The Deduction for Qualified Business Income of Pass-through Entities under Section 199A

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This paper reviews the new Section 199A deduction for pass-through entity income, and the revised C corporation tax rate under The Tax Cuts and Jobs Act of 2017. The revised long-term capital gains tax rates that apply to dividend distributions, and the revised individual tax rates for pass-through entity income are also examined. This paper provides a comparison of the total tax burden of C corporations as compared to pass-through entities under the assumption that 100 percent of after-tax C corporation income is distributed to the shareholders.

INTRODUCTION

The C corporation tax rate has been changed from a graduated structure ranging from 15 to 35 percent to a flat rate of 21 percent. There may be a misnomer going around that due to the 21 percent flat corporate tax rate, there is no longer a tax benefit for pass-through entity status. However, individual tax rates have been lowered for 2018-2025, and there is a new Section 199A deduction for qualified pass-through entity income. This paper examines the impact of the Tax Cuts and Jobs Act of 2017 on C corporations, pass-through entities, and after-tax cash flow to the shareholder/owner.

Businesses can be classified under one of several entity forms. The choice of business entity forms includes C corporation, S corporation, Partnership, LLC, and sole proprietorship. A business entity my elect its classification by filing Form 8832 Entity Classification Election under the check-the-box regulations. An unincorporated business entity with two or more owners is taxed as a partnership, unless it elects to be taxed as a corporation. Unless it elects to be taxed as a corporation, an unincorporated business entity with one owner is treated as a disregarded entity and is taxed as a sole proprietorship on Form 1040, Schedule C.

A C corporation is a separate tax paying entity. Tax is paid by the C corporation at the entity level. Dividend distributions are taxed a second time at the shareholder level. This two-level, or two-tier tax structure may lead a higher rate of taxed when considering the total tax at both the entity level and the shareholder level.

A partnership is not a tax paying entity, it is a reporting entity which acts as a conduit from the business entity to the partner owners. Items of income, deduction, gain, loss, and credit pass through to the partner level, and are taxed on the partner's tax returns. A partnership can be a general partnership, a limited partnership. A limited liability company (LLC) is taxed as a partnership, but has the limited liability protections of a corporation. A limited liability partnership (LLP) is similar to an LLC but is a very attractive business form for professional services businesses because LLP partners are only not liable for the misconduct or negligence of other LLP partners. LLP partners are only liable for their own acts or the acts of individuals under their supervision.

An S corporation is a corporation that elects to be taxed similarly to a partnership. In general, no tax is paid by the S corporation at the entity level. Items of income, deduction, gains, loss, and credit flow through to the shareholder level and are taxed on the tax returns of the shareholders. The code sections applicable to C corporations also apply to S corporations, unless the Subchapter S provisions override the C corporation provisions.

In general, S corporations, partnerships, and proprietorships have a single level tax structure with taxes paid only at the owner level. C corporations have a two-tier tax structure where tax is paid on corporate taxable income at the entity level, and again at the shareholder level on dividend distributions. The Tax Cuts and Jobs Act of 2017 has introduced a flat corporate tax rate of 21 percent on C corporation income, and the new Section 199A deduction for pass-through entity income. The type of entity selected will impact the total tax burden on the entity and shareholders as well as the after-tax cash flows to the owners.

C Corporation Tax Rates and Taxation of Dividend Distributions Prior to 2018

Prior to 2018, C corporations were taxed under a graduated tax rate structure ranging from 15 percent on the first $50,000 of taxable income to 35 percent on taxable income in excess of $10 million (I.R.C. Section 11(b)). Qualified dividends were taxed at long-term capital gain tax rates. The maximum rate of tax on qualified dividends under prior law was as follows (IRS Publication 17):

- 0% on any amount that otherwise would be taxed at a 10% or 15% rate.
- 15% on any amount that otherwise would be taxed at rates greater than 15% but less than 39.6%.
- 20% on any amount that otherwise would be taxed at a 39.6% rate.

