned by individual pass-through owners.[4] Just as the corporate rate reduction was widely promoted as improving the international competitiveness of U.S. corporations, § 199A was justified in terms of maintaining tax parity between corporate and noncorporate businesses.[5] Nevertheless, the concept of pass-through parity has proven

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1. *See* Tax Cuts and Jobs Act, Pub. L. No. 115–97, § 11011(a), 131 Stat. 2054, 2063 (2017) (adding the pass-through deduction for qualified business income).

2. By temporarily inverting the corporate and individual rates, the 1986 Tax Reform Act helped to fuel the rise of pass-throughs. *See* George A. Plesko & Eric J. Toder, *Changes in the Organization of Business Activity and Implications for Tax Reform*, 66 NAT'L TAX J. 855, 856–57 (2013) (explaining that provisions in the 1986 Tax Reform Act had, prior to 2017, increased incentives for businesses to be taxed as pass-throughs rather than as C corporations subject to a higher tax burden).

3. *See* Daniel Shaviro, *Evaluating the New US Pass-Through Rules*, 2018 BRIT. TAX REV. 49, 49–50 (2018) (noting the pivotal role of Senators Johnson and Corker, both active business owners who stood to benefit significantly from the pass-through deduction).

4. I.R.C. § 199A. The deduction effectively reduces the top individual rate from 37% to 29.6% (80% × 37%) for eligible pass-through owners.

5. *See* STAFF OF JOINT COMM. ON TAX'N, 115TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 115–97, at 20 (Comm. Print 2018) ("The provision [§ 199A] reflects Congress's belief

singularly devoid of meaning, while the § 199A deduction offers high-income owner-managers a fertile field for shifting income and avoiding employment taxes.[6]

This Article explores the likely effects of § 199A on the choice of business form, particularly the relative tax efficiency of different pass-through types. Contrary to the oft-repeated claim that § 199A was needed to prevent noncorporate entities from converting to corporate form,[7] Part II suggests that § 199A represented pass-through owners' attempt to preserve the pre-2017 pass-through preference, notwithstanding the altered rate structure. Part III considers the illusory nature of § 199A's constraints on the 20% deduction for primarily service businesses,[8] coupled with a lack of any restrictions under § 199A on income derived from publicly traded partnerships and real estate investment trusts. Part IV maintains that the traditional benefits of operating in partnership form—including the ease of stepping up inside basis with only a single level of tax—are likely to outweigh the advantage of the 21% rate when a C corporation accumulates and eventually distributes income. Part V addresses active owner-managers' ability to use close corporations and pass-throughs to avoid employment taxes by recharacterizing labor income as capital income. The Article concludes that progressive tax reform should include repeal of § 199A and closing of employment tax gaps.

that . . . treating corporate and noncorporate business income more similarly . . . under the Federal income tax requires distinguishing labor income from capital income in a noncorporate business.") [hereinafter JCT, GENERAL EXPLANATION]; H.R. REP. NO. 115-409, at 129 (2017); S. COMM. ON THE BUDGET, 115TH CONG., RECONCILIATION RECOMMENDATIONS PURSUANT TO H. CON. RES. 71, at 19 (Comm. Print 2017) (describing reasons for reducing the corporate income tax rate). The Conference Report incorporates the sparse legislative history for § 199A. H.R. REP. NO. 115-466, at 205–24 (2017) [hereinafter CONFERENCE REPORT]; *but see* Jane G. Gravelle, *Does the Concept of Competitiveness Have Meaning in Formulating Corporate Tax Policy?*, 65 TAX L. REV. 323, 323 (2012) ("[I]nternational competitiveness . . . is a concept that is almost always simply asserted and virtually nowhere defined.").

6. For an early assessment, *see* David Kamin et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. 1439, 1459 (2019) (describing § 199A as "the most notorious change" of the 2017 tax legislation); *see generally* Ari Glogower & David Kamin, *The Progressivity Ratchet*, 104 MINN. L. REV. 1499 (2020) (highlighting constraints the Act imposes on policymakers and its impact on future tax reform).

7. For a critique of this view, see generally Michael S. Knoll, *The TCJA and the Questionable Incentive to Incorporate*, 162 TAX NOTES 977 (2019) [hereinafter Knoll I]; Michael S. Knoll, *The TCJA and the Questionable Incentive to Incorporate, Part* 2, 162 TAX NOTES 1447 (2019) [hereinafter Knoll II]. For a response to Knoll, *see generally* Ari Glogower & David Kamin, *Sheltering Income Through a Corporation*, 164 TAX NOTES 507 (2019) (questioning whether current tax law creates a level playing field for corporate and pass-through entities).

8. Under § 199A, income of a business engaged in law, health, accounting, consulting, performing arts, or other professional services, or whose principal asset is the reputation or skill of one or more of its owners or employees, generally does not qualify for the deduction. I.R.C. §§ 199A(d)(2), 1202(e)(3)(A).

II. PASS-THROUGH PARITY—A MEANINGLESS CONCEPT

A. *Flawed Rationale for § 199A*

Although the House and Senate versions of § 199A diverged, the end results were remarkably similar. The House adopted a formulary approach—a 30% safe-harbor exclusion for the deemed "capital" component—for mixed returns from labor and capital when pass-through owner-managers actively participate in the business.[9] The House's 30% exclusion morphed into the Senate's 20% deduction for pass-through business income for both active and passive owners. Under the House version, active owner-managers would have been taxed at a higher blended rate than passive owners.[10] Given the near revolt by pass-through stakeholders, the House version was never a serious contender as a reform proposal.[11] By contrast, the Senate version allowed high-income active owner-managers to reduce their entire business income (including labor returns) by the full pass-through deduction of 20%, reducing their effective individual rate to 29.6%.

The legislative history of the 2017 Act is remarkably devoid of any serious explanation of what the drafters believed constituted tax parity between corporate and noncorporate businesses. The notion that Congress's action reflects the flawed implementation of a "neutrality principle" misses the mark.[12] It obscures the underlying reality that lobbying efforts leading up to § 199A were activated mainly by a desire to maintain (and potentially expand) the existing rate preference for pass-through income over corporate income. While supporters claimed that the § 199A deduction was needed to maintain the "competitive" position of pass-through businesses vis-à-vis large multinational businesses,[13] only a handful of large pass-through entities even plausibly compete with

9. CONFERENCE REPORT, *supra* note 5, at 212–13 (setting the capital percentage at 30% for active businesses). Qualified business income was defined as 100% of income from any passive business activity plus the capital percentage of net business income from any active business activity. *Id.* at 209–10.

10. Under the House version, passive pass-through business income was taxed at a maximum rate of 25% but active pass-through business income was taxed at a higher blended rate of 35.22% (70% × 39.6%) + (30% × 25%). CONFERENCE REPORT, *supra* note 5, at 212. The Senate version reduced the pre-2017 top individual rate from 39.6% to 37%.

11. The House bill was perceived as doing "little or nothing for active business owners." C. Wells Hall III, *New Code Sec. 199A and the Configurations of Qualified Business Income: Leveling the Playing Field for Pass-Thru Entities After the C Corporation Rate Cut*, J. PASSTHROUGH ENTITIES 45, 46 (2018).

12. Glogower & Kamin, *supra* note 6, at 1507 ("[T]he corporate rate reduction and Section 199A both reflect a similar mistake: Congress's failure to properly apply the neutrality principle.").

13. *See* SCOTT GREENBERG & NICOLE KAEDING, FISCAL FACT NO. 593: REFORMING THE PASS-THROUGH DEDUCTION 2 (Tax Found., 2018) ("Supporters of the [§ 199A] deduction argue that it . . . helps put the pass-through sector on an equal footing with the largest multinational corporations.").

multinational corporations.[14] Instead, a targeted special rate (or equivalent deduction) for pass-through business income emerged as an alternative to an individual tax rate cut that was prohibitively expensive in terms of revenue loss.[15] Despite attempts to justify the provision in terms of creating a "level tax playing field between the different kinds of entities,"[16] § 199A was always a political, not an economic, necessity.[17]

B. Preserving Pass-Through Preference

Prior to the 2017 Act, pass-through income was generally taxed more lightly than corporate income.[18] Indeed, following the 1986 tax legislation, the preferred treatment of pass-through income accounted for the dramatic rise of pass-throughs and precipitous decline of C corporations.[19] The following table illustrates the relative pass-through preference immediately before and after the 2017 Act.

14. *See* Michael J. Graetz, *Foreword—The 2017 Tax Cuts: How Polarized Politics Produced Precarious Policy*, 128 YALE L.J.F. 315, 334 (2018) (noting that many larger businesses also clearly qualified for the deduction).

15. Although the temporary individual tax cuts generally expire in 2026, § 199A permanently cut tax rates for pass-through owners in the top 1%. *See* Michael Cooper et al., *Business in the United States: Who Owns It, and How Much Tax Do They Pay?*, 30 TAX POL'Y & ECON. 91, 94 (2016) ("Overall, 69% of pass-through income earned by individuals accrues to the top 1%.").

16. Glogower & Kamin, *supra* note 6, at 1523 (quoting former Congressional Budget Office Director Douglas Holtz-Eakin).

17. Pass-throughs could simply have checked-the-box to be treated as corporations. *See* Michael L. Schler, *Reflections on the Pending Tax Cuts and Jobs Act*, 157 TAX NOTES 1731, 1735–36 (2017).

18. *See* Plesko & Toder, *supra* note 2, at 868–69 (predicting that a corporate rate reduction below the individual tax rate would reverse the organizational choices following the 1986 Act).

19. *Id.* at 861 (noting that the share of net business income attributable to C corporations declined from 70% in 1986 to 40% in 2008).

Top Statutory Rates in 2017 and 2018
Full Distribution

	2017		2018			
	C Corp. (1)	Pass-through (2)	C Corp. (3)	Pass-through (no § 199A) (4)	Pass-through (§ 199A) (5)	Pass-through (§ 199A) (no 3.8% tax) (6)
Entity-Level Tax	35%	0%	21%	0%	0%	0%
Individual Tax	20%	39.6%	20%	37%	29.6%	29.6%
NIIT	3.8%	3.8%	3.8%	3.8%	3.8%	
Net Tax Rate	**50.5%**	**43.4%**	**39.8%**	**40.8%**	**33.4%**	**29.6%**
Rate Differential		7.1%		−1%	6.4%	10.2%

In 2017, corporate income was subject to a top 35% rate at the entity level, and dividends were subject to a top 23.8% tax in the shareholder's hands. If a corporation distributed all of its earnings currently as dividends ("full distribution"), the net double tax burden was 50.5%, compared to a maximum pass-through tax burden of 43.4%.[20] Thus, the benefit of pass-through taxation was a 7.1 percentage point reduction in the effective federal tax rate.

