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The Impact of the 2017 Act's Tax Rate Changes on Choice of Entity

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THE IMPACT OF THE 2017 ACT'S TAX RATE CHANGES ON CHOICE OF ENTITY

by

*James R. Repetti**

I.	INTRODUCTION.....	687
II.	EFFECTIVE STATUTORY TAX RATES PRIOR TO THE 2017 TAX ACT	689
III.	EFFECTIVE STATUTORY RATES AFTER THE 2017 TAX ACT.....	690
	<i>A. Tax Changes in the 2017 Tax Act</i>	<i>690</i>
	<i>B. A Level Playing Field in a Narrow Unrealistic Circumstance: No Section 199A 20% Deduction, No Retention of Earnings, and No Medicare Surtax</i>	<i>695</i>
	<i>C. The Conditions for Parity Are Unrealistic Because the Medicare Surtax Applies to Dividends from the C Corporation and Passive Trade or Business Income from the Partnership</i>	<i>697</i>
	<i>D. The Conditions for Parity Are Also Unrealistic Because the 20% Deduction Under Section 199A Will Be Available in Some Situations</i>	<i>699</i>
	<i>E. The Conditions for Parity Are Also Unrealistic Because Earnings Will Often Be Retained.....</i>	<i>702</i>
	<i>1. Corporate Earnings Are Retained in a Qualified Small Business Corporation and Investors Realize Corporate Profits by Selling Stock.....</i>	<i>703</i>

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2. *Investors Realize Corporate Profits Through Dividend Distributions After Earnings Are Retained or Corporation Is Not a QSB*..... 704

 a. *Partnership Qualifies for Section 199A 20% Deduction, Earnings Are Retained, and the C Corporation Is Not a QSB*..... 705

 b. *Impact of Unavailability of the Section 199A 20% Deduction Where Earnings Are Retained*..... 709

IV. CONCLUSION..... 714

I. INTRODUCTION

The double tax imposed on the earnings of C corporations results in significant economic inefficiencies because of its effect on the choice of entity for conducting a business.¹ All other items being equal, the double tax distorts taxpayers’ choice of entity because it motivates taxpayers to favor flow-through entities when they otherwise would not. The reduction in the corporate and individual tax rates in the legislation popularly known as the Tax Cuts and Jobs Act of 2017² (the “2017 Tax Act”) has been in part justified on the grounds that the rate changes

1. Jane G. Gravelle & Laurence J. Kotlikoff, *The Incidence and Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good*, 97 J. POL. ECON. 749 (1989); Robert Carroll & David Joulfaian, *Taxes and Corporate Choice of Organizational Form* (Office of Tax Analysis, U.S. Treas. Dep’t, Working Paper No. 73, 1997), <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-73.pdf>; Austan Goolsbee, *The Impact and Inefficiency of the Corporate Income Tax: Evidence from State Organizational Form Data* (Nat’l Bureau of Econ. Research, Working Paper No. 9141, 2002), <http://www.nber.org/papers/w9141.pdf>.

2. Pub. L. No. 115-97 (2017) [hereinafter 2017 Tax Act]. Senate rules forced the Act’s name to be changed in the 11th hour from the “Tax Cuts and Jobs Act” to “ An Act [t]o provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.” Eli Watkins, *Senate Rules Force Republicans to Go with Lengthy Name for Tax Plan*, CNN (Dec. 20, 2017, 3:14 GMT), <http://edition.cnn.com/2017/12/19/politics/tax-bill-name-delay/index.html>.

would help achieve parity between effective tax rates imposed on C corporations and on flow-through entities.³

This Article suggests that the 2017 Tax Act has not achieved this goal. To illustrate, this Article focuses on three changes made by the 2017 Tax Act—the reduction of the corporate tax rate to 21%, the reduction of the maximum individual tax rate to 37%, and the allowance of a 20% deduction in Code section 199A for “qualified business income.” It shows that the interaction of these changes with three existing factors (a corporation’s ability to retain earnings, the rate of return on those earnings, and the 3.8% Medicare surtax) have increased the complexity in selecting between a C corporation and an entity taxable as a partnership.⁴ As discussed below, depending on the mix of these factors, the effective tax rate for a partnership will be less than, equal to, or greater than the effective rate for a C corporation. As a result, the 2017 Tax Act has made tax planning more important in selecting an entity to conduct a business, not less.

3. See, e.g., Scott Greenberg, *Should the Corporate Rate and the Pass-Through Rate Be Identical?*, TAX FOUND. (July 13, 2017), <https://taxfoundation.org/corporate-rate-pass-through-rate-parity/>.

4. There are, of course, several other factors that will impact the choice of entity for conducting a business. Moreover, selection of an appropriate entity will frequently involve consideration of an S corporation, as well as a partnership and C corporation. Other tax factors that impact the decision include the desirability of preserving net operating losses at the corporate level versus having losses flow out to partners or S corporation stockholders; the availability of a step-up in basis for partnership assets upon the death of a partner; the availability of tax-favored profits interests in partnerships (although this may be partially offset by the new 5-year deferral in I.R.C. § 83(i)); the applicability of employment and self-employment taxes; the favorable tax treatment for partnership distributions of appreciated property versus the double tax for C corporations and single tax for S corporations; the relatively more user-friendly aspects of I.R.C. § 721 versus I.R.C. § 351; the alternative minimum tax for individuals; and the “look through” to the assets of a partnership or S corporation when an interest in such entity is sold for purposes of applying the 3.8% Medicare surtax of I.R.C. § 1411. In addition, there are several estate planning considerations, state tax factors, and other non-tax factors relating to entity governance, securities laws, and financing availability that will influence the decision. This Article focuses only on the factors listed in the text and on C corporations and partnerships because consideration of those key factors illustrates that the 2017 Tax Act has not improved the situation in terms of effective tax rate parity and corresponding clarity in entity selection.

II. EFFECTIVE STATUTORY TAX RATES PRIOR TO THE 2017 TAX ACT

Prior to the 2017 Tax Act, it could be safely predicted based on the relative tax rates for C corporations and individuals that entities taxable as partnerships would have a lower effective tax rate than C corporations on their operating incomes. The effective tax rate for a C corporation and individual stockholders, assuming a maximum corporate rate of 35% on the C corporation's income and 20% on the dividend income of the individual stockholders, was 48%,⁵ ignoring the Medicare surtax under Code section 1411. Including the Medicare surtax, which would apply to dividends paid by the C corporation to its stockholders who are individuals,⁶ the effective rate was 50.47%.⁷ In contrast, the effective tax rate on a flow-through entity, such as a partnership, was 39.6%, assuming that the partner was an individual subject to the maximum marginal tax rate and was not subject to the 3.8% Medicare surtax because her share of the partnership's income was not passive.⁸ If the partnership's income was passive to an individual partner, the effective tax rate was 43.4% as a result of the application of the 3.8% Medicare surtax. In all situations, regardless of whether the Medicare surtax applied, the partnership had the more favorable effective tax rate.