In addition, the net investment income tax (NIIT) of 3.8% is imposed on the lesser of net investment income for the taxable year, or the excess (if any) of modified adjusted gross income for the taxable year over the threshold amount (I.R.C. Section 1411(a)). C corporation dividend distributions are subject to the 3.8% NIIT if modified adjusted gross income exceeds:

- $250,000 for married filing jointly
- $125,000 for married filing separately
- $200,000 for single and head of household.

Flat Corporate Tax Rate of 21 Percent Beginning January 1, 2018

The act replaced the prior-law graduated corporate tax rate, which taxed income over $10 million at 35%, with a flat rate of 21%. The House version of the bill had provided for a special 25% rate on personal service corporations, but that special rate did not appear in the final act. The new rate took effect Jan. 1, 2018. Personal service corporations (PSCs) were previously taxed at a flat rate of 35 percent on taxable income, the highest corporate rate. PSCs will continue to be taxed at the "highest corporate rate", but the rate is no 21% (I.R.C. Section 11(b)).

New Dividend (Capital Gain) Tax Rates

Beginning January 1, 2018, qualified dividends use the capital gains tax rates as follows (I.R.C. Section 1(h)):

TABLE 1
LONG-TERM CAPITAL GAIN TAX RATES

Long-term Capital Gain Tax Rate	Single Taxpayers	Married Filing Jointly	Head of Household	Married Filing Separately
0%	Up tp $38,600	Up to $77,200	Up to $51,700	Up tp $38,600
15%	$38,600-$425,800	$77,200-$479,000	$51,700-$452,400	$38,600-$239,500
20%	Over $425,800	Over $479,000	Over $452,400	Over $239,500

Net Investment Income Tax (NIIT)

The 3.8 percent NIIT under Section 1411 continues to apply if modified adjusted gross income exceeds the threshold amounts of $250,000 for joint returns, $125,000 for married filing separately, and $200,000 for all other filing statuses.

Pass-through Entity Tax Rates

Pass-through entity income is taxed at the shareholder level using individual tax rates. Items of income, gains, loss, deductions, and credits pass-through from the entity level to the shareholder/partner level and retain their character. The shareholder/partner is taxed on these items regardless of whether the income was distributed to the shareholder/partner (I.R.C. 1366). The individual tax rates are progressive, and increase as the taxpayer's income increases. Before 2018, the tax rates were 10, 15, 25, 28, 33, and 39.6 percent. For 2018 through 2025, the individual tax rates are 10, 12, 22, 24, 32, 35, and 37 percent (I.R.C. Section 1). Special brackets will apply for certain children with unearned income. The brackets will be indexed for inflation using chained CPI (I.R.C. Section 1(f)). The tax rate schedules for 2018 are provided below.

TABLE 2
INDIVIDUAL TAX RATE SCHEDULES 2018-2025

Single Taxpayers			
Taxable Income Over	But Not Over	The tax is:	Of the amount over
$0	$9,525	$0 + 10%	$0
$9,525	$38,700	$952.50 + 12%	$9,525
$38,700	$82,500	$4,443.50 + 22%	$38,700
$82,500	$157,500	$14,089.50 + 24%	$82,500
$157,500	$200,000	$32,089.50 + 32%	$157,500
$200,000	$500,000	$45,689.50 + 35%	$200,000
$500,000	-	$150,689.50 + 37%	$500,000