In the case of full distribution, the 2017 Act reduces the combined corporate-shareholder rate to 39.8%, which represents a 10.7 percentage point reduction in the overall corporate tax burden (50.5% versus 39.8%).[21] Notwithstanding this dramatic reduction in the double-tax burden, the 2017 Act also reduces the tax burden on pass-through income (assuming § 199A is fully available) to 33.4%, or 6.4 percentage points below the combined corporate-shareholder rate.[22] The slight reduction (0.7%) in the preference for pass-through income in comparison to corporate income (from 7.1% to 6.4%) seems unlikely to spur a mass

20. *Compare* col. (1) *and* (2). The combined corporate-shareholder rate (50.5%) equals 35% plus 23.8% × (1 − 35%).
21. *See* col. (3). The combined corporate-shareholder rate (39.8%) equals 21% plus 23.8% × (1 − 21%).
22. *See* col. (5).

exodus from pass-throughs.[23] If a corporation expects to distribute dividends, the double tax continues to impose a significant burden on corporate income.[24]

For high-income active owner-managers, pass-throughs offer yet another advantage over C corporations—namely, the ability to avoid the 3.8% net investment income tax (NIIT) under § 1411, while also avoiding the parallel 3.8% Medicare tax on wages (FICA) and self-employment income (SECA).[25] S corporation active owner-managers can (and notoriously do) minimize their employment tax liabilities by paying themselves low (or no) salaries, thereby increasing net business income that is passed through unburdened by FICA taxes.[26] While pass-through income earned by general partners is generally treated as self-employment income, limited partners are exempt from SECA taxes but are subject to the § 1411 tax on passive income.[27] Nevertheless, active owner-managers who own both a general and limited partnership interests routinely claim that the "limited partner exception" allows them to exclude up to 99% of their distributive share from SECA taxes; their entire distributive share is exempt from the NIIT because they are active in the business.[28] When § 199A applies and the NIIT does not, the pass-through advantage for high-income owner-managers is 10.2 percentage points (29.6% versus 39.8%).[29]

23. *Compare* col. (2) *and* (5).

24. *See Projecting the Mass Conversion from Pass-Through Entities to C-Corporations*, UNIV. PA.: PENN WHARTON BUDGET MODEL, http://budgetmodel.wharton.upenn.edu/issues/2018/6/12/projecting-the-mass-conversion-from-pass-through-entities-to-c-corporations [https://perma.cc/772N-MGMU] (June 13, 2018) [hereinafter PENN WHARTON BUDGET MODEL] (illustrating that between 1959 and 2015, the average dividend payout rate was 52%).

25. The NIIT base does not include FICA wages and self-employment income taken into account under SECA. *See generally* Karen C. Burke, *Exploiting the Medicare Tax Loophole*, 21 FLA. TAX REV. 570 (2018) (discussing gaps in the three taxes). The NIIT generally applies only to income and gain from a trade or business that is a passive activity with respect to the taxpayer (within the meaning of I.R.C. § 469) or a trade or business consisting of trading financial instruments or commodities (a "Financial Trading Business") (as defined in I.R.C. § 475(e)(2)). I.R.C. § 1411(c)(1)(A)(i)–(ii), (c)(2).

26. *See* Rev. Rul. 59-221, 1959-1 C.B. 225 (ruling that, because S shareholders do not carry on a trade or business directly, their distributive shares are not included in self-employment income); *see also* OFF. OF TAX ANALYSIS, U.S. DEP'T OF THE TREASURY, GAPS BETWEEN THE NET INVESTMENT INCOME TAX BASE AND THE EMPLOYMENT TAX BASE 2 (2016) (finding that 60% of active S income escapes both FICA and the NIIT).

27. I.R.C. § 1402(a)(13). Enacted in 1977, the exception was originally intended to prevent passive limited partners from paying SECA tax on their distributive share in order to qualify for Social Security benefits. *See* David W. Mayo & Rebecca C. Freeland, *Delimiting Limited Partners: Self-Employment Tax of Limited Partners*, 66 TAX LAW. 391, 393 (2013) (describing origins of limited partner exception).

28. Burke, *supra* note 25, at 601 ("The individual investment professionals claim that they owe self-employment taxes only on a distributive share of income attributable to the 1% GP interest . . . [and they] also claim that their fee income is exempt from section 1411 . . . .").

29. *Compare* col. (3) *and* (6).

To a lesser extent, use of the corporate form also provides a Medicare tax saving. First, the portion of pretax earnings used to pay corporate tax is effectively deducted from the Medicare tax base; only the after-corporate-tax retained earnings are subject to the shareholder-level dividend tax.[30] In addition, deferring the Medicare tax on after-tax retained earnings until distribution is essentially equivalent to exempting the investment return on the deferred amount.[31] This deferral benefit is not offset by any compensatory tax, since no Medicare tax is imposed at the corporate level on the deferred amounts. By comparison, active pass-through owners' ability to entirely avoid the 3.8% tax outweighs these two corporate advantages—reduction in the Medicare tax base and yield exemption. When corporate earnings are withdrawn as wages, dividends, or capital gains, the 3.8% tax is unavoidable. Under current law, active pass-through owner-managers taxed at 29.6% enjoy a 10.6 percentage point advantage over other high-income wage earners.[32] Subjecting all pass-through business income to the 3.8% tax (through FICA, SECA, or the NIIT) would reduce the pass-through preference and protect the Medicare tax base.

C. Understanding the Corporate Advantage

The concern about mass conversions to corporate form focuses on the gap between the maximum tax rates on retained corporate income and pass-through income (taxed immediately whether or not distributed). As illustrated below, the gap increased significantly as a result of the 2017 Act.

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30. Under current rates, the effective corporate deduction for the Medicare tax saves 0.8% ($0.21 \times 0.038 = 0.7980$), reducing the Medicare tax burden from 3.8% to 3%.

31. *See* Edward D. Kleinbard, *Corporate Capital and Labor Stuffing in the New Tax Rate Environment* 19 n.35 (USC Gould Sch. of Law, Legal Studies Research Paper Series No. 13-5, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239360 [https://perma.cc/R6AZ-P7SN] ("[The advantage] boils down to earning a tax-free return on the compounding of each year's . . . deferred tax for the period of the deferral.").

32. Since the employer half of the Medicare tax (1.45%) is deductible, the highest marginal tax rate on wages is approximately 40.2% (rather than 40.8%). Kamin et al., *supra* note 6, at 1452–53 n.47.

Top Statutory Rates in 2017 and 2018

Full Retention

	2017		**2018**			
	C Corp. (1)	Pass-through (2)	C Corp. (3)	Pass-through (no § 199A) (4)	Pass-through (§ 199A) (5)	Pass-through (§ 199A) (no 3.8% tax) (6)
Entity-Level Tax	35%	0%	21%	0%	0%	0%
Individual Income Tax	0%	39.6%	0%	37%	29.6%	29.6%
NIIT	0%	3.8%	0%	3.8%	3.8%	0%
Net Tax Rate	**35%**	**43.4%**	**21%**	**40.8%**	**33.4%**	**29.6%**
Rate Differential		−8.4%		−19.8%	−12.4%	−8.6%

Assuming full retention of corporate earnings and no § 199A deduction, the 2017 Act increased the gap between the maximum corporate tax rate and the maximum pass-through tax rate by 11.4 percentage points (from 8.4% to 19.8%).[33] Even after the § 199A deduction, the gap increased by 4 percentage points (from 8.4% to 12.4%).[34] The 2017 Act also increased the stakes for active owner-managers to avoid the 3.8% Medicare/NIIT tax, while maximizing their distributive share of qualified business income eligible for the § 199A deduction. For this significant category of pass-through participants, the gap between the maximum pass-through tax rate and the maximum corporate tax rate is currently 8.6%.[35] On the one hand, reducing the maximum corporate tax rate significantly below the individual income tax rate threatens to tilt the choice of organizational form away from pass-through entities;[36] on the other hand, the widely perceived instability of the 2017 Act militates against this effect.[37]

33. *Compare* col. (2) *and* (4).
34. *Compare* col. (2) *and* (5).
35. *See* col. (6).
36. Plesko & Toder, *supra* note 2, at 869 (noting that an individual tax rate exceeding the corporate income tax rate may reverse organizational choice).
37. *See* Shaviro, *supra* note 3, at 57 (noting the United States' political instability and low public support for the Act).

In the run-up to the 2017 Act, the notion of pass-through parity provided a useful rhetorical gambit to justify lower rates on pass-through income but lacked any rigorous conceptual underpinning. When distributions are deferred, corporate shareholders enjoy a higher after-tax rate of return on reinvested earnings taxed at 21%; the longer the period of deferral, the greater the advantage.[38] The corporate advantage—the ability to retain and reinvest corporate earnings—depends on the relationship between the combined corporate-shareholder tax rate and the maximum individual tax rate. Under current law (ignoring the 3.8% tax), the combined corporate-shareholder tax rate would be identical to the maximum individual rate (37%) if the dividend tax were increased modestly to 20.25% rounded.[39] Corporate earnings of $100 would attract a corporate tax of $21 and the after-corporate-tax distribution ($79) would attract a shareholder-level tax of $16 ($79 × 20.25%), or a total tax of $37 equal to the maximum individual tax on $100 of earnings outside the corporation. Under the 2017 Act, no such rate identity exists because the maximum individual tax burden (37%) slightly exceeds the combined corporate-shareholder tax burden (36.8%), resulting in a "negative tax wedge" of 0.2%.[40]

To understand the corporate advantage, it is helpful to think of corporate income as actually subject to two different tax rates. The return on originally invested capital is subject to a combined corporate-shareholder tax burden of 36.8%, slightly below the individual rate of 37%. By contrast, the return on reinvested earnings is effectively taxed only at the 21% corporate rate and permanently escapes tax at the shareholder level.[41] While the corporate advantage is often framed in terms of deferral, the actual advantage is the ability to earn a higher after-tax rate of return on reinvested earnings (unreduced by the ultimate

38. *See* Daniel Halperin, *Mitigating the Potential Inequity of Reducing Corporate Rates*, 126 TAX NOTES 641, 646–48 (2010) (illustrating advantages of reinvesting lower-taxed earnings in the corporation).