This is illustrated in Example 1.

Example 1: Individuals *A* and *B* were considering in 2017 whether they should organize a real estate investment business as a partnership or as a C corporation. They anticipated that their real estate investments in land would generate rental income of approximately \$500,000 per year, which they would share equally. *A* and *B* have significant income from other sources and their shares of the \$500,000 rental income would be subject to tax in 2017 at the maximum marginal rate of 39.6%.

First, if *A* and *B* placed their land into a partnership, the \$500,000 rental income would be recognized by them, and they would pay a federal tax of \$198,000 (39.6% of \$500,000) in 2017. If the partnership's activity qualified as a trade or business

5. $1 - ((1 - .35)(1 - .20))$.

6. I.R.C. § 1411(a)(1)(A), (c)(1).

7. $1 - ((1 - .35)(1 - .238))$.

8. Trade or business income, which is not passive within the meaning of I.R.C. § 469, is excluded from the Medicare surtax. I.R.C. § 1411(c)(1)–(2).

that is not passive within the meaning of Code section 469, the 3.8% Medicare surtax would not apply.⁹ Moreover, no further income tax liability would be incurred when the partnership distributed the rental income to them because their outside bases increased by their share of the partnership's income.

In contrast, if they placed their land into a C corporation, the income would be taxable to the corporation and would be taxed again when distributed to them. This would result in a total tax of \$252,350 in 2017. A tax of \$175,000 would have been incurred at the corporate level (assuming a maximum corporate tax rate of 35% applied to \$500,000), and an additional tax of \$77,350¹⁰ would have been incurred when the income remaining after payment of the corporate tax was distributed to *A* and *B* as a dividend subject to the 20% dividend tax¹¹ and 3.8% Medicare surtax.¹² Since the effective tax rate of the partnership was 39.6%, while the effective rate for the C corporation was 50.47%,¹³ all other items being equal, *A* and *B* would prefer the partnership.

If the partnership's income were subject to the 3.8% Medicare surtax, the outcome would not change. The partnership's income would now cause *A* and *B* to incur a \$217,000 tax liability¹⁴ in 2017 for an effective tax rate of 43.4%. This would still be less than the C corporation's effective tax rate of 50.47% in 2017.

III. EFFECTIVE STATUTORY RATES AFTER THE 2017 TAX ACT

A. Tax Changes in the 2017 Tax Act

The 2017 Tax Act directly changed the rates illustrated in Example 1 for taxable years beginning after December 31, 2017, by lowering the

9. I.R.C. § 1411(c)(1)–(2).

10. $.238 \times \$325,000$.

11. Qualified dividend income received by an individual will be taxed at a rate of not more than 20%. I.R.C. § 1(h)(11).

12. Most dividends are characterized as investment income subject to the surcharge. I.R.C. § 1411(c)(1)(A)(i).

13. $1 - ((1 - .35)(1 - .238))$.

14. $(.396 + .038) \times \$500,000$.

corporate rate to a flat 21%¹⁵ and reducing the maximum individual rate to 37%.¹⁶ It also indirectly reduced the maximum rate for individuals for their “qualified business income” by allowing a new 20% deduction in section 199A. The section 199A deduction in effect reduces the maximum individual tax rate from 37% to 29.6%.

The complexity of section 199A makes it difficult to determine when and to what extent it will apply. Section 199A allows non-corporate partners and S corporation shareholders to deduct an amount equal to 20% of the “qualified business income” generated by the flow-through entity’s “qualified trade or business.” Sole proprietors are also allowed to deduct 20% of the “qualified business income” generated by their “qualified trade or business.” Corporations are not allowed to claim the deduction.

The application of these terms and the calculation of the deduction occurs for each individual sole proprietor, partner, and S corporation stockholder based on his or her individual circumstances.¹⁷ The result is that some owners of an entity may be eligible for the deduction, while others will not. For taxpayers with incomes below the “threshold amount” (\$157,500 for single taxpayer, \$315,000 for married taxpayers), all trades or businesses are “qualified trades or businesses.” For taxpayers with taxable incomes above the threshold amount plus \$50,000 (\$100,000 for joint returns), a “qualified trade or business” does not include most professional services (so-called “specified service trades or businesses”), such as those provided by accountants, lawyers, financial services, and medical providers, but does include professional services provided by architects and engineers.¹⁸ For all taxpayers, regardless of their amount of taxable income, the term qualified trade or business does not include the trade or business of being an employee.¹⁹

“Qualified business income” in general means income from a qualified trade or business conducted in the United States, but does not

15. 2017 Tax Act, *supra* note 2, § 13001(a) (amending I.R.C. § 11(b)).

16. *Id.* § 11001(a) (amending I.R.C. § 1(j)).

17. I.R.C. § 199A(a).

18. I.R.C. § 199A(d)(2). The amount of income from specified service trades or businesses that is qualified business income begins to phase out at the threshold amount and is eliminated for taxpayers with taxable income equal to the threshold amount plus \$50,000 (\$100,000 for joint returns).

19. I.R.C. § 199A(d)(1)(B).

generally include investment income.²⁰ The 20% deduction can, in general, be reduced or eliminated for taxpayers with taxable income in excess of the threshold amount if the trade or business does not pay certain levels of wages or utilize certain levels of depreciable tangible assets in the U.S. trade or business.²¹ The greater the amount of wages paid or the amount of depreciable property held in the trade or business, the less likely the limitation will apply. In addition, the amount of each taxpayer's 20% deduction is reduced if the taxpayer has net losses from other qualified trades or businesses because the amount of the deduction is determined by combining the taxpayer's deductible amounts for all of the taxpayer's qualified trades or businesses.²²

The unavailability of the deduction for "specified service trades or businesses" creates uncertainty because of some broad language in Code section 1202(e)(3)(A), which section 199A incorporates by reference. Section 199A(d)(2) states that the "term 'specified service trade or business' means any trade or business—which is described in section 1202(e)(3)(A) (applied without regard to the words 'engineering, architecture')." Section 1202(e)(3)(A) in turn lists specific trades or businesses and then very broadly adds, "or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees." This language creates uncertainty because it is not clear what is meant by "principal asset." Most successful businesses depend at least in part on the "reputation or skill" of their employees. The difficult issue is when will such skills be determined to constitute an "asset" of the trade or business and what magnitude of such asset will cause it to be a "principal" asset. Guidance will be necessary to help flesh this term out for purposes of section 199A.²³ Uncertainty also arises about the role of section 199A(c)(4), which in general terms excludes compensation for services rendered from "qualified business income." Section 199A(c)(4) contains a general rule of seemingly broad application in subparagraph (A) and some specific rules for partnerships in subparagraphs (B) and (C). It states:

20. I.R.C. § 199A(c)(1)–(3).

21. I.R.C. § 199A(b).

22. I.R.C. § 199A(b)(1)(2).

23. Donald B. Susswein, *Understanding the New Passthrough Rules*,

Qualified business income shall not include—

(A) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,

(B) any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and

(C) to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.