Married Filing Joint Returns or Surviving Spouses			
Taxable Income Over	But Not Over	The tax is:	Of the amount over
$0	$19,050	$0 + 10%	$0
$19,050	$77,400	$1,905.00 + 12%	$19,050
$77,400	$165,000	$8,907.00 + 22%	$77,400
$165,000	$315,000	$28,179.00 + 24%	$165,000
$315,000	$400,000	$64,179.00 + 32%	$315,000
$400,000	$600,000	$91,379.00 + 35%	$400,000
$600,000	-	$161,379.00 + 37%	$600,000
Married Filing Separately			
Taxable Income Over	But Not Over	The tax is:	Of the amount over
$0	$9,525	$0 + 10%	$0
$9,525	$38,700	$952.50 + 12%	$9,525
$38,700	$82,500	$4,443.50 + 22%	$38,700
$82,500	$157,500	$14,089.50 + 24%	$82,500
$157,500	$200,000	$32,089.50 + 32%	$157,500
$200,000	$500,000	$45,689.50 + 35%	$200,000
$500,000	-	$150,689.50 + 37%	$500,000
Head of Household			
Taxable Income Over	But Not Over	The tax is:	Of the amount over
$0	$13,600	$0 + 10%	$0
$13,600	$51,800	$1,360.00 + 12%	$13,600
$51,800	$82,500	$5,944.00 + 22%	$51,800
$82,500	$157,500	$12,689.00 + 24%	$82,500
$157,500	$200,000	$30,398.00 + 32%	$157,500
$200,000	$500,000	$44,298.00 + 35%	$200,000
$500,000	-	$149,298.00 + 37%	$500,000

Section 199A Deduction for Qualified Business Income of Pass-Through Entities

The Tax Cuts and Jobs Act adds the new Internal Revenue Code Section 199A deduction for qualified business income of pass-through entities. For taxable years 2018-2025, an individual taxpayer generally may deduct 20 percent of qualified business income from a partnership, S corporation, or sole proprietorship. The taxpayer may also deduct 20 percent of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income. There is a W-2 wage limitation, similar to the W-2 wage limitation that was included in the domestic production activities deduction under Section 199. The Tax Cuts and Jobs Act repeals the Section 199 domestic production activities deduction (I.R.C. Section 199 was stricken by PL 115-97, Sec. 13305(a).) The W-2 limitation is phased in when taxable income exceeds a threshold amount. There is also a phased-in disallowance of the Section 199A deduction for service businesses with taxable income above the threshold amount. There are special rules for agricultural or horticultural cooperatives. The Section 199A deduction is equal to the sum of:

1. The lesser of the combined qualified business income, or an amount equal to 20 percent of the excess (if any) of:

a. The combined qualified business income of the taxpayer, or
b. 20 percent of the excess (if any) of the taxpayer's taxable income over the taxpayer's net capital gain (as defined under Sec. 1(h)), plus the aggregate amount of qualified cooperative dividends, plus
2. The lesser of
a. 20 percent of aggregate qualified corporate dividends, or
b. Taxable income, reduced by net capital gain, not to exceed taxable income (I.R.C. Section 199A(a)).

The taxable income is computed without regard to the Section 199A deduction (I.R.C. Section 199A(e)(1)).

Qualified Business Income

Qualified business income means the net amounts of qualified items of income, gain, deduction, and loss with respect to each qualified trade or business of the taxpayer, plus 20 percent of the aggregate qualified REIT dividends and qualified PTP income (I.R.C. Section 199A(b)(1)). Net losses are carried over to the next tax year. If the net amount of qualified income, gain, deduction, and loss with respect to the qualified trade or business is a loss, then the loss may be carried over to the succeeding tax year (I.R.C. Section 199A(b)(2).

W-2 Wage/Qualified Property Limitation

The Section 199A deduction has a limitation of 50 percent of W-2 wages, or the sum of 25 percent of W-2 wages, plus 2.5 percent of the unadjusted basis of qualified property acquired during the year. The deduction is the lesser of:

1. 20 percent of qualified business income or
2. The W-2 wages/qualified property limitation. The W-2 wages/qualified property limitation is the greater of
    a. 50 percent of W-2 wages with respect to qualified business income,
    b. or the sum of 25 percent of W-2 wages, plus 2.5 percent of the unadjusted basis of qualified property acquired during the year (I.R.C. Section 199A(b)(2)(B)).

Qualified property means tangible property subject to the allowance for depreciation under Section 167, that is available for use in the qualified trade or business at the end of the tax year, which is used at any point during the year in the production of qualified business income, and the depreciable period has not ended before the close of the taxable year (I.R.C. Section 199A(b)(6)(A).