39. The dividend rate (20.25%) equals (37% − 21%) / (1 − 21%). *See* Daniel Halperin, *Corporate Rate Reduction and Fairness to Passthrough Entities*, 147 TAX NOTES 1299, 1300 n.11 (2015) (explaining that the distribution rate (d) equals $(p - c) / (1 - c)$, where p is the personal tax rate and c is the corporate tax rate).

40. Richard Prisinzano & James Pearce, *Tax-Based Switching of Business Income* 4 (Penn Wharton Budget Model, Working Paper No. 2018-2, 2018), https://budgetmodel.wharton.upenn.edu/issues/2018/3/16/w2018-2 [https://perma.cc/6ZA4-6G4V]. The NIIT adds 3% (3.8% × (1 − 21%)) to the combined corporate-shareholder burden (39.8%) and 3.8% to the maximum individual tax (40.8%), producing a negative tax wedge of 1%.

41. Halperin, *supra* note 39, at 1301 ("[T]he accumulated earnings on the reinvestment of [after-tax corporate income] are effectively never subject to individual rates. These earnings are taxed only at the corporate level.").

shareholder-level tax).[42] The shareholder-level tax levied on distribution of the accumulated amounts is equal to the present value of the tax that would be imposed if the original corporate earnings were distributed currently (and the investment return on such earnings remains taxed effectively only at 21%). As a result, the shareholder-level tax on distribution does not compensate for the higher after-tax rate of return on reinvested earnings.

To illustrate, assume that the corporate tax rate is 25%, the dividend tax rate is 25%, and the individual tax rate is 43.75%; all investments earn a 10% pretax return. Under these circumstances, the combined corporate-shareholder tax burden (43.75%) is identical to the individual tax rate.[43] If a pass-through business earned $100 and invested $56.25 after tax ($100 less $43.75 tax), the amount available for distribution would be $62.75 at the end of two years, assuming an after-tax return of 5.625% (10% × (1 − 43.75%)). Alternatively, if a corporate business earned $100 and invested $75 after tax ($100 less $25 tax), the amount available for distribution would be $86.67 at the end of two years, assuming an after-tax return of 7.5% (10% × (1 − 25%)); the corporate accumulation would be subject a 25% dividend tax, leaving the shareholders with $65. The corporate advantage ($2.25) reflects the higher after-tax rate of return on retained earnings undiminished by any shareholder-level tax.[44]

In the example, the initial corporate investment ($75) is higher than the initial pass-through investment ($56.25). Since the combined corporate-shareholder tax burden is $43.75, however, the effective corporate investment is only $56.25 ($100 × (1 − 43.75%)), identical to the pass-through investment.[45] If the pass-through investment earned the same after-tax return (7.5%) as the corporate investment, the pass-through accumulation would be identical to the corporate accumulation ($65) at the end of two years.[46] When the pass-through tax rate is *lower* than the

42. Daniel Halperin, *Choice of Entity—A Conceptual Approach*, 159 TAX NOTES 1601, 1603 (2018) ("[T]he benefit of the corporate form can be described as permanently taxing the return on reinvested earnings at the 21 percent corporate rate whether or not they are later distributed . . . ."); *see also* Daniel Halperin, *2009 Erwin N. Griswold Lecture Before the American College of Tax Counsel: Rethinking the Advantage of Tax Deferral*, 62 TAX LAW. 535, 546 (2009) (explaining that deferral of the distribution results in the shareholder not paying taxes on the interim corporate income).

43. The corporation would pay $25 tax on earnings of $100 and shareholders would pay $18.75 tax on the dividend of $75; the total tax equals $43.75.

44. The $2.25 difference between $62.75 and $65 reflects the advantage of investing $56.25 at the higher return of 7.5% rather than 5.625% ($\$56.25 \times [1.075^2 - 1.05625^2]$).

45. If the shareholder-level tax were imposed immediately on the $100 of corporate earnings, the corporation would be left with $56.25 to invest, the identical amount as the pass-through investment. Nevertheless, the return on the corporate investment will eventually produce a larger accumulation, since it is taxed only at 21%.

46. $\$56.25 \times 1.075^2$ equals $65.

combined corporate-shareholder tax rate—as under current law—the corporate form may be either advantageous or disadvantageous, depending on the pretax rate of return and the deferral period.[47] Under current law, the pass-through investment from $100 of earnings taxed at 29.6% ($70.40) is higher than the effective corporate investment from the identical $100 of earnings ($60.20). Since reinvested corporate earnings are taxed at a lower rate (21%), the corporate accumulation may nevertheless eventually exceed the pass-through accumulation.[48] By contrast, despite the double tax burden, a corporate investment can never fare worse than a noncorporate investment taxed at 40.8%.[49]

If pass-through parity were the goal, a more narrowly tailored solution would be to set the tax rate on reinvested pass-through business income equal to the tax rate on reinvested corporate earnings, rather than allowing an arbitrary 20% deduction for pass-through income.[50] Identifying the return on reinvested capital eligible for the lower rate would undoubtedly prove challenging, since the lower rate should not be available for commingled service income. Leaving aside administrative difficulties, such an approach would address directly the issue of "fairness" to pass-through owners by matching the actual benefit from the lower corporate tax rate, namely, the ability to earn a higher after-tax rate of return on reinvested earnings.[51] Pass-through parity conflates fairness between different entity forms with equitable distribution of the ultimate tax burden among labor and capital.

III. SSTBs, PTPs and REITs

A. Illusory Guardrails for Service Businesses

Despite the purported goal of distinguishing "labor income from capital income in noncorporate businesses,"[52] § 199A clearly falls short

47. Ignoring the 3.8% tax, the corporate form is *never* disadvantageous compared to the 37% individual tax, since the combined corporate-shareholder rate is 36.8%.

48. *See generally* James R. Repetti, *The Impact of the 2017 Act's Tax Rate Changes on Choice of Entity*, 21 FLA. TAX REV. 686 (2018); Calvin H. Johnson, *Choice of Entity by Reason of Tax Rates*, 158 TAX NOTES 1641 (2018).

49. *See* col. (4) (assuming a 37% maximum individual rate plus a 3.8% NIIT). The effective corporate investment ($60.20) exceeds the effective pass-through investment ($59.20), and the corporation earns a higher after-tax rate of return on the larger investment.

50. Halperin, *supra* note 39, at 1300 ("[W]e can provide equivalent treatment to pass-throughs if we can identify earnings from the reinvestment of business profits and . . . limit the tax rate on these earnings to no more than the corporate rate.").

51. *Id.* ("[R]ecognizing the actual benefit of reducing corporate rates . . . suggests another possible approach to fairness to pass-throughs.")

52. *See* JCT, GENERAL EXPLANATION, *supra* note 5, at 20 ("[W]hile the corporate tax is a tax on capital income, the tax on income from noncorporate businesses may fall on both labor income and capital income.").

of this goal. The 2017 Act provides a subsidy for most active pass-through owner-managers by taxing mixed labor and capital returns at 29.6%, while disallowing the 20% pass-through deduction in the case of a specified service trade or business (SSTB).[53] The SSTB exclusion was purportedly intended to provide a "guardrail" in the case of labor-intensive businesses.[54] Assuming the SSTB restriction is fully applicable, pass-through business income may be classified based on whether such income is derived from a "tainted" service business and whether the owner is active or passive, as shown below.

	Individual Income Tax	**NIIT**	**Combined Federal Tax**
Pass-through SSTB active owner	37%	0%	37%
Pass-through non-SSTB active owner	29.6%	0%	29.6%
Pass-through non-SSTB passive owner	29.6%	3.8%	33.4%

A maximum 37% rate applies when pass-through income of an SSTB is ineligible for the 20% deduction, encouraging SSTBs to switch to corporate form.[55] Below the taxable income threshold, § 199A allows a deduction equal to 20% of qualified business income (QBI) even if the business is an SSTB, reducing the incentive to incorporate.[56] Above the taxable income threshold, conversion provides access to the opportunity to reinvest earnings at the lower corporate rate, undercutting the supposed rationale for the guardrails. Corporate conversions are likely to be most attractive when the SSTB or other § 199A constraints—including the wage limit and wage-and-property limit—are binding.[57] However, the

53. I.R.C. § 199A(d)(2) (defining SSTB).

54. *See* Shaviro, *supra* note 3, at 51 n.19 ("[T]he guardrails may have been directed more at Congressional revenue estimators . . . than at the aim of creating strong impediments in practice.").

55. The 2017 Act repealed the special rate for personal service corporations. *See* former I.R.C. § 11(b)(2) (2012) (imposing 35% rate on the taxable income of a qualified personal service corporation (as defined in section 448(d)(2)).

56. I.R.C. § 199A(b)(3)(A), (d)(3).

57. Above the taxable income threshold ($315,000 for joint filers, and $157,500 for other filers), the wage and wage-and-property limits are phased in over a specified range. I.R.C.

generous threshold levels and other features of § 199A ensure that these constraints are mostly illusory, preserving the pass-through advantage.

B. Converting PTPs to Corporate Status

Under § 7704, a publicly traded partnership (PTP) is classified as a corporation unless it satisfies a 90% qualifying income exception.[58] Congress could simply have required PTPs to convert to corporate status to obtain the benefit of the 21% rate. Instead, § 199A allows a 20% deduction for PTP income and qualified dividends from real estate investment trusts (REITs), regardless of whether such income would otherwise constitute qualifying business income.[59] Recently, the conversion of several publicly traded private equity firms from a partnership structure (up-PTP) to a corporate structure (up-C) has prompted speculation concerning a broader trend away from pass-through taxation.[60] While the 21% corporate tax rate reduces the cost of such PTP conversions, the switch is likely driven mainly by a desire to enhance access to capital markets, broaden the investor base, and simplify reporting.[61]

Even prior to the 2017 Act, the public PTP investors were subject to corporate taxes on "nonqualifying" income flowing through blocker corporations (inserted to meet the qualifying income exception under § 7704). Under the up-C structure, public investors will bear corporate tax on their entire income share, rather than only a portion; nevertheless, the postconversion basis step-up for the underlying assets will generate deductions that reduce (or even eliminate) the corporate tax burden in the early years.[62] Since the operating partnerships in these structures generally remain pass-through entities,[63] the conversion at the top level of the structure affects only the public investors whose interests are now held through a C corporation rather than a partnership. Following the

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§ 199A(b)(2)(3), (d)(3), (e)(2). Once these limits are fully phased in, no § 199A deduction is allowed for an SSTB. I.R.C. § 199A(d)(3).