Recall that a partnership's payments to partners can take three forms: (1) distributive shares, (2) Code section 707(c) guaranteed payments to partners in their capacity as partners, and (3) Code section 707(a) payments to partners in their non-partner capacity.²⁴ Because subparagraphs (B) and (C) deal explicitly with two of the three types of payments (section 707(c) payments in subparagraph (B) and section 707(a) payments in subparagraph (C)), subparagraph (A) begs the question whether its reasonable compensation exclusion from qualified business income applies to partnership distributive shares. The Conference Committee report makes clear that subparagraph (A) applies to S corporations but is silent about its applicability to partnerships.²⁵ It is difficult to glean a reason that application of the provision should be restricted to S corporations, and the statutory language supports application of the reasonable compensation exclusion to partnership distributive shares. A Treasury official has stated that Treasury is studying this issue.²⁶

24. See JAMES R. REPETTI, WILLIAM H. LYONS & CHARLENE D. LUKE, *PARTNERSHIP INCOME TAXATION (CONCEPTS AND INSIGHTS SERIES)* ch. 9 (6th ed., forthcoming 2018) (describing and analyzing the three types of payments).

25. H.R. REP. NO. 115-466, at 215 (2017).

26. Laura Davison, *Treasury Mulls Applying Reasonable-Compensation Rules to Partners*, BLOOMBERG LAW (Feb. 9, 2018), <https://www.bna.com/treasury-mulls-applying-n57982088602/>.

Assuming that the trade or business is not a “specified service” and that taxpayers do not trip over the reasonable compensation requirement, the wage limitations in section 199A(b)(2) will often not be a major barrier. Section 199A(b)(2) limits the 20% deduction to the greater of (1) 50% of the W-2 wages paid by the trade or business or (2) the sum of 25% of the W-2 wages and 2.5% of the unadjusted basis of depreciable tangible property.²⁷ Although not entirely clear, the wage limitation may serve two purposes. It may have been included in section 199A to prevent an employee from converting his income taxable at the ordinary rate of 37% into qualified business income qualifying for the 20% deduction,²⁸ and it may also serve as an additional measure to encourage businesses to hire more employees. Regardless of the purpose, it will not take significant W-2 wages to be able to claim the full 20% deduction. For example, consider a qualified trade or business that has a profit margin (which we will assume consists entirely of qualified business income) equal to 10% of its revenues. Under section 199A(b)(2), it will be allowed to deduct 20% of its qualified business income, which would represent 2% of its revenues, if that amount equals 50% of its W-2 wages. To achieve that, its W-2 wages need only equal 4% of its revenues.²⁹ This will likely not be difficult for most businesses. For a very rough comparison, consider a 2016 PWC study, which found that on average labor

27. These limitations do not apply to taxpayers below the “threshold amount.” I.R.C. § 199A(b)(2). The limitations, however, are fully phased in for taxpayers with taxable income above the threshold amount plus \$50,000 (\$100,000 for joint returns). I.R.C. § 199A(b)(3).

28. Susswein, *supra* note 23, at 504; Tony Niti, *Tax Geek Tuesday: Making Sense of the New ‘20% Qualified Business Income Deduction,’* FORBES (Dec. 26, 2017, 8:48 AM), <https://www.forbes.com/sites/anthonymitti/2017/12/26/tax-geek-tuesday-making-sense-of-the-new-20-qualified-business-income-deduction/#758eebf44fda>. As noted by Susswein, it is not clear that this concern is addressed effectively by the statute. Susswein, *supra* note 23, at 504.

29. For example, if the qualified trade or business has revenues of \$100 that result in qualified business income of \$10, its W-2 wages need only equal \$4. To see this, consider that the § 199A deduction would be \$2 (20% of \$10). The limit would also be \$2 (50% of the wages of \$4). As a result, the entire § 199A deduction of \$2 would be deductible.

costs represented 21.3% of revenues in the manufacturing and engineering sectors.³⁰

If the qualified trade or business has few or no employees, it need only invest in a sufficient amount of depreciable tangible property to avoid the limit. The limit in section 199A(b)(2) that is calculated as 2.5% of the depreciable tangible property allows up to a 12.5% pretax return on that property to qualify fully for the 20% deduction.³¹ For example, assume that taxpayers purchase an office tower on leased land for \$4,000,000. Further assume that the office tower generates a 12.5% pretax return of \$500,000 that is qualified business income. In that scenario, taxpayers can claim the 20% deduction with respect to all \$500,000 of the income generated by the office tower, which represents a 12.5% return on the office tower investment.³²

*B. A Level Playing Field in a Narrow Unrealistic Circumstance:
No Section 199A 20% Deduction, No Retention of Earnings,
and No Medicare Surtax*

With that background, let's now turn to the impact of these provisions on the choice of entity. The 2017 Tax Act significantly complicates the analysis for selecting an entity and does not eliminate the importance of considering different effective tax rates that may apply to the operating income of entities. Indeed, the reductions of the corporate tax rate to a flat rate of 21% and of the maximum individual rate to 37% now almost completely level the playing field in only one narrow situation that has *no* real-world application. Specifically, the rate changes in the 2017 Tax Act cause the tax liability for a partnership and a C corporation to be essentially equivalent when the following three conditions are satisfied:

30. *Trends in HR Effectiveness*, PwC 8 (Nov. 2016), <https://www.pwc.com/us/en/hr-management/publications/assets/pwc-trends-in-hr-effectiveness-final.pdf>.

31. The maximum percentage return on an asset that will qualify for the 20% deduction may be calculated by the equation: $(20\%)(r) = 2.5$. The left side of the equation represents the § 199A deduction, calculated as 20% of the return (r) generated by the asset measured as a percentage of the asset's unadjusted basis. The right side equals the 2.5% limitation of § 199A(b)(2). Solving for r , we find that r equals 12.5%.

32. The § 199A deduction would be \$100,000 (20% of \$500,000). The § 199A limit would also be \$100,000 (2.5% of \$4,000,000). As a result, the taxpayers would be able to deduct the entire \$100,000.

1. The 3.8% Medicare surtax does *not* apply to the owners of either entity;
2. The 20% deduction under section 199A is *not* available to the flow-through entity's owners,³³ and
3. The entities will distribute their earnings annually.

When these three conditions are satisfied, the effective tax rate for income from a flow-through entity is 37%, the individual tax rate. By comparison, the effective tax rate for income from a C corporation is 36.8%.³⁴ Full parity is almost achieved. This is illustrated in Example 2.