The depreciable period with respect to qualified property means the period beginning on the date the property was placed in service, and ending on the later of 10 years after the date placed in service, or the last day of the last full year in the applicable recovery period. The depreciable period does not include the last year if it is a partial year (I.R.C. Section 199A((b)(6)(B)).

Phase-in of the W-2 Wage/Qualified Property Limitation

The W-2 wage/qualified property limitation is phased-in when taxable income of the shareholder/owner exceeds the threshold amount. The threshold amount is $157,500 for all taxpayers other than married filing jointly, and $315,000 in the case of a joint return. If the taxpayer's taxable income does not exceed the threshold amount, then the threshold W-2 wage limitation o does not apply (I.R.C. Section 199A(b)(2)(B)). The threshold amount is indexed for inflation under Section 1(f)(3) (I.R.C. Section 199A(c)(2)). Code Section 1(f)(3) is amended by the Tax Cuts and Job Act to base inflation on chained CPI, just as the individual tax brackets are indexed for inflation based on chained CPI. Once taxable income of the taxpayer for any taxable year exceeds the threshold amount, the W-2 wage/qualified property limitation is phased-in over the next $50,000 of taxable income ($100,000 for married filing joint) (I.R.C. Section 199A(b)(3)(B)). Therefore, the threshold amounts are:

- All filing statuses except MFJ $157,500-$207-500
- MFJ $315,000-$415,000

Example of the W-2 Wage/Qualified Property Limitation

Steve is the 100 percent owner of an S corporation that makes patio table umbrellas. The S corporation buys a machine for $200,000 that manufactures the umbrellas., and places the machine in service in 2021. The business has no employees. The W-2 wages/qualified property limit on the business's deductible amount for 2021 is $5,000, calculated as the greater of:

(1) 50% of W-2 wages ($0 × 50% = $0), or
(2) the sum of 25% of W-2 wages ($0) plus 2.5% of the unadjusted basis of the machine immediately after its acquisition ($200,000 × 0.025 = $5,000).

Effectively Connected U.S. Business

Qualified items of income, gain, deduction, and loss are qualified items only to the extent they are effectively connected with the conduct of a trade or business within the United States, and Puerto Rico. Qualified income items do not include the following specific items of investment income, gain, or loss:

1. Capital gains and losses
2. Dividends
3. Interest income not allocable to the trade or business
4. Gains on commodities transactions in excess of losses not in the ordinary course of business.
5. Foreign currency gains in excess of foreign currency losses from Section 988 transactions not directly related to the needs of the business.
6. Net income from notional principal contracts
7. Annuity income not in connection with the trade or business (I.R.C. Section 199A(c)(3)).

Guaranteed Payments and Reasonable Compensation

Qualified business income does not include reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered to the trade or business, guaranteed payments to partners/members of partnerships/LLCs with respect to the trade or business under Section 707(c), or any payment under Section 707(a) to a partner for services rendered to the trade or business (I.R.C. Section 199A(c)(4)).

Qualified Trade or Business

A qualified trade or business means any trade or business other than a specified service trade or business. A specified trade or service business means any trade or business described in Sec. 1202(e)(3)(A), with the exception of engineering or architecture. Therefore, a specified trade or service business means any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading or dealing in securities, partnership interests, or commodities, or any trade or business, where the principal asset of the trade, or business is the reputation or skill of one or more of its employees or owners (I.R.C. Section 1202(e)(3)). Section 448(d)(2)(A) and Reg. Sec. 1.448-1T(e)(4) provide a definition of a qualified personal service corporation under exceptions to the limitation on the use of the cash method of accounting.

Phase-out of the 199A Deduction for Specified Service Businesses

There is an exclusion for the specified trade or service businesses above a threshold amount. The threshold amount is $157,500, or $315,000 in the case of a joint return (I.R.C. Section 199A(e)(2)). If the taxpayer's taxable income does not exceed the threshold amount, then the specified service business limitation o does not apply. Similar to the phase-in of the W-2 limitation, once taxable income of the taxpayer for any taxable year exceeds the threshold amount, the Section 199A deduction is phased out over the next $50,000 of taxable income ($100,000 for married filing joint) (I.R.C. Section 199A(d)(3)(A)). Therefore, the phaseouts for specified service businesses are similar to the phaseouts for the W-2 wage limitation.