58. *See* I.R.C. § 7704(c)(2) (requiring that 90% or more of a PTP's gross income consist of qualifying income).

59. I.R.C. § 199A(b)(1). In the case of REITs, the § 199A deduction generally applies to any dividends paid by the REIT other than qualified capital gain dividends and ordinary dividends taxed at capital gain rates. *Id.* § 199A(e)(3).

60. PENN WHARTON BUDGET MODEL, *supra* note 24 (citing KKR and Ares conversions from PTPs to C corporations).

61. Peter F. G. Schuur, *Choice of Entity Considerations After the TCJA*, TAXES: THE TAX MAG., Mar. 2019, at 141–42.

62. *See* I.R.S. Priv. Ltr. Rul. 201906002 (Oct. 26, 2018) (discussing the § 743(b) basis adjustment).

63. *See* Eric Yauch, *Passthrough Basis Step-Up Still Drives Private Equity Planning*, 163 TAX NOTES 892, 893 (2019) (quoting Clifford Warren, who stated that such conversions affected just the "top level for investors").

conversion, the founders typically continue to own their interests through a pass-through entity, unburdened by the corporate tax.[64]

Unlike PTPs, nonpublicly traded private equity firms do not benefit from converting to corporate status. In 2017, Congress enacted § 1061, imposing a three-year holding period for long-term capital gain attributable to "applicable partnership interests."[65] Otherwise, the 2017 Act leaves largely intact the tax treatment for "carried" interests received in exchange for services. As a result, private equity professionals will continue to have an incentive to use pass-through vehicles to convert ordinary income into capital gain. Structuring investment management companies as partnerships or S corporations serves to further limit employment taxes.[66] Although investment management is an SSTB, converting management companies to C status is unlikely to be attractive. If most of the firm's income consists of long-term capital gain (taxed at 23.8%), the advantage from reinvesting earnings at the corporate rate (21%) is small. Moreover, conversion is a one-way street that would potentially expose gain on assets such as appreciated goodwill to double taxation if the corporation is later unwound.[67]

C. Extending § 199A Benefit to REITs (and RICs)

Like PTPs, REITs are also eligible for an unrestricted 20% deduction for qualifying income.[68] Although the 2017 Act may encourage REITs to convert to corporate status to benefit from the 21% rate,[69] such

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64. *Cf.* Emily L. Foster, *Carlyle*'*s* '*Full C Corp*' *Conversion Differs from Others*, 164 TAX NOTES 920, 920 (2019) ("[T]he partnerships that have converted . . . expect to pay more income taxes as corporations than they would have as partnerships, but the investor benefits outweigh the additional tax cost.").

65. I.R.C. § 1061. Because § 1061 does not apply to a partnership interest held by a corporation, it was initially unclear whether this exception applied to S corporations. *See* I.R.S. Notice 2018-18, 2018-12 I.R.B. 443 (indicating that future regulations would exclude S corporations from the term "corporation" for purposes of § 1061(c)(4)(A)). The Treasury recently issued proposed regulations under § 1061. *See* Guidance Under Section 1061, REG-107213-18, 85 Fed. Reg. 49,754 (August 14, 2020).

66. Burke, *supra* note 25, at 588–89 (illustrating use of S corporation to block employment taxes); *see* Dagres v. Comm'r, 136 T.C. 263, 268 (2011) (describing the structure of investment partnership with blocker S corporation).

67. Schuur, *supra* note 61, at 141.

68. The special rule for REITs was presumably added to ensure that the § 199A deduction would be allowed even though REITs do not pay W-2 wages. *See* Karen C. Burke, *Section 199A and Choice of Passthrough Entity*, 72 TAX LAW. 551, 566 (2018) ("The unstated purpose of the wage-and-property limit was to allow rental real estate owners to benefit fully from the section 199A deduction even if they paid no W-2 wages."). A REIT is generally restricted to earning certain types of passive income and must also meet certain distribution requirements. I.R.C. §§ 856–57.

69. See Gillian Tan, *Under New Tax Law the Question Is, To Be or Not to Be a REIT?*, BLOOMBERG L. DAILY TAX REP. (BNA) (Apr. 26, 2018), https://www.bloomberg.com/news/articles/2018-04-25/under-new-tax-law-the-question-is-to-be-or-not-to-be-a-reit

conversions seem unlikely given the tax-advantaged status of REITs under the current rules. Indeed, the 2017 Act is likely to fuel further expansion of REITs, since the § 199A deduction is available even for income earned indirectly through a REIT that would not qualify if earned directly by the REIT shareholders. Thus, inserting a REIT into a pass-through structure has the potential to convert nonqualifying income—such as income not derived from a trade or business, non-U.S. trade-or-business income, and income derived from an SSTB—into income eligible for the § 199A deduction.[70] Nevertheless, foreign and tax-exempt investors tend to view REITs as risky because of the potential default to corporate status if REIT requirements are not satisfied.[71]

Recently, the U.S. Department of the Treasury extended the § 199A deduction to dividends paid by a regulated investment company (RIC) to the extent that the RIC receives dividends from one or more REITs.[72] Normally, a RIC would not be entitled to any § 199A deduction, since it is a corporation; under "conduit" treatment a RIC may pay dividends that a mutual fund investor treats in the same manner (or a similar manner) as if the underlying item of income or gain were realized directly by the investor.[73] Although the 2017 legislative history contemplated that RIC dividends attributable to qualifying REIT dividends would be eligible for the § 199A deduction, the statutory language was unclear.[74] The § 199A deduction for RIC dividends attributable to REIT dividends could be viewed as simply eliminating a distortion "whereby direct ownership of REITs is tax-advantaged relative to indirect ownership of REITs through RICs."[75] Given the failure of Congress to explain the rationale for

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[https://perma.cc/Q863-ACG5] (speculating that conversion might be attractive to REITs that seek to retain capital to finance expansion or other business needs rather than pay out dividends to REIT investors).

70. Stephen Giordano & Ryan Taylor, *Section 199A, REITs, and Real Estate Funds: A Janus Face of Tax Reform*, 161 TAX NOTES 941, 942 (2018).

71. *See id.* at 943–44. ("Both foreign and tax-exempt investors may view a REIT as a source of potential risk even if the use of the REIT would not, when used properly, result in an operational or tax inefficiency to investors.").

72. Treas. Reg. § 1.199A-3(d). Generally, the § 199A dividends reported by a RIC for the taxable year may not exceed REIT dividends received less allocable expenses. Treas. Reg. § 1.199A-3(d)(2)(ii); *see also* Treas. Reg. § 1.199A-3(d)(4)(ii) (holding period requirement).

73. *See, e.g.*, I.R.C. § 852(b)(3) (explaining shareholder treatment of capital gain dividends); Qualified Business Income Deduction, REG-134652-18, Preamble, 84 Fed. Reg. 3,015, 3,016 (Feb. 8, 2019) [hereinafter Preamble to REG-134652-18] ("These proposed regulations provide rules under which a RIC that receives qualified REIT dividends may pay section 199A dividends.").

74. *See* JCT, GENERAL EXPLANATION, *supra* note 5, at 29–30 (discussing qualifying REIT dividends); *see also* Preamble to REG-134652-18, *supra* note 73, at 3,015 (justifying special RIC treatment under Treasury's authority to prescribe regulations "necessary to carry out the purposes of section 199A" with respect to tiered entities).

75. Preamble to REG-134652-18, *supra* note 73, at 3,020. Conduit treatment of qualified PTP income received by RICs raises "several novel issues." *Id.* at 3,017 (reserving on this issue).

favorable treatment of REITs in the first place,[76] however, extending the § 199A benefit to RICs arguably merely compounds the problem.

IV. CORPORATE VS. PASS-THROUGH ENTITY CHOICE

Although § 199A was justified as a measure to maintain competitiveness between pass-throughs and C corporations, the reduced corporate tax rate is unlikely to significantly alter choice of organizational form, at least in the short run.[77] The portion of business income taxed under the individual income tax has increased greatly since 1986; by 2016, pass-throughs reported over half of all business income.[78] Given the uncertainty concerning the durability of the 2017 Act and the high tax cost of exiting a C corporation, business owners may be cautious about converting from pass-through to corporate form. Choice of entity is likely to be driven at the margin by particular facts and circumstances.[79] To the extent that particular types of businesses are excluded from the benefits of § 199A, corporations will provide an attractive alternative, notwithstanding a potential second level of tax when earnings are withdrawn. Other features of pass-through treatment—including the ability to step-up asset basis at the cost of only a single level of tax—will likely continue to render such entities more tax efficient than C corporations, particularly upon sale or other disposition of a business.

A. Ordinary Business Profits and Unrealized Appreciation

When individual income is taxed at an average rate below 21%, pass-through treatment produces the better result, even if there is no tax on corporate distributions.[80] Likewise, the corporate form generally offers

76. *See* GREENBERG & KAEDING, *supra* note 13, at 12 (noting that Congress's reasons for exempting REITs and PTPs from the limits under § 199A are not clear).

77. *See* Erin Henry et al., *Tax Policy and Organizational Form: Assessing the Effects of the Tax Cuts and Jobs Act of 2017*, 71 NAT'L TAX J. 635, 655–56 (2018) ("[O]rganizational form decisions following [the 2017 Act] will be significantly more nuanced than those following the [1986 Act]."); *id.* at 657 ("[T]he net effect on organizational form in the aggregate is not likely to be as large as those caused by the TRA86."). The tax burden of investing in a C corporation (as compared to a pass-through entity) depends on (1) the statutory corporate and individual tax rates, (2) the tax rates for dividends and capital gains, (3) the dividend payout rate, and (4) the capital gains realization rate. *See* Plesko & Toder, *supra* note 2, at 863–64.

78. Cooper et al., *supra* note 15, at 91. In 2016, there were about 4.6 million S corporations, 3.8 million partnerships (including LLCs), and 1.6 million C corporations. GEORGE K. YIN & KAREN C. BURKE, PARTNERSHIP TAXATION 22 (4th ed. 2020) (graphing the number of partnerships, C corporations, and S corporations from 1980 through 2016).

79. *See* Henry et al., *supra* note 77, at 656 ("[T]here is no 'one size fits all' approach for a particular organizational form in the post-TCJA era."); *see generally* Bradley T. Borden, *Income-Based Effective Tax Rates and Choice-Of-Entity Considerations Under the 2017 Tax Act*, 71 NAT'L TAX J. 613 (2018).