Example 2 (3.8% Medicare surtax does *not* apply to owners of both entities; 20% deduction under section 199A is *not* available to partners; both entities will distribute their earnings annually):

Consider a situation where individuals *C* and *D* are contemplating an investment in land that would generate rental income of approximately \$500,000 per year, which they will share equally. Assume that both are subject to the maximum individual rate of 37% and that the income generated by the land does not qualify for the 20% section 199A deduction. Assume further that the two entities will distribute their income annually to *C* and *D* and that the Medicare surtax does not apply.

As a result, if *C* and *D* hold the land in a partnership, they will incur a federal tax liability of \$185,000 (37% of \$500,000), resulting in an effective tax rate of 37%. If instead they hold the land in a C corporation, they will incur a total tax of \$184,000, resulting in an effective tax rate of 36.8%. This is calculated as follows: A tax of \$105,000 is incurred at the corporate level (21% times \$500,000), and an additional tax of \$79,000 is incurred when the income remaining after payment of the corporate tax is distributed to *C* and *D* as a dividend

33. See Part III.A for a discussion of § 199A.

34. $1 - ((1 - .21)(1 - .20))$.

(20%³⁵ of \$395,000). This total tax of \$184,000 results in an effective tax rate of 36.8%.³⁶

C. The Conditions for Parity Are Unrealistic Because the Medicare Surtax Applies to Dividends from the C Corporation and Passive Trade or Business Income from the Partnership

The problem with Example 2, of course, is that all these conditions do not exist in the real world. First, let's deal with the most unrealistic condition for parity—that the Medicare surtax will not apply to either entity. The Medicare surtax will certainly apply to the C corporation's dividends since dividends are included in the type of investment income subject to the surcharge.³⁷ Consequently, the effective tax rate on the C corporation's income when distributed to *C* and *D* will be 39.8%.³⁸ This represents the combined effect of the 21% corporate rate, the 20% on dividends *C* and *D* receive from the C corporation, and the 3.8% Medicare surtax that will apply to the dividends.

The Medicare surtax will also apply to the partnership's income if the real estate activity is treated as being passive for *C* and *D*.³⁹ This will increase the effective rate on *C* and *D*'s partnership income to 40.8%, the 37% individual tax rate plus the 3.8% Medicare surtax. Thus, where the Medicare surcharge applies to both, the C corporation, with its effective tax rate of 39.8% versus the partnership's effective rate of 40.8%, has a slight advantage.

Example 3A (3.8% Medicare surtax does apply to owners of both entities; 20% deduction under section 199A is *not* available to partners; both entities will distribute their earnings annually):

Assume the same facts as Example 2, except that the 3.8% surtax does apply to both entities. If *C* and *D* hold the land in a C corporation, the \$500,000 income will generate a corporate tax liability of \$105,000 (21% of \$500,000). When the remaining \$395,000 (\$500,000 minus \$105,000) is distributed, *C* and

35. I.R.C. § 1(h)(11).

36. $\$184,000 \div \$500,000 = 36.8\%$.

37. I.R.C. § 1411(c)(1)(A)(i).

38. $1 - ((1 - .21)(1 - .238))$.

39. I.R.C. § 1411(a)(1), (c)(1)–(2).

D will incur a tax liability of \$94,010 (23.8% of \$395,000), leaving them with \$300,990. The effective marginal rate on the C corporation's income after distribution to *C* and *D* is 39.8%.

If *C* and *D* instead hold the land in a partnership, they will incur a federal tax liability of \$204,000 (40.8%⁴⁰ of \$500,000), leaving them with \$296,000 after tax and resulting in an effective tax rate of 40.8%.

The result is that the C corporation has a slight advantage with the slightly lower tax rate of 39.8% versus the partnership's effective tax rate of 40.8%.

But if the real estate activity is not a passive activity for *C* and *D*, the result flips. The partnership now offers a lower effective rate because the Medicare surtax will not apply⁴¹ and the partnership's effective tax rate will be only 37%. All other things being equal, therefore, *C* and *D* would prefer the partnership's effective tax rate of 37% to the C corporation's effective rate of 39.8%. This is shown in Example 3B.

Example 3B (3.8% Medicare surtax applies to C corporation's owner, but not to the partnership's owners; 20% deduction under section 199A is *not* available to the partners; both entities will distribute their earnings annually):

Assume the same facts as Example 2, except that the 3.8% Medicare surtax applies to the C corporation's stockholders but not to the partnership's partners. If *C* and *D* hold the land in a C corporation, the \$500,000 income will generate a corporate tax liability of \$105,000 (21% of \$500,000) and a tax liability of \$94,010 for *C* and *D* when the remaining amount is distributed to them, leaving them with \$300,990. The effective marginal rate on the C corporation's income after distribution to *C* and *D* is 39.8%.

If *C* and *D* instead hold the land in a partnership, they will incur a federal tax liability of \$185,000 (37% of \$500,000), leaving them with \$315,000 after tax and resulting in an effective tax rate of 37%.

40. The 37% individual income tax rate, plus the 3.8% Medicare surtax.

41. I.R.C. § 1411(c)(2)(A).

The result is *C* and *D* will prefer the partnership since it has an advantage with the lower effective tax rate of 37% versus the C corporation's effective tax rate of 39.8%.

But we will see below that when we relax the other two conditions (the unavailability of the 20% section 199A deduction and the annual distribution of earnings) *C* and *D*'s preferences will be less apparent.

D. The Conditions for Parity Are Also Unrealistic Because the 20% Deduction Under Section 199A Will Be Available in Some Situations

We have seen that the existence of the first condition for parity between C corporations and partnerships, the non-application of the 3.8% Medicare surtax to both entities, is totally unrealistic. The existence of the second condition (the unavailability of the 20% section 199A deduction) is also unlikely in many situations for partnerships. (The 20% deduction, however, is never available to C corporations.⁴²) As discussed earlier, the 20% deduction under section 199A will be available to individual partners if all the requirements of section 199A are satisfied.⁴³

Let's examine what happens if condition 2 (the unavailability of the 20% section 199A deduction) changes. If an activity will generate income that is eligible for the 20% section 199A deduction and will regularly distribute its earnings, a flow-through entity will be preferable to a C corporation regardless of whether the 3.8% Medicare surtax applies to the partnership because a C corporation cannot claim the section 199A deduction.⁴⁴ Consider first a scenario where the Medicare surtax does not apply.