- All filing statuses except MFJ $157,500-$207-500
- MFJ $315,000-$415,000

The threshold amount is indexed for inflation under Section 1(f)(3) and is based on chained CPI (I.R.C. Section 199A(e)(2)(B)).

Qualified REIT Dividends, Cooperative Dividends, and Publicly Traded Partnership Income

There is a deduction for 20 percent of the taxpayer's aggregate REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income. Qualified REIT dividends do not include capital gain dividends (As defined in I.R.C. Section 857(b)(3)), or qualified dividends (As defined in I.R.C. Section 1(h)(11)). Qualified cooperative dividends means any patronage dividend (As defined in I.R.C. Section 1388(a)), any per-unit retain allocation (As defined in I.R.C. Section 1388(f))., and any qualified written notice of allocation (As defined in I.R.C. Section 1388(c)), or any similar amount received from a tax-exempt benevolent life insurance association (As defined in I.R.C. Section 501(c)(12)), or an organization engaged in furnishing electric energy, or providing telephone service to persons in rural areas (As defined in I.R.C. Section 1381(a)), or a taxable cooperative under the rules before the 1962 enactment of Subchapter T (I.R.C. Section 199A(e)(4)). Qualified publicly traded partnership income means the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss, that are effectively connect with a U.S. PTP, and not including reasonable compensation of the taxpayer from the PTP, guaranteed payments for services rendered to the PTP, not treated as a corporation under Section 7704(c), plus any gain recognized by the taxpayer from the disposition of its interest in the PTP to the extend the gain is treated as ordinary income under Section 751(a) (I.R.C. Section 199A(e)(5)).

Specified agricultural or horticultural cooperatives

For taxable years 2018-2025, a 20 percent deduction is allowed for agricultural or horticultural cooperatives in an amount equal to the lesser of 20 percent of the cooperative's income of the for the year or 50 percent of the W-2 wages of the cooperative I.R.C. Section 199A(g)).

Section 199A Deduction is Applied at the Partner of Shareholder Level

In the case of a partnership or an S corporation, the Section 199A deduction applies at the partner or shareholder level. Each partner considers their allocable share of each qualified item of income, gain, deduction, and loss. Each partner or shareholder is treated as having W-2 wages and unadjusted basis immediately after the acquisition of qualified property for the taxable year equal to the partner's or shareholder's allocable share of W-2 wages of the partnership or S corporation. Qualified business income is determined without regard to any adjustments prescribed under the alternative minimum tax. The Secretary shall prescribe regulations as necessary to carry out the purposes of Section 199A (I.R.C. Section 199A(f)).

Example 1

Dan and Jennifer are married. Jennifer has a qualified business that is not a specified service business and operates as an S corporation. For tax year 2018, they file a joint return reporting taxable income of $345,000. In 2018, taxable income from the qualified business is $75,000. In 2018, 20 percent of the qualified business income from Jennifer's business is $15,000. Jennifer's share of wages paid by the business in 2018 is $20,000, with 50 percent of the W-2 wages from the business being $10,000. The qualified business did not acquire any qualified property for purposes of the Section 199A deduction. The deduction is the lesser of:

- 20 percent of qualified business income $75,000 x 20% = $15,000 or
- The W-2 wages/qualified property limitation. The W-2 wages/qualified property limitation is <u>the greater of</u>

- 50 percent of W-2 wages with respect to qualified business income
  - The W-2 Wages limitation is $20,000 x 50% = $10,000.
  - The W-2 wages/qualified property limitation is phased-in for MFJ from $315,000-$415,000.
  - The W-2 wages/qualified property limitation is 30% phased-in. $345,000-315,000=$30,000/$100,000 = 30%
  - 30% of the W-2 wage limitation is phased-in on the $5,000 excess ($15,000 – Wage limitation $10,000).
  - $5,000 x 30% = <u>$1,500 reduction in the Section 199A Deduction</u>
- or the sum of 25 percent of W-2 wages, plus 2.5 percent of the unadjusted basis of qualified property acquired during the year.
  - $0. There was no property purchased

- Amount of their deduction is $75,000 x 20% = $15,000 - $1,500 = $13,500.