80. In this situation, splitting the business between a pass-through and a C corporation might

only a relatively small advantage in the case of portfolio investments taxed at 23.8% if held individually.[81] Since the corporate tax effectively substitutes for the individual tax on portfolio investments, the benefit to wealthy individuals from stuffing corporations with portfolio investments is thus constrained.[82] An increasingly large percentage of pass-through income is taxed at preferential capital gains rates, reducing the benefit of conversion.[83]

The "strongest case" for the corporate advantage is when business profits (taxed as ordinary income) are reinvested in the business for a lengthy period.[84] Indeed, the spread between the low corporate rate and the higher pass-through rate on ordinary business profits "has been offered as a major driver for a shift to the corporate form."[85] Unlike portfolio income taxed at roughly the same rates both inside and outside the corporation, the corporate rate on reinvested ordinary business profits is significantly below the pass-through rate. Even when § 199A is fully applicable, the tax gap is 8.6 percentage points (29.6% versus 21%). Upon closer inspection, however, even the strongest case for the corporate advantage proves surprisingly weak.

To illustrate, assume that a corporation with invested capital of $1,000,000 earns $100,000 annually; all earnings are fully taxable as ordinary income, subject to the 21% corporate rate, and are reinvested in the business for 30 years at a pretax rate of 10%. At the end of Year 30, the accumulated after-tax amount is distributed to shareholders, subject to a 23.8% tax. Alternatively, assume that a pass-through is used for the identical investment, the NIIT does not apply, and all ordinary business profits are taxed directly to the individual owners at 29.6%. The pass-through makes annual tax-free distributions sufficient to cover the owner-level taxes and reinvests all after-tax profits for 30 years.[86] At the end of

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nevertheless save taxes. *See* Halperin, *supra* note 42, at 1602 n.7 (suggesting that, in certain income ranges, "tax could be reduced by splitting the business between a C corporation and a pass-through so that all income is taxed at 21 percent or lower").

81. *See* Knoll I, *supra* note 7, at 982–84 (noting that for pass-through entities, there is no further tax); Knoll II, *supra* note 7, at 1451–53 (describing the effect of the 3.8% Medicare tax). The dividends-received deduction under § 243 may reduce the tax rate on intercorporate qualified dividends to 10.5%. *See* I.R.C. § 243(a)(1).

82. Knoll I, *supra* note 7, at 985 (explaining that use of the corporate form does not reduce the tax burden on portfolio income).

83. *See* Cooper et al., *supra* note 15, at 115 ("Nearly half of partnership income allocated to taxable entities accrues in the form of tax preferred capital gains and dividends."); *see also* PENN WHARTON BUDGET MODEL, *supra* note 24 (noting that "both capital gains and qualified dividends already face the lowest possible rate if received through a pass-through business").

84. Knoll II, *supra* note 7, at 1456–57.

85. *Id.* at 1454.

86. The annual tax distributions reduce outside basis but do not trigger gain recognition. I.R.C. §§ 705, 731. The owners' outside bases are increased to reflect their taxable share of income less tax distributions, preserving equality between inside and outside bases.

Year 30, the corporate after-tax return ($8,786,859)[87] exceeds the pass-through after-tax return ($6,698,091)[88] before any distribution to shareholders; once shareholder-level taxes are taken into account, however, the pass-through is clearly superior.[89] Since distributions of previously taxed income are tax free, pass-through owners enjoy higher net consumption.[90] Indeed, the crossover point for the corporate and pass-through investments is 30.057 years, after which point the corporate form becomes more advantageous.[91] Given the current rate instability, however, a thirty-year deferral strategy would be exceedingly risky.

Assuming full retention, the crossover point depends on the relationship between the corporate and pass-through tax rates, the pretax rate of return, and the length of deferral. A corporate investment may easily overtake a pass-through investment taxed at the highest individual rate (37%), notwithstanding the burden of the double tax. Ignoring the NIIT, the crossover point is reached more quickly because the corporate after-tax rate of return on reinvested earnings is higher relative to the pass-through after-tax rate of return. The 37% rate is likely to apply, however, only if the pass-through business is an SSTB, in which case the SSTB would convert to corporate status. For purposes of assessing the corporate advantage (or disadvantage), the weakness of the § 199A constraints suggests that 29.6% is the most relevant rate for pass-through income. Moreover, there is ample evidence to support the assumption that

87. At a 7.9% after-tax return (10% × (1 − 21%)), the initial investment grows to $9,786,859 (1,000,000 × 1.079^{30}); the corporate after-tax return is $8,786,859 ($9,786,859 less $1,000,000 initial investment).

88. At a 7.04% after-tax return (10% × (1 − 29.6%)), the initial investment grows to $7,698,091 ($1,000,000 × 1.0704^{30}); the pass-through after-tax return is $6,698,091 ($7,698,091 less $1,000,000 initial investment).

89.

Ordinary Income Taxed Currently (30 Years at 10% Pretax)

	Cumulative after-tax return (1)	Owner-level tax on net distribution (2)	Owner net consumption (3)
C Corporation	$8,786,859	$2,091,272	$6,695,587
Pass-through (full § 199A; no NIIT)	$6,698,091	0	$6,698,091

90. After payment of the shareholder level tax of $2,261,958, the shareholders are left with net consumption of $6,695,587 ($8,786,859 × (1 − 23.8%)), or $2,504 less than the pass-through owners' net consumption ($6,698,091).

91. The following equation can be used to calculate the crossover point: $0.762 \times [(\$1{,}000{,}000 \times 1.079^t) - \$1{,}000{,}000)] = (\$1{,}000{,}000 \times 1.0704^t) - \$1{,}000{,}000$, where 0.762 represents the corporate distribution reduced by the shareholder-level tax (1 − 23.8%), 1.079^t represents the after-tax corporate return on reinvested earnings for *t* years, and 1.0704^t equals the after-tax pass-through return on reinvested earnings for *t* years. *See* Repetti, *supra* note 48, at 706 n.54 (deriving the equation). To determine the net accumulation, the initial investment of $1,000,000 must be backed out.

aggressive use of the S corporation loophole and limited partner exception allows high-income active pass-through owners to successfully avoid nearly all of the 3.8% taxes under FICA, SECA, and § 1411.[92]

Alternatively, a business may plow back after-tax ordinary business income into an asset that accrues unrealized gain (potentially taxable at capital gain rates) and is subsequently sold. To illustrate, assume that a corporation (or pass-through entity) with invested capital of $1,000,000 earns $100,000 annually and reinvests its after-tax earnings for 20 years at a pretax rate of 10% in an appreciating capital asset. At the end of Year 20, the appreciated asset is sold, and the net proceeds are distributed after payment of any entity-level tax. The appreciated value of the corporate asset ($4,524,725)[93] exceeds that of the pass-through asset ($4,032,160)[94] before any distributions to shareholders. Even when accrued appreciation is taxed entirely at ordinary income rates, however, the pass-through investment is significantly more advantageous than the corporate investment.[95] The amount available for shareholder-level consumption is reduced by (1) the corporate tax on the accrued appreciation and (2) the shareholder-level tax on the entire amount distributed (less corporate-level taxes and return of the shareholders' initial investment).[96] By contrast, the pass-through return on the initial investment and the unrealized appreciation is taxed only once, leaving

92. Owners may be active for purposes of § 1411 but still take advantage of the limited partner exception. I.R.C. §§ 1402(a)(13), 1411.

93. The appreciated value of the corporate asset is $4,524,725 ($79,000 annual payments × 1.10^{20}), i.e., the cumulative after-tax cash invested in the asset ($1,580,000) plus the accrued appreciation ($2,944,725).

94. The appreciated value of the pass-through asset is $4,032,160 ($70,400 annual payments × 1.10^{20}), i.e., the cumulative after-tax cash invested in the asset ($1,408,000) plus the accrued appreciation ($2,624,160).

95.

Investment with Unrealized Appreciation (20 Years at 10% Pretax)

	Cumulative after-tax cash (1)	Cumulative appreciation (2)	Entity-level tax on appreciation (3)	Owner-level tax (4)	Owner net consumption (5)
C corporation	$1,580,000	$2,944,725	$618,392	$929,707	$2,976,625
Pass-through (full § 199A; no NIIT)	$1,408,000	$2,624,160	0	$776,751	$3,255,409

96. The corporate-level tax equals $618,392 (21% × $2,944,725 appreciation) and the shareholder-level tax equals $553,667 (23.8% × 79% × $2,944,725 appreciation) plus $376,040 (23.8% × $1,580,000 cumulative after-tax cash). The net shareholder consumption equals $2,976,625 ($4,524,725 less combined taxes of $1,548,099).

the pass-through owners with higher net consumption.[97]

If the accrued appreciation is taxed at preferential capital gain rates, the pass-through advantage is even greater. Although the § 199A deduction is not available, the pass-through advantage is magnified because (1) individual capital gains are taxed at a lower rate (20%) than the corporate rate (21%), (2) active pass-through owners may avoid the 3.8% NIIT on pass-through income (including gain from sale of assets or interests), and (3) the corporate advantage from taxing ordinary business profits at a lower rate is attenuated when after-tax profits are reinvested in assets accruing unrealized appreciation. The corporate disadvantage could be eliminated by electing S corporation status and waiting five years to sell the former C corporation's assets, thereby avoiding the built-in gain tax under § 1374.[98] Although conversion to S status thus potentially eliminates the second level of tax on sale of corporate assets, the five-year waiting period is unlikely to be attractive given the precariousness of the 2017 legislation.

Exempting all business income from taxation would level the organizational playing field. While taxing business profits at a zero rate may seem extreme, the 2017 Act expanded § 168(k) to allow expensing of both new and used business assets.[99] Of course, not all assets are eligible for expensing—for example, most real property does not qualify and intangibles continue to be amortized over a fifteen-year period.[100] Immediate expensing is equivalent to exempting from taxation the normal return to an investment (assuming constant tax rates).[101] If expensing applied uniformly to all capital investments (and were permanent), there would be no tax incentive to structure a business as a corporation rather than a pass-through, even if the investment produced ordinary income.[102] Nevertheless, § 168(k) expensing applies unevenly to business investments and is slated to expire in 2023. Moreover, even if the normal return were exempt, the supranormal return would remain fully taxable. To the extent that unrealized appreciation in business assets (such as goodwill)

97. The net pass-through consumption equals $3,255,409 ($1,408,000 previously taxed income plus 70.4% × $2,624,160 appreciation), or $278,784 more than the net shareholder consumption.