Example 4A (3.8% Medicare surcharge does not apply to partners; 20% deduction under section 199A is available to the partners; both entities will distribute their earnings annually):

Individuals *E* and *F* are considering investing in an office tower that will generate \$500,000 of taxable income for them

42. I.R.C. § 199A(a).

43. See Part III.A.

44. This deduction is, however, not available to corporations. I.R.C. § 199A(a) (flush language).

before taking into account the section 199A deduction. Assume that all the income will be qualified business income for *E* and *F* and that they will be able to claim a deduction of 20% under section 199A.⁴⁵ Assume further that the income is not passive for *E* and *F* so that the 3.8% Medicare surtax does not apply. If they invest in the building using a partnership, their tax liability will be \$148,000. This is calculated by subtracting the section 199A deduction of \$100,000 (20% of \$500,000) from their pre-deduction income of \$500,000 and multiplying the difference by 37%. In other words, their effective tax rate on the income is 29.6%.⁴⁶

If *E* and *F* instead hold the building in a C corporation, they will have a tax liability of \$199,010, representing an effective tax rate of about 39.8%.⁴⁷ A tax of \$105,000 will be incurred at the corporate level (21% of \$500,000) and an additional tax of \$94,010 will be incurred when the income remaining after payment of the corporate tax is distributed to *E* and *F* as a dividend because of the 20% income tax⁴⁸ and 3.8% Medicare surcharge (23.8% of \$395,000).

Note that in Example 4A, the 39.8% effective tax for the C corporation is larger than the 29.6% effective rate for the partnership because the C corporation cannot qualify for the section 199A deduction. A similar result occurs if we instead assume that the Medicare surcharge does apply to partners. In that situation, the effective tax rate for the partnership is 32.6% versus 39.8% for the C corporation.

Example 4B (Medicare surcharge does apply to partners):

Assume the same facts as in Example 4A, except that the Medicare surcharge does apply to partners. Now the partners will incur a tax liability of \$163,200, which represents an effective rate of 32.6%. The tax liability is calculated by subtracting the section 199A deduction of \$100,000 (20% of \$500,000) from their pre-deduction income of \$500,000 and

45. As described in the text accompanying note 17, the availability and amount of the deduction depends on each partner's individual circumstance.

46. $.37(1 - .20)$.

47. $1 - ((1 - .21)(1 - .238))$.

48. I.R.C. § 1(h)(11).

multiplying the difference by 40.8% (the 37% maximum individual rate and the 3.8% Medicare surtax rate).

If *E* and *F* instead held the building in a C corporation, they would have the same tax liability of \$199,010, as in Example 4A, above, representing an effective tax rate of about 39.8%.⁴⁹

Once again, the availability of the 20% section 199A deduction causes the partnership to have the lowest effective tax rate even if the Medicare surcharge applies.

The conditions and conclusions of Examples 3 through 4 are summarized in Chart 1, below.

Chart 1

	3.8% Medicare Surtax	20% § 199A Deduction	Distribute Earnings Annually	Effective Marginal Tax Rate
Example 3A				
Partnership	Yes	No	Yes	40.8%
C Corporation	Yes	No	Yes	39.8%
Example 3B				
Partnership	No	No	Yes	37%
C Corporation	Yes	No	Yes	39.8%
Example 4A				
Partnership	No	Yes	Yes	29.6%
C Corporation	Yes	No	Yes	39.8%
Example 4B				
Partnership	Yes	Yes	Yes	32.6%
C Corporation	Yes	No	Yes	39.8%

As summarized in Chart 1, the partnership frequently has the lower effective tax rate where earnings are distributed annually. Only in Example 3A does the C corporation have a slight advantage where the 3.8% Medicare surtax applies to both entities and the 20% section 199A deduction is not available to partners in the partnership.

49. $1 - ((1 - .21)(1 - .238))$.

E. The Conditions for Parity Are Also Unrealistic Because Earnings Will Often Be Retained

In the foregoing Examples, we assumed that the partnership and the C corporation would distribute their earnings each year to *E* and *F*. (This was the requirement of condition 3, above.) In fact, many businesses finance their growth through retained earnings, so it is likely that many will not want to distribute all their income every year. Although Code section 531 imposes a tax on corporations for excessive accumulated earnings, that tax can be avoided by showing a reasonable business need for the accumulation.⁵⁰

If we now relax the condition that the entity will distribute its earnings annually, investors may be better off in some circumstances using a C corporation. Income earned on the retained earnings of a C corporation is taxed at a maximum of 21%. In contrast, investors would have to pay taxes on the partnership's earnings at an effective rate of 29.6% (assuming that the section 199A 20% deduction is available) regardless of whether the income is distributed to them. Depending on how long the earnings will be retained, the amount of income generated by the investment of those earnings, and the manner in which investors will obtain the entity's earnings, a C corporation may provide a more favorable tax outcome.

50. See, for example, BORIS I. BITTKER & LAURENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 99.1.2 (2d/3d ed. 2018), which summarizes the cases as follows:

Most of the cases have thus been won or lost on the battleground of reasonable business needs. If a corporation establishes business needs for an accumulation, the government ordinarily concedes or suffers defeat, despite the theoretical possibility that the accumulation was in fact motivated by a tax-avoidance purpose rather than by business needs. Conversely, once accumulations have been found unreasonable, taxpayers rarely succeed in rebutting the inference that tax avoidance was the motive for the accumulation.

1. Corporate Earnings Are Retained in a Qualified Small Business Corporation and Investors Realize Corporate Profits by Selling Stock

The starkest example of where a C corporation is preferable is a scenario in which investors plan to have the entity accumulate earnings until they dispose of their equity interests in the entity. In that situation, a C corporation issuing “qualified small business” (“QSB”) stock that qualifies for the capital gain exemption under section 1202 clearly has the lowest effective tax rate on its earnings.⁵¹ The effective tax rate on the return to the investors will be only 21%, the tax rate of the C corporation since the 3.8% Medicare surtax also does not apply.⁵² In contrast,

51. I.R.C. § 1202(a) excludes 100% of the gain from QSB stock acquired after September 28, 2010, and held for more than five years. In addition, the excluded gain is not a tax preference item for purposes of the alternative minimum tax. I.R.C. § 1202(a)(4). The excluded amount is equal to the greater of (1) \$10,000,000 per issuing corporation, reduced by the aggregate amount of eligible gain recognized by the taxpayer for prior years on stock issued by that corporation or (2) ten times the aggregate adjusted bases of QSB stock issued by the corporation to the taxpayer and sold by the taxpayer during the taxable year. I.R.C. § 1202(b)(1).

To qualify as a QSB the entity must be a C corporation that at all times prior to issuance of the § 1202 stock and immediately after such issuance has aggregate gross assets of no more than \$50,000,000. I.R.C. § 1202(d). In addition, 80% or more of its assets must be used in the active conduct of a “qualified trade or business.” Qualified trades or businesses do not include most of the same types of businesses that are treated as “specified service” businesses in § 199A(d). Thus qualified trades or businesses do not include:

any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees. . . .

I.R.C. § 1202(e)(3)(A). Qualified trades or businesses also do not include “any banking, insurance, financing, leasing, investing, or similar business” and “any business of operating a hotel, motel, restaurant, or similar business.” I.R.C. § 1202(e)(3)(B), (E).

52. I.R.C. § 1411(c)(1)(A); *see* Reg. § 1.1411-4(d)(3)(ii), Ex. 3.

the effective tax rate is 29.6% in the best case scenario for a partnership (one in which the 20% section 199A deduction applies and the 3.8% Medicare surtax does not apply). This is illustrated in Example 5.