98. *See* I.R.C. § 1374(a), (d)(7) (imposing the five-year waiting period).

99. *Id.* § 168(k).

100. *Id.* § 168(k)(2) (qualified property).

101. *See* Knoll II, *supra* note 7, at 1457 (noting that immediate deduction of the full amount invested is equivalent to exempting the return on that investment); Glogower & Kamin, *supra* note 7, at 514 (noting that the first-year deduction "offsets the future tax liability as the investment generates taxable income"). Of course, the assumption of constant tax rates is unlikely to hold, given the instability of the current corporate rate.

102. Knoll II, *supra* note 7, at 1457 ("Accordingly, for there to be a tax benefit from incorporating, the reinvested expenditures cannot be immediately deductible.").

represents disproportionately supranormal returns, the pass-through form would again be favored.

B. Higher Disposition Cost of Corporate Business

Even if a business owner plans to retain and reinvest all earnings in a C corporation, disposition of a corporate business generally entails a higher tax cost compared to a pass-through business. While a deceased shareholder's stock basis is stepped up to fair market value under § 1014, any unrealized gain lurking in the corporation's assets is preserved for subsequent taxation. On a stock sale, the buyer will discount the purchase price to reflect the lack of a stepped-up basis in corporate assets.[103] By contrast, an asset sale allows a stepped-up basis for corporate assets at the cost of only a corporate-level tax, but a subsequent distribution will trigger a shareholder-level tax.[104]

When sale of qualified small business stock (QSBS) is eligible for the 100% gain exclusion under § 1202, disposition of a corporate business is treated more favorably.[105] Exclusion of the seller's stock gain potentially compensates for lack of an inside basis step-up. Moreover, excluded gain is not subject to the NIIT.[106] Under current law, a liquidating sale of QSBS assets—coupled with a tax-free deemed sale of QSBS stock—is subject only to a 21% corporate-level tax (rather than a 35% tax under prior law).[107] Such an asset acquisition may offer the best of all options—an asset basis step-up for the purchaser and full gain exclusion for the seller on the deemed stock sale.[108] Nevertheless, these considerations underscore the downside of the corporate form generally—the lack of an inside basis step-up upon sale or other disposition of an owner's interest—compared to the pass-through form. Moreover, the QSBS exclusion is subject to numerous limitations—and the § 1202 definition of a qualified trade or business generally precludes SSTBs from qualifying.[109] Thus, § 1202 is unlikely to provide much incentive to

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103. The buyer should take into account both the present value of lower expected depreciation deductions and higher gain resulting from a lower basis upon disposition.

104. I.R.C. §§ 338(h)(10), 336(e) (stock sale treated as asset sale).

105. I.R.C. § 1202(a), (b)(1). Under § 1202(b)(1), the excludible gain is limited to the greater of $10 million or 10 times the adjusted basis of the stock. For 2019, the estimated revenue cost of § 1202 ranges between $1.1 billion and $1.3 billion. Manoj Viswanathan, *The Qualified Small Business Stock Exclusion: How Startup Shareholders Get $10 Million (Or More) Tax-Free*, 120 COLUM. L. REV. F. 29, 32 (2020).

106. *See* I.R.C. § 1411(c)(1)(A)(iii) (limiting the 3.8% tax to net taxable gain); Treas. Reg. § 1.1411-4(d)(3) (example 3). By contrast, gain on an individual shareholder's sale of corporate stock will generally be subject to the NIIT.

107. *See* I.R.C. §§ 331, 336.

108. Thomas Lenz & Ben Wasmuth, *A New Twist on an Old Battle: Basis Step-Up or 100% QSBS Gain Exclusion—or Both?*, 21 J. PASSTHROUGH ENTITIES 31, 34 (2018).

109. *See* I.R.C. § 1202(c)(2), (e)(3) (specifying the qualifications).

convert existing pass-through businesses to corporate form.[110]

C. Partnership Inside Basis Step-Up

Upon the death of a partner, a § 743(b) adjustment steps up to fair market value the successor's outside basis and proportionate share of the partnership's common basis.[111] Even though the deceased partner's gross estate includes only the deathtime fair market value of the partnership interest (net of liabilities), the successor takes an outside basis equal to the estate tax value increased by the successor's share of partnership liabilities.[112] The inclusion of liabilities in the successor's outside basis is necessary to provide a full "cost" basis in the assets. By contrast, the basis of a deceased S corporation shareholder's stock is stepped up (or down) to fair market value under § 1014, but the inside basis of the S corporation's assets remains unchanged.[113] Similarly, there is generally no way to step up the basis of the S corporation's assets for the benefit of a purchaser who acquires S stock, unless the parties agree to treat the stock sale as an asset acquisition under § 338.[114] In this situation, gain on the deemed asset sale flows through to the selling S corporation shareholders whose stock basis is increased immediately before any liquidating distribution.

Indeed, the ease of stepping up inside basis with only a single level of tax represents one of the primary benefits of operating in partnership form. Such an inside basis step-up will often be crucial because an unrelated acquiror may be able to expense the purchase price of assets qualifying under § 168(k). Under the 2017 Act, immediate expensing enhances the tax benefit derived from an inside basis step-up, while lower rates diminish the tax benefit. Upon acquisition of a partnership interest, an unrelated transferee is entitled to expense immediately any positive § 743 adjustment with respect to the transferee's share of eligible partnership property.[115] An existing partner who purchases an additional interest is viewed as acquiring a portion of the partnership's assets not

110. Knoll II, *supra* note 7, at 1454 (concluding that the "impact on incorporations is probably modest").

111. I.R.C. § 743(b).

112. *But see* I.R.C. § 753 (excluding income in respect of a decedent (IRD) items).

113. Although an S corporation is generally treated as a separate entity, a look-through rule applies to IRD items. *See* I.R.C. § 1367(b) (denying a § 1014 basis step-up to the extent the value of a deceased shareholder's stock is attributable to IRD items).

114. The equivalent of an inside-basis step-up (at the cost of a single shareholder-level tax) is possible, however, if § 338(h)(10) or § 336(e) applies to a qualified stock purchase or disposition of S corporation stock. *See* I.R.C. §§ 338(h)(10) (treating certain stock sales as asset sales), 336(e) (treating certain stock sales and distributions as asset transfers); *but see* I.R.C. § 1374 (imposing built-in gain tax).

115. *See* Treas. Reg. §§ 1.168(k)-2(b)(3)(iv)(D), 1.743-1(j)(4)(i)(B)(*1*) (treating increased portion of asset basis as newly purchased property).

previously owned by such partner; thus, an existing partner who purchases another partner's interest may also be eligible to expense a positive § 743(b) adjustment.[116]

The ability to step up asset basis with a single-level tax helps to explain why partnerships are likely to remain "king" in sophisticated tax planning.[117] Although it is still too early to predict, partnerships will most likely continue to be used for essentially the same planning purposes as under pre-2017 law. Partnerships continue to offer unrivaled benefits in terms of loss pass-through and tax-advantaged allocations, while preserving flexible classification when the corporate rate increases in the future.[118] Moreover, if the buyer wishes to acquire some (but not all) of a business, partnerships generally offer greater flexibility for structuring a tax-efficient exit strategy.

V. Close Corporations, Pass-Throughs, and Employment Tax Gaps

Regardless of organizational form, the 2017 Act offers active owner-managers of closely held C corporations and pass-through entities novel incentives to mischaracterize labor income as lower-taxed business income. In the guise of taxing corporate and noncorporate capital income more alike, § 199A further exacerbates existing disparities in the taxation of capital and labor income.[119] Prior to the 2017 Act, high-income active pass-through owners typically sought to exploit employment tax loopholes to avoid the 3.8% Medicare tax.[120] Rather than address these well-known loopholes, the 2017 Act encourages active owner-managers to relabel compensation as business income, thereby reducing both income and employment taxes. Indeed, the 2017 Act extends the S corporation employment tax loophole to closely held C corporations, while providing an incentive to prefer partnerships over S corporations to maximize the § 199A deduction. These perverse incentives pose a fundamental challenge to long-standing rules concerning reasonable compensation.

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116. *See* Treas. Reg. §§ 1.168(k)-2(b)(3)(iv)(D), 1.743-1(j)(4)(i)(B)(*1*) (applying aggregate approach).

117. Yauch, *supra* note 63, at 892 ("[P]assthroughs continue to be king in terms of planning.").

118. I.R.C. § 704(b), (d). *See generally* Stephan Utz, *Substantiality of QBI Allocations Under Subchapter K*, 162 TAX NOTES 55 (2019).

119. Prior to the 2017 Act, the "carried interest" strategy and the S corporation loophole arguably represented the two most egregious examples of labor income disguised as capital income. *See* Kleinbard, *supra* note 31, at 60 ("Two instances where the distinction between labor and capital income does matter today . . . are the well-known carried interest debates [and] the 'John Edwards' payroll tax avoidance gambit . . . .").

120. Burke, *supra* note 25, at 579 (noting incentive for high-income owner-managers to opt out of the system of mandatory contributions for social insurance).

A. Closely Held C Corporations

Prior to the 2017 Act, it was generally advantageous for a corporation to pay compensation rather than dividends to owner-managers, thereby mitigating the double tax burden. In the case of closely held C corporations, high-income owner-managers benefited from graduated corporate tax rates and had an incentive to distribute excess corporate profits as deductible compensation rather than nondeductible dividends taxed as ordinary income.[121] The preferential rate for qualified dividends, introduced in 2003, reduced the relative disadvantage of paying dividends in comparison to compensation.[122] Nevertheless, paying compensation generally remained more tax-efficient than paying dividends at higher income levels.[123]

As in the case of sheltering capital investments, retention and reinvestment of compensation-flavored income permits an owner-manager to benefit from a higher rate of return on after-tax amounts reinvested in the corporation. Unlike in the partnership context, however, understating compensation does "not . . . convert labor income to [lower taxed] capital income . . . in the first instance . . . ."[124] The 2017 Act decisively shifts the balance in favor of paying dividends rather than compensation.[125] Indeed, the flat 21% corporate rate gives rise to a preference for dividends over compensation "at almost all levels of corporate income."[126] The relative advantage of dividends versus compensation declines somewhat at higher income levels because (1) FICA taxes do not apply above the Social Security cap and (2) both the 3.8% NIIT and 20% dividend rate come into play.[127] At lower income

121. The benefit of the low corporate income tax rates was clawed back by a 5% additional tax between $100,000 and $335,000 of corporate income, resulting in a flat rate of 34%. I.R.C. § 11(b) (2012), *amended by* Tax Cuts and Jobs Act, Pub. L. No. 115–97, § 13001(a), 131 Stat. 2054, 2096 (2017). The 2017 Act abolished the graduated corporate tax rates. *Id*.

122. *See* I.R.C. § 1(h)(11) (taxing qualified dividends as net capital gain).

123. *See* Bob G. Kilpatrick & Dennis R. Lassila, *Compensation vs. Qualified Dividends for Shareholder-Employees After the TCJA*, J. TAX'N 6, 6 (2018) (noting the preference for corporations to pay compensation before 2003); *see also* David J. Roberts, *Undercompensated Shareholder-Employees and the New Rate Structure*, 162 TAX NOTES 165, 170 (2019) (noting that the historical tax rate structure was biased against paying dividends to owner-managers).

124. *See* Kleinbard, *supra* note 31, at 46–47.

125. *See* Kilpatrick & Lassila, *supra* note 123, at 7 ("[The TCJA] substantially altered the playing field . . . when it comes to deciding whether to pay compensation or dividends to shareholder-employees . . . ."); *see also* Donald T. Williamson, Peter Rivera & A. Blair Staley, *Optimizing Salary/Dividends of a C Corporation After TCJA*, 158 TAX NOTES 1335, 1335 (2018) (noting that the 2017 Act changes "will require all small businesses, including C corporations with a single shareholder-employee, to reconsider the most tax-efficient mix of salary and dividends").

126. Williamson, Rivera & Staley, *supra* note 125, at 1342.

127. Taxpayers with taxable income above $425,800 ($479,000 joint return) face a 20% dividend tax. *See* I.R.C. § 1(j)(5)(B)(ii)(I), (III) (modifying I.R.C. § 1(h)(1)(C)(ii)(I)) (adjusted for

levels, dividends are extremely attractive because they are not subject to employment taxes and the first $38,600 is taxed at a marginal rate of zero; these factors outweigh the loss of a 21% corporate-level deduction for compensation.[128]

For a closely held business, the decision whether to pay compensation or dividends depends on the combined tax burden of entity-level and individual income taxes, employment taxes, and the NIIT.[129] Because most small C corporations closely resemble S corporations with few shareholders, active owner-managers can effectively minimize taxes by controlling the form of distributions.[130] The failure to exclude closely held businesses from the flat 21% corporate rate compounds the problem of sheltering labor income within C corporations. The corporate penalty taxes—the personal holding company tax and accumulated earnings tax—have proven "notoriously ineffective" against use of corporations to shelter accumulated earnings from the individual income tax.[131] When, as under current law (ignoring the NIIT), the combined corporate-shareholder rate (36.8%) is lower than the maximum individual rate (37%), sheltering labor income within a C corporation is always advantageous: this strategy saves income taxes, even without taking employment taxes into account.

If a corporation distributes earnings as salary to high-income active owner-managers, the top marginal tax rate is roughly 40.2% (taking into account the deductibility of the employer half of the Medicare tax), or slightly more than the combined corporate-shareholder burden of 39.8%

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inflation by I.R.C. § 1(j)(5)(C)) ("The maximum 15-percent rate amount shall be—in the case of a joint return or surviving spouse, $479,000 . . . [and] in the case of any other individual . . . , $425,800 . . . ."); *see also* I.R.C. § 1(h)(1)(D) (effectively capping the dividend rate at 20%).

128. *See* I.R.C. § 1(j)(5)(B)(i)(I), (III) (specifying the maximum zero rate amount). For 2020, the Social Security wage limit is $137,700. *Contribution and Benefit Base*, SOC. SEC. ADMIN., https://www.ssa.gov/oact/cola/cbb.html [https://perma.cc/WXF4-MY24] (last visited Sept. 19, 2020).

129. Under the 21% rate, the corporate tax savings reduce the net burden of the employer share of FICA taxes to 4.9% (6.2% − 1.3%) and the employer share of Medicare taxes to 1.15% (1.45% − 0.3%).

130. *See* JOINT COMM. ON TAX'N, CHOICE OF BUSINESS ENTITY: PRESENT LAW AND DATA RELATING TO C CORPORATIONS, PARTNERSHIPS, AND S CORPORATIONS (JCX-71-15) 22–23 (Apr. 10, 2015) (noting that, while about 45% of C corporations report assets under $50,000, roughly 50% of S corporations and 40% of partnerships also report assets under $50,000). In 2016, all S corporations averaged fewer than two shareholders per firm. *See Table 7: Returns of Active Corporations, Form 1120S, Tax Year 2016*, INTERNAL REVENUE SERV., https://www.irs.gov/pub/irs-soi/16co07ccr.xlsx [https://perma.cc/7Z2Z-BQZR] (last visited Nov. 17, 2020) (dividing Number of shareholders for All industries (7,434,479) by Number of returns for All industries (4,592,042) yielding an average of 1.6 shareholders per S corporation return); YIN & BURKE, *supra* note 78, at 26.

131. Schler, *supra* note 17, at 1733. *See* I.R.C. §§ 531–537, 541–547 (imposing accumulated earnings tax and personal holding company tax).

if earnings are distributed as dividends.[132] Given the relatively small difference in the combined tax burden (40.2% versus 39.8%), the new rate environment arguably renders the reasonable compensation standard moot for high-income owner-managers of C corporations. When owner-managers' wage income exceeds the Social Security cap, the dividend strategy may have only a minimal impact on employment taxes, since the 3.8% tax cannot be avoided on dividend distributions.[133] Below the Social Security cap, however, the dividend strategy allows owner-managers to reduce both income and employment taxes, thereby further eroding the Social Security system. The experience with S corporation owner-managers augurs poorly for the IRS's ability to combat such tax avoidance.

B. S Corporation Loophole and § 199A

While the § 199A deduction provides an incentive to operate a business in pass-through form, the paramount issue concerns which type of pass-through entity is likely to be most tax efficient. Prior to the 2017 Act, S corporations were often viewed as the default entity, given the ability of active owner-managers to avoid FICA taxes, subject to a difficult-to-enforce constraint to pay reasonable compensation.[134] Section 1402(a)(13) allows limited partners to escape SECA taxes, but only if the entity is formed as a state law limited partnership, not an LLC.[135] High-income owner-managers could also avoid the 3.8% tax under § 1411, thereby exempting the pass-through income from all of the 3.8% taxes.[136] These techniques reduced employment taxes but did not save income taxes, since only the character of the owner-managers' distributive share was affected. By contrast, under current law, the goal is to structure a pass-through business to maximize the § 199A deduction

132. *See supra* notes 20 (taking into account the NIIT, the combined corporate-shareholder rate equals 39.8%) and 32 (taking into account deductibility of employer's half of Medicare taxes, the top marginal rate on wages equals about 40.2%).

133. Since the 6.2% payroll tax rate applies only up to the Social Security cap, the effective rate approaches zero for high earners. Henry et al., *supra* note 77, at 647 n.18 (explaining why the model ignores the Social Security tax at high income levels).

134. David R. Sicular, *Subchapter S at 55—Has Time Passed This Passthrough By? Maybe Not*, 68 TAX LAW. 185, 187, 211 (2015) (noting that owner-managers of S corporations do not pay self-employment taxes and can minimize payroll taxes by paying minimal compensation).

135. *See* Burke, *supra* note 25, at 578 ("[T]he emergence of LLCs . . . created uncertainty concerning the meaning of the term 'limited partner' for purposes of the SECA rules."); *see also* Renkemeyer, Campbell & Weaver, LLP v. Comm'r, 136 T.C. 137, 147–50 (2011) (holding that owner-managers of a Kansas LLP law firm were not mere "passive investors" but rather active managers and hence not "limited partners" as Congress intended for purposes of § 1402(a)(13)).

136. *See* Burke, *supra* note 25, at 576 ("When Congress enacted section 1411, it clearly understood that income and gain from active pass-through businesses could potentially fall outside all three of the 3.8% taxes.").

and eliminate the NIIT, yielding income and employment tax savings of 11.2%.[137]

Nevertheless, the interaction between § 199A and the disparate employment tax regimes for pass-through entities can give rise to surprising results. In the case of S corporations, an owner-manager's share of QBI is reduced by reasonable compensation and the employer's share of FICA taxes. In maximizing QBI and hence the § 199A deduction, the formal requirement to pay reasonable compensation to owner-managers may render S corporations less tax efficient than partnerships, whose owners are not subject to the reasonable compensation constraint but are subject to SECA taxes. Nevertheless, the purported S corporation disadvantage may be largely negated if active owner-managers are effectively unconstrained in their ability to pay unreasonably low compensation, thereby avoiding both FICA and SECA taxes and restoring S corporations to a favored position. Given the higher tax stakes under the 2017 Act, enforcing the reasonable compensation constraint will prove even more difficult.

Below the taxable income threshold, § 199A provides a straightforward 20% deduction for qualified business income.[138] In this situation, paying any compensation to S corporation owner-managers is doubly disadvantageous, since wages increase FICA taxes and reduce QBI (and hence the § 199A deduction). Section 199A therefore heightens the incentive of S corporation owner-managers to reclassify compensation as a share of business income, thereby saving both income and employment taxes. Given the § 199A incentives to reduce (or eliminate) wages to maximize QBI, compensation paid to S corporation owner-managers may be expected to decline even further relative to business profits.[139] Prior to the 2017 Act, the S corporation loophole garnered attention mainly because of avoidance of the 3.8% Medicare tax by high-income owner-managers. Under § 199A, the incentive to minimize S corporation compensation is even greater below the Social Security cap, since reclassifying wages as a distributive share saves an additional 15.3% FICA tax (ignoring the employer deduction).

When the wage (or wage-and-property) limit is fully phased in,[140] compensating high-income S corporation owner-employees may be

137. (40.8% − 29.6%).

138. I.R.C. § 199A(b)(3)(A).

139. *See* Susan C. Nelson, *Paying Themselves: S Corporation Owners and Trends in S Corporation Income, 1980-2013* 4–5 (Office of Tax Analysis, Dep't of Treas., Working Paper No. 107, 2016), https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-107.pdf [https://perma.cc/B5DY-V8VC] (reporting of business-owners' income as wages or profits is responsive to tax law changes).