Example 5 (C corporation issues QSB Stock and retains earnings):

Investors purchase stock for \$1,000,000 from a C corporation that will qualify for the capital gain exclusion in section 1202. The corporation generates a 10% pretax return on the \$1,000,000 it received from the investors, which is a 7.9% after-tax return after accounting for the corporation's 21% marginal tax rate. At the end of 5 years, the corporation now holds assets with a value of \$1,462,538, which represents the 7.9% after-tax return on the \$1,000,000 stockholder investment.⁵³

Contrast this with an investment of \$1,000,000 in a partnership, assuming that the 20% section 199A deduction applies and the 3.8% Medicare surtax does not apply. In that situation, the investors will face an effective tax rate of 29.6%, and the partnership will hold assets with a value of \$1,405,175 at the end of 5 years.

The section 1202 exclusion of capital gain on the sale of QSB stock clearly allows a C corporation to have the lower effective tax rate if all the requirements of section 1202 are satisfied and the investors wish to have the entity retain all its earnings and then sell their stock.

2. Investors Realize Corporate Profits Through Dividend Distributions After Earnings Are Retained or Corporation Is Not a QSB

But what if investors do not wish to sell their stock in order to benefit from the entity's earnings? What if they wish to retain earnings to finance growth and then distribute those earnings as dividends in the future? Alternatively, what if the corporation is not a QSB so that gain on the sale of stock is taxable? As illustrated below, if a C corporation will accumulate income for a sufficiently long time, the low corporate

53. $(1 + .0704)^5(\$100,000,000)$.

rate of 21% gives the C corporation a rate advantage even though the 20% section 199A deduction is unavailable for C corporations.

*a. Partnership Qualifies for Section 199A 20% Deduction,
Earnings Are Retained, and the C Corporation
Is Not a QSB*

Consider first a situation where the partnership's income qualifies for the 20% section 199A deduction. The calculations can become very complex. Although the impact of the Medicare surcharge is dwarfed by the section 199A 20% deduction and the low corporate rate of 21% on the return from investing retained earnings, Examples 6A and 6B will illustrate scenarios where the Medicare surtax is not assessed and then assessed on the partnership's income.

Example 6A (Medicare surtax does not apply to partnership's income; the 20% deduction under section 199A is available to the partners; and the entities will not distribute earnings annually):

G and *H* are considering starting a computer manufacturing business that they expect to generate a pretax profit of 10% per year on their initial investment of \$1,000,000 and on all subsequent earnings that will be retained and reinvested in the business. If the business is organized as a C corporation, the earnings of the corporation will be taxed at 21%, and *G* and *H* will pay an additional tax of 23.8% when the earnings are eventually distributed to them (or if they sell their stock for a price that reflects their initial investment plus earnings accumulated thereon). If, instead, the business is organized as a flow-through entity, there will be only one level of tax, which will be paid by *G* and *H*. Assume that *G*'s and *H*'s individual incomes are taxed at the maximum rate of 37% and that all the income flowing out to them from the partnership will qualify for the section 199A 20% deduction and will not be subject to the 3.8% Medicare surtax.

If *G* and *H* were to cause the business to distribute all its earnings every year, the flow-through entity would have the advantage. (This was illustrated in Example 4A, above.) This is because only a single level of tax is assessed at an effective rate of 29.6% (the maximum tax rate of 37% reduced by the

section 199A 20% deduction). In contrast, had *G* and *H* used a C corporation, there would have been a 21% tax assessed at the corporate level on the corporation's earnings each year and a 23.8% tax assessed at the stockholder level when the earnings are distributed.

But if *G* and *H* intend to have the business retain all its earnings for a long period of time, the fact that the retained earnings are being taxed at the lower corporate tax rate of 21% as they continue to be reinvested and generate additional income will eventually cause the C corporation to have the tax advantage. Under the facts in this Example 6A, if the C corporation continues to retain and reinvest its earnings in the business for approximately 30.1 years or more, the C corporation will have a lower tax liability.⁵⁴

54. This is calculated by using the following equation:

$$.762((1,000,000)(1 + .079)^t - 1,000,000) = (1,000,000)(1 + .0704)^t - 1,000,000.$$

The left side of the equation represents the after-tax return for the corporation. Here is what each term represents. The amount earned by the corporation and eventually distributed as dividends to stockholders will be taxed to them at 23.8% (the 20% dividend tax and the 3.8% Medicare surtax), leaving them with 76.2% of the distribution after tax. The (.762) in the equation represents this. The (1,000,000) in the equation represents the \$1,000,000 invested by *G* and *H*. The corporate rate of 21% on the pretax return of 10% results in an after-tax return of 7.9% on the retained earnings. The $(1 + .079)^t$ represents this after-tax return earned for t years while the corporation is investing the \$1,000,000 and reinvesting all subsequently generated earnings. The $-1,000,000$ represents the fact that the \$1,000,000 initial investment by *G* and *H* will be returned to them tax free.

The right side of the equation represents the after-tax return using the partnership. The (1,000,000) again represents the \$1,000,000 invested by *G* and *H* in the flow-through entity. The $(1 + .0704)^t$ represents the after-tax return earned by the flow-through entity while it is investing the \$1,000,000 and its subsequent earnings at a pretax return of 10% for t years. The maximum individual tax rate of 37% and the 20% § 199A deduction result in an effective tax rate of 29.6%, which in turn means that the after-tax return is 7.04%. Because the earnings in the flow-through entity are only subject to a single tax, there is no additional tax liability upon distribution of all the retained earnings to *G* and *H*. The $-1,000,000$ represents the fact that the initial \$1,000,000 investment by *G* and *H* will be returned to them tax free.

Thirty years is a long time, so it is quite possible that in the scenario of Example 6A, *G* and *H* would elect to conduct business as a flow-through entity. But, unfortunately, there is no clear rule to apply to every case because the rate of return on the retained earnings will impact the time period. If the pretax rate of return is expected to be 20% in Example 6A, rather than 10%, the C corporation would produce a higher after-tax return in approximately 16.3 years.⁵⁵ Given the short time horizon for investors, it may very well be that 16.3 years is also too long. But at a sufficiently high pretax rate of return, taxpayers may opt for the C corporation in this scenario.

Similar results occur if we now assume that the Medicare surcharge will apply to the partnership's income as well as to the C corporation's dividends.

Example 6B (Medicare surtax does apply to partnership's income; the 20% deduction under section 199A is available to the partners; and the entities will not distribute earnings annually):

Solving for t , we find that t equals 30.0575 years. This means that, if the C corporation retained its earnings for 30.0575 years, the C corporation and the partnership would have exactly the same after-tax return. If *G* and *H* intend that the entity not retain and reinvest its earnings for 30.0575 years, the flow-through entity will have the higher after-tax return. On the other hand, the C corporation is preferable if *G* and *H* intend that the entity retain and reinvest all its assets for more than 30.0575 years.