140. *See supra* note 57.

either beneficial or detrimental. Within certain ranges, a quirk in the operation of § 199A provides an incentive for a noncapital intensive S corporation to overstate (rather than understate) compensation, since owner wages are counted for purposes of the § 199A wage limit.[141] The final regulations under § 199A leave intact the beneficial quirk for S corporations, while clarifying that the reasonable compensation requirement applies only to S corporation shareholders.[142] As the Treasury recognized, the interaction between § 199A and the reasonable compensation requirement gives rise to "disparities between taxpayers operating businesses in different entity structures" and may have the "unintended consequence of encouraging taxpayers to select or avoid certain business entities."[143]

C. Partnerships and Sole Proprietorships

The reasonable compensation constraint does not apply to partners, who cannot be employees of a partnership.[144] To maximize the § 199A deduction, partnerships must nevertheless be careful to structure compensation-like payments as a distributive share of partnership income rather than § 707(c) guaranteed payments (or § 707(a) nonpartner payments).[145] Guaranteed payments are disfavored under § 199A from the perspective of both the recipient partner (since they are not QBI) and the partnership-payor (since they decrease entity-level QBI but do not count toward the wage limit).[146] Because partnerships are not obliged to use guaranteed payments to compensate service partners, however, the

141. *See* Shaviro, *supra* note 3, at 63 ("[The Senate bill] without explanation, haphazardly weighted the dice in favour of using an S corporation . . . .").

142. Qualified Business Income Deduction, REG-107892-18, Preamble, 83 Fed. Reg. 40,884, 40,893 (Aug. 16, 2018) ("'[R]easonable compensation' is best read as limited to the context from which it derives: compensation of S corporation shareholder-employees."). The special rule for S corporations is "merely a clarification" that such shareholder-employees are "prevented from including an amount equal to reasonable compensation in QBI," even if the S corporation fails to pay reasonable compensation. *Id.*; *see also* Treas. Reg. § 1.199A-3(b)(2)(ii)(H) (excluding reasonable compensation received by S shareholders from QBI).

143. Qualified Business Income Deduction, T.D. 9847, Preamble, 84 Fed. Reg. 2,952, 2,964 (Feb. 8, 2019) [hereinafter Preamble to T.D. 9847].

144. *See* Self-Employment Tax Treatment of Partners in a Partnership That Owns a Disregarded Entity, T.D. 9766, Preamble, 81 Fed. Reg. 26,693, 26,693 (May 4, 2016) (reaffirming the holding of Rev. Rul. 69–184, 1969–1 CB 256, that treats a partner who performs services as a self-employed independent contractor rather than an employee).

145. *See* I.R.C. § 707(a), (c) (governing nonpartner capacity payments and guaranteed payments to partners for services or the use of capital). The recipient treats the guaranteed payment as ordinary income, subject to the SECA tax; guaranteed payments do not constitute FICA wages. Treas. Reg. §§ 1.707-1(c), 1.1402(a)-1(b).

146. *See* Treas. Reg. § 1.199A-3(b)(2)(ii)(I) (excluding § 707(c) payments for services from QBI); *see also* Treas. Reg. § 1.199A-3(b)(2)(ii)(J) (same treatment for § 707(a) payments).

purported guardrails under § 199A are largely illusory.[147] Particularly if high-income partners can also avoid SECA and the 3.8% tax, partnerships will often prove more tax efficient than S corporations, since QBI and hence the § 199A deduction are easier to maximize.

Sole proprietors are not subject to the reasonable compensation constraint but cannot easily avoid SECA taxes. Not surprisingly, prior to 2017 the growth of S corporations was fueled largely by sole proprietorships converting to S status to eliminate SECA taxes. For purposes of § 199A, the deductible portion of the SECA tax imposed on sole proprietors is treated in the same manner as the deductible employer portion of the FICA tax; thus, the employer half of the SECA tax reduces QBI for purposes of the 20% limit.[148] Under the 2017 Act, converting a sole proprietorship to S status and paying no owner-manager compensation potentially maximizes the 20% deduction under § 199A, while saving taxes equal to the avoided net SECA burden.[149] If the reasonable compensation constraint significantly disadvantaged S corporations, one might expect a reversal of the trend for sole proprietorships to convert to S status. Given the nearly insurmountable difficulties of enforcing reasonable compensation, however, S corporations are likely to maintain their preferred status by reducing owner compensation to save employment and income taxes jointly.

Under the 2017 legislation, an individual's itemized deduction for all state or local taxes is capped at $10,000.[150] Thus, pass-through owners (partners, S corporation shareholders, and sole proprietors) potentially stand to lose a substantial portion of the benefit from deducting state income taxes on their share of business profits. In response to these concerns, several states have restructured their state income tax regimes by enacting an elective pass-through entity tax.[151] The new entity-level tax purportedly allows state income taxes to be deducted at the entity level, circumventing the limitation on itemized deductions passed

147. *See* Kamin et al., *supra* note 6, at 1460 n.77 ("[R]estrictions . . . are easy for partners . . . to avoid.").

148. I.R.C. § 164(f); Treas. Reg. § 1.199A-3(b)(1)(vi); *see* Preamble to T.D. 9847, *supra* note 143, at 2,962 (listing deductions that reduce QBI).

149. From a combined tax perspective, S corporation owner-managers who understate compensation may often fare better than sole proprietors (or general partners) subject to SECA tax. *See* Burke, *supra* note 68, at 586 (describing low-income and high-income scenarios).

150. I.R.C. § 164(b)(6). By contrast, C corporations may deduct as § 162 ordinary and necessary business expenses any state or local income, property, or sales taxes incurred in connection with business operations. I.R.C. § 162(f)(4).

151. *See* Jeffrey A. Cooper, *Red States, Blue States: Lessons from the State Death Tax Credit and the "SALT" Deduction*, 73 TAX LAW. 341, 362–63 (2020) (discussing elective entity-level tax regimes).

through to the individual owners.[152] This work-around for the $10,000 cap provides an additional incentive for sole proprietors (and individual owners of disregarded entities) to convert to S corporation status, hopefully substituting a deductible entity-level tax on business profits for a nondeductible itemized deduction. While the government could attack these elective regimes under substance-over-form principles, it has so far failed to do so, encouraging other states to adopt their own entity-level taxes.[153]

VI. CONCLUSION

Even prior to the coronavirus pandemic, the case for outright repeal of § 199A was compelling: the pass-through deduction benefits primarily high-income owner-managers and undermines the efficiency and equity of the tax system. Although § 199A was rationalized on the ground that it would reduce incentives for pass-through owners to incorporate, it creates a new preference for pass-through income by encouraging business owners to convert labor income into qualifying income to take advantage of the deduction. In late 2017, proponents simply asserted that § 199A was needed to maintain parity between pass-through entities and C corporations, without offering any meaningful definition of parity. In political terms, § 199A was the price that the pass-through lobby extracted for supporting the lowering of the corporate tax rate to 21%, while preserving intact the pre-2017 favored status of pass-through entities.

In light of growing concern over inequality and unsustainable deficits, § 199A should be repealed as quickly as possible. Congress also needs to eliminate loopholes that allow active pass-through owners to avoid employment and Medicare taxes on the disguised labor component of pass-through income. Underreporting of pass-through income—which often accrues in opaque categories—and employment taxes represents a

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152. Entity-level state income taxes will reduce the pass-through owners' share of non-separately-stated items (but will not be subject to limitation at the individual level as separately stated items). In describing the operation of § 164(b)(6), the Conference Report apparently sanctions this gambit. *See* CONFERENCE REPORT, *supra* note 5, at 260 n.172 ("[T]axes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law."); *see also* JCT, GENERAL EXPLANATION, *supra* note 5, at 68 n.296 (reiterating language of the Conference Report).

153. By contrast, the Treasury quickly shut down attempts to convert state taxes into deductible charitable contributions. *See* REG-107431-19, 2020-3 I.R.B. 332–33 (addressing contributions in exchange for state and local tax credits). The Treasury recently announced that it plans to issue regulations clarifying the ability of partnerships and S corporations to deduct entity-level state and local income taxes. I.R.S. Notice 2020-75, 2020-49 I.R.B. 1453.

significant source of the "tax gap."[154] Properly understood, pass-through parity would require S corporation owner-managers to pay self-employment tax on their entire distributive share of income, reducing the controversy over reasonable compensation. Similarly, Congress should eliminate the outmoded limited partner exception used by active owner-managers to avoid the 3.8% tax under Medicare and § 1411. Since sophisticated pass-through tax avoidance is skewed toward the top of the income scale, these reforms would be highly progressive and would help to prevent further erosion of the social safety net.

Sensible reform would require all nonpublicly traded businesses to be taxed as partnerships (including limited liability companies), S corporations, or sole proprietorships.[155] Elimination of § 199A would ensure that pass-through income, other than capital gain, is taxed at the same rate as wage income without the need for elaborate rules intended to subsidize particular types of qualifying income.[156] If the corporate tax rate were increased modestly to 25% (or 28%) as widely discussed prior to the 2017 Act, shareholders would continue to be taxed at capital gain rates on distributed corporate profits. Increasing the capital gain rate to 25% would raise the combined corporate-shareholder tax rate on distributed earnings to 46.6%,[157] only slightly higher than the maximum statutory rate (46%) on undistributed corporate profits prior to the 1986 Act. Depending on the highest individual rate, corporations might still provide a shelter for disguised labor income, given the ability to earn a higher after-tax return on reinvested earnings.[158] Since corporate and noncorporate business forms would enjoy roughly equivalent treatment, however, the distorting effect of tax rate differences on choice of entity would be greatly diminished.

154. Eliminating § 199A and closing the pass-through employment tax gap would raise an estimated $730 billion over a ten-year period (2020–2029). Natasha Sarin, Lawrence H. Summers & Joe Kupferberg, *Tax Reform for Progressivity: A Pragmatic Approach*, *in* TACKLING THE TAX CODE: EFFICIENT AND EQUITABLE WAYS TO RAISE REVENUE 317, 318, 334, 340–41 (Hamilton Project, Brookings Inst., 2020), https://www.hamiltonproject.org/assets/files/TaxBookforWeb_12320.pdf [https://perma.cc/XG56-YGAP].

155. REITs and RICs could still be subject to modified pass-through treatment.

156. Addressing the carried interest problem would eliminate the most egregious opportunity to convert labor income into capital gain.

157. The combined rate equals 25% plus 28.8% × (1 − 25%).

158. *See, e.g.*, Karen C. Burke, *Passthrough Entities: The Missing Element in Business Tax Reform*, 40 PEPP. L. REV. 1329, 1330 (2013) (noting that the pre-1986 two-tier corporate tax system often functioned as "a shelter rather than a burden").