55. The equation from note 54 would now be altered to reflect the fact that we have doubled the pretax rate of return for each entity:

$$.762((1,000,000)(1 + .158)^t - 1,000,000) = (1,000,000)(1 + .1408)^t - 1,000,000.$$

The expression $(1 + .158)^t$ represents the after-tax return for the corporation for t years while the corporation is investing the \$1,000,000 and subsequently generated earnings at a pretax return of 20%. The expression $(1 + .1408)^t$ represents the after-tax return earned by the flow-through entity while it is investing the \$1,000,000 and its subsequently generated earnings at a pretax return of 20%.

Solving for t , we find that t equals 16.2724. Thus, the C corporation is preferable in this scenario if *G* and *H* intend that the entity retain and reinvest all its assets for more than 16.2724 years.

Assume the same facts as 6A, except that the Medicare surcharge now applies to the partnership's income as well as to the C corporation's dividends. As a result, if the business is organized as a C corporation, the earnings of the corporation will be taxed at 21%, and *G* and *H* will pay an additional tax of 23.8% when the earnings are eventually distributed. If, instead, the business is organized as a flow-through entity, there will be only one level of tax, which will be paid by *G* and *H*. Assume that *G* and *H* are taxed at the maximum rate of 37% and that all the income flowing out to them from the partnership will qualify for the section 199A 20% deduction and will be subject to the 3.8% Medicare surtax. This results in an effective tax of 33.4% on the partnership's earnings.⁵⁶

Under the facts in this Example 6B, if the C corporation continues to retain and reinvest its earnings in the business for more than approximately 15.7 years, the C corporation will have a lower tax liability.⁵⁷

56. The 37% maximum individual tax rate is reduced to an effective rate of 29.6% to reflect the 20% deduction and then increased by 3.8% to represent the Medicare surtax.

57. The equation from note 54 would now be altered to reflect the fact that the after-tax return for the partnership is reduced to reflect the Medicare surtax.

$$.762((1,000,000)(1 + .079)^t - 1,000,000) = (1,000,000)(1 + .0666)^t - 1,000,000.$$

The left hand side of the equation represents the after-tax return for the corporation. Here, again, is what each term represents. The amount earned by the corporation and eventually distributed to stockholders will be taxed at 23.8% (the 20% dividend tax and the 3.8% Medicare surtax) to the stockholders, leaving them with 76.2% of the distribution after tax. The (.762) in the equation represents this. The (1,000,000) in the equation represents the \$1,000,000 invested by *G* and *H*. The $(1 + .079)^t$ represents the after-tax return earned by the corporation for *t* years while the corporation is investing the \$1,000,000 and reinvesting all subsequently generated earnings at a pretax return of 10%. The corporate rate of 21% results in an after-tax return of 7.9% on the retained earnings. The $- 1,000,000$ represents the fact that \$1,000,000 will be a tax free return of the initial investment.

If we double the pretax return to 20%, the C corporation has the advantage if it retains its earnings for more than about 8.7 years.⁵⁸

*b. Impact of Unavailability of the Section 199A
20% Deduction Where Earnings Are Retained*

Suppose that the income generated by the entity will not be eligible for the 20% section 199A deduction for *G* and *H*, but that they still want to have the entity keep retaining and investing its earnings to finance growth. If the earnings from the flow-through entity do not qualify for the section 199A 20% deduction, the period for the C corporation to catch up with the partnership will be shorter because the after-tax return from the partnership will be lower. The partnership's earnings will now be taxed to *G* and *H* at an effective rate of 37% rather than 29.6%.

Example 7A (Medicare surtax does not apply to partnership's income; the 20% deduction under section 199A is not available)

The right hand side of the equation represents the after-tax return using the partnership. The $(1,000,000)$ again represents the \$1,000,000 invested by *G* and *H* in the flow-through entity. The $(1 + .0666)^t$ represents the after-tax return earned by the flow-through entity while it is investing the \$1,000,000 and its subsequent earnings at a pretax return of 10%. The maximum individual tax rate of 37% and the 20% § 199A deduction result in an effective tax rate of 29.6%, which is then increased by 3.8% to reflect the Medicare surtax to 33.4%. This means that the after-tax return is 6.66%. The $(1 + .0666)^t$ is the return earned by the partnership for t years. Because the earnings in the flow-through entity are only subject to a single tax, there is no additional tax liability upon distribution of all the retained earnings to *G* and *H*. The $-1,000,000$ represents the fact that \$1,000,000 will be a tax free return of the initial investment.

Solving for t , we find that t equals 15.6779 years.

58. The equation in note 57 is altered to reflect the fact that we have doubled the pretax rate of return for each entity:

$$.762((1,000,000)(1 + .158)^t - 1,000,000) = (1,000,000) 1 + .1332)^t - 1,000,000.$$

Solving for t , we find that t equals 8.6886 years.

to the flow-through entity's owners; and the entities will not distribute earnings annually):

Assume the same facts as Example 6A, except that the 20% section 199A deduction is not available. Thus, we assume a pretax profit of 10% per year on *G* and *H*'s initial investment of \$1,000,000 and on all subsequent earnings that will be retained and reinvested in the business. If the business is organized as a C corporation, the earnings of the corporation will be taxed at 21%, and *G* and *H* will pay an additional tax of 23.8% when the earnings are eventually distributed (or if they sell their stock for a price that reflects their initial investment plus earnings accumulated thereon). If, instead, the business is organized as a flow-through entity, there will be only one level of tax, which will be paid by *G* and *H*. Assume that *G* and *H*'s individual incomes are taxed at the maximum rate of 37% and that all the income flowing out to them from the partnership will *not* qualify for the section 199A 20% deduction and will *not* be subject to the 3.8% Medicare surtax.

Under the facts of this Example 7A, *G* and *H* would have to keep reinvesting earnings in the business for more than approximately 6.6 years at a 10% pretax return before they would be better off with the C corporation.⁵⁹

If we instead assume a 20% pretax return, they would be better off with the C corporation by having the entity retain

59. This is again calculated by using the same equation as in footnote 54 with one difference on the right-hand side of the equation:

$$.762((1,000,000)(1 + .079)^t - 1,000,000) = (1,000,000) (1 + .063)^t - 1,000,000.$$

The left-hand side of the equation again represents the after-tax return for the corporation and the expressions represent the same items as described above in footnote 54.

The right-hand side of the equation again represents the after-tax return using a flow-through entity. Note that the after-tax return is now smaller than it was in footnote 54: $(1 + .063)^t$ versus $(1 + .0704)^t$. This is because the flow-through entity's income is now being taxed at the full 37% for *G* and *H* without the benefit of the § 199A 20% deduction.

Solving for *t*, we find that *t* equals 6.6052. Thus, the C corporation will be preferable if *G* and *H* intend that the entity they select will retain and reinvest all its earnings for more than 6.6052 years.

earnings for more than approximately 3.93 years.⁶⁰ Even 3.93 years is a long time in a rapidly changing world, and taxpayers may very well decide in that scenario to select the partnership.

If the facts of Example 7A are changed slightly to impose the 3.8% Medicare tax on the partnership's income as well as on the C corporation's income, the C corporation is favored immediately regardless of whether earnings are retained. The C corporation does not have to retain earnings to have a rate advantage because its 39.8% effective rate when earnings are distributed immediately is less than the partnership's 40.8% effective rate. This was shown in Example 3A, above. The 1% difference in the effective marginal rates does not give the C corporation a huge advantage, however. To get some perspective on the C corporation's advantage in this scenario, we can calculate how long it must retain earnings in order to earn twice as much after-tax income as the partnership.

Example 7B (Medicare surtax does apply to partnership's income; the 20% deduction under section 199A is not available to the flow-through entity's owners; and the entities will not distribute earnings annually):

Assume the same facts as Example 7A, except that the Medicare surtax now applies to the partnership's income as well as to the C corporation's dividends. This will result in an effective tax rate of 40.8% on *G* and *H*'s return from the partnership, which will reduce their after-tax rate of return to 5.92%. In contrast, the C corporation will have an effective tax rate of 39.8% if it were to distribute earnings immediately, so the C corporation is preferable regardless of whether it retains earnings. (See Example 3A, above.)

60. The equation used in note 59 is altered to reflect the fact that we have doubled the pretax rate of return:

$$.762((1,000,000)(1 + .158)^t - 1,000,000) = (1,000,000) (1 + .126)^t - 1,000,000.$$

We now calculate *t* to equal 3.9293. Thus, the C corporation will be preferable if *G* and *H* intend that the entity retain and reinvest all its earnings for more than 3.9293 years.

The C corporation will have an even greater advantage in this scenario if it retains and reinvests its earnings because of the low 21% corporate tax. To get some perspective on the magnitude of the advantage of the C corporation in this scenario, we can calculate how long the C corporation must retain earnings in order for it to have earned various amounts that are greater than a partnership. It will take approximately 50.2 years for the C corporation to earn twice as much after tax as the partnership.⁶¹ Alternatively, it will take 32.2 years for the C corporation to produce 50% more earnings,⁶² 16.07 years to earn 20% more,⁶³ and 8.67 years to earn 10% more.⁶⁴

The conditions and conclusions of Examples 5, 6, and 7 are summarized in Chart 2, below.

The foregoing analysis shows that changing the conditions can have significant effects on the effective marginal tax rates of the

61. The equation in note 54 is altered to reflect that the after-tax return for *G* and *H* from the partnership has been reduced to 5.92%. This affects the right side of the equation. In addition, since we are trying to determine how long it will take the C corporation (which is on the left side of the equation) to earn twice as much as the partnership (which is on the right side), we multiply the right side by 2:

$$.762((1,000,000)(1 + .079)^t - 1,000,000) = 2((1,000,000)(1 + .0592)^t - 1,000,000).$$

Solving for *t*, *t* equals 50.2064 years. Thus it would take more than approximately 50.2064 years for the C corporation to produce twice as much after-tax earnings as the partnership.

62. The variable *t* equals 32.2402 where:

$$.762((1,000,000)(1 + .079)^t - 1,000,000) = 1.5((1,000,000)(1 + .0592)^t - 1,000,000).$$

63. The variable *t* equals 16.0736 where:

$$.762((1,000,000)(1 + .079)^t - 1,000,000) = 1.2((1,000,000)(1 + .0592)^t - 1,000,000).$$

64. The variable *t* equals 8.6668 where:

$$.762((1,000,000)(1 + .079)^t - 1,000,000) = 1.1((1,000,000)(1 + .0592)^t - 1,000,000).$$

Chart 2

	3.8% Medicare Surtax	20% § 199A Deduction	Distribute Earnings Annually	Years Required for C Corp.'s After-Tax Retained Earnings to Exceed Partnership's After-Tax Earnings
Example 5				
Partnership	No	Yes	No	
QSB Corporation	No	No	No	0*
Example 6A				
Partnership	No	Yes	No	
C Corporation	Yes	No	No	> 30.1** > 16.3***
Example 6B				
Partnership	Yes	Yes	No	
C Corporation	Yes	No	No	> 15.7** > 8.7***
Example 7A				
Partnership	No	No	No	
C Corporation	Yes	No	No	> 6.6** > 3.9***
Example 7B				
Partnership	Yes	No	No	
C Corporation	Yes	No	No	0*

*Corporation's after-tax earnings immediately exceed partnership's.

**Pretax return of 10%.

***Pretax return of 20%.

entities. If the entities will be distributing earnings annually, the partnership frequently fares better than the C corporation. The one exception where the C corporation fares better is Example 3A when the 3.8% Medicare surtax applies to the partnership and the 20% section 199A deduction is not available. In that situation, the C corporation has a slight advantage regardless of whether it will retain earnings (Example 7B).

The picture changes, however, if the C corporation will retain earnings. A C corporation that qualifies as a QSB will have a lower effective tax rate if investors intend to sell their stock instead of having the corporation distribute its earnings (Example 5). If the corporation is not a QSB or investors do not wish to sell their stock, the C corporation will have the advantage if investors are willing to allow the corporation to retain earnings for a sufficiently long period. The pay-back period in many of our examples from retaining earnings, however, may be too long for investors with shorter-term investment horizons. Planning will require investors to look into their crystal balls and predict how they wish to benefit from the entity's success.

IV. CONCLUSION

In an ideal world, the effective tax rates for C corporations and partnerships would not play a role in selecting an entity for conducting a business. Unfortunately, the new statutory rates in the 2017 Tax Act and the 20% section 199A deduction have not leveled the playing field.

This Article has shown that the choice of an appropriate entity under the effective tax rates of the 2017 Tax Act is complex and is affected by whether an entity will retain and reinvest its earnings, by how long this retention will occur, by the availability of the section 199A deduction, by the applicability of the 3.8% Medicare surtax, and by the pretax rate of return on retained earnings. If entities will distribute earnings annually, a partnership frequently has a lower effective tax rate than a C corporation. The picture changes, however, if a C corporation will retain earnings. A C corporation qualifying as a QSB under section 1202 will have a lower effective tax rate than a partnership if investors intend to sell their stock in lieu of having the corporation distribute its earnings. If a C corporation is not a QSB or investors do not wish to sell their stock, a C corporation will still have a lower effective tax rate if investors permit the corporation to retain earnings for sufficiently long periods. Investors may view such retention periods as too long, however, if they have short-term investment horizons.

The result is that the 2017 Tax Act has made it more difficult to predict which choice of entity will have the lowest effective tax rate in the long run. Tax planning has become more important, not less.