With $345,000 of taxable income, the $61,500 ($75,000-$13,500) of pass-through income is taxed at the married filing joint rate of 32 percent, which is a tax of $19,680. The effective tax rate on the $75,000 of pass-through income is $19,680/$75,000, or 26.24 percent.

TABLE 3
EXAMPLE 1 AS AN S CORPORATION

	S Corp
Qualifed Business Income	$ 75,000
Section 199A Deduction	13,500
Tabable Qualifed Business Income	61,500
Personal Tax Rate	32%
Tax	19,680
Available to the shareholder	$ 55,320
Effective Tax Rate	26.24%

If the $75,000 of business income was C corporation income, the income would be taxed at a 21 percent flat corporate rate. The entity level tax for the C corporation $75,000 x .21, or $15,750. That leaves $59,250 of income after federal taxes that is available for dividend distribution ($75,000 - $15,750). If 100 percent of the $59,250 is distributed as a dividend, it will be taxed at a 15% capital gain tax, which is $59,250 x .15, or $8,887.50. Next, add the 3.8% NIIT of $2,251.50. This results in a total tax burden of $26,889 ($15,750 + $8,887.50 + $2,251.50 = $26,889). With the NIIT the total tax burden of C corporation income is $26,889/$75,000 = 35.85%. The dollar difference in tax cost in favor of the S corporation is $26,889 - $19,680 = $7,209. The percent difference in favor of the S corporation is 35.85 percent - 26.24 percent, or 9.61percent.

TABLE 4
EXAMPLE 1 AS A C CORPORATION

		C Corp
Qualified Business Income	$	75,000
Corporate tax rate		21.00%
Entity Level Tax		15,750
Available and paid as dividends		59,250
Dividend or personal tax rate		15.00%
Dividend tax		8,887.50
NIIT rate		3.80%
NIIT Tax		2,251.50
Total Shareholder level tax		11,139
Total tax burden		26,889
Available to shareholders	$	48,111
Effective Tax Rate		35.85%

S Corporation Compared to an Otherwise Identical C Corporation

In Tables 4 through 13 we examine $1,000 of qualified business income taxed at each personal tax rate in the federal tax rate schedules for married filing jointly. In tables 4 through 10, we assume that the taxpayer qualifies for the full 20 percent Section 199A deduction. In Tables 4 and 5, where pass-through income is taxed in the 10 percent and 12 percent brackets, the dividend tax rate is zero percent, and the NIIT is zero because the taxable income of the shareholder is below the threshold amount discussed above.

TABLE 4
PERSONAL TAX RATE 10%; DIVIDEND TAX RATE 0%, SECTION 199A DEDUCTION 20%

	S Corp		C corp
Qualified business income	$ 1,000	Qualifed business income	$ 1,000
Section 199A deduction 20%	200	Corporate tax rate	21.00%
Taxable qualified business income	800	Entity level tax	$ 210
Personal tax rate	10%		
Tax	80	Available and paid as dividends 100%	$ 790
Available to the shareholder	$ 920	Dividend or personal tax rate	0.00%
Effective tax rate	8.00%	Dividend tax	0
		NIIT rate	0.00%
		NIIT tax	0
		Total shareholder level tax	0
		Total tax burden	$ 210
		Available to the shareholders	$ 790
		Effective tax rate	21.00%

TABLE 5
PERSONAL TAX RATE 12%; DIVIDEND TAX RATE 0%, SECTION 199A DEDUCTION 20%

	S Corp		C corp
Qualified business income	$ 1,000	Qualifed business income	$ 1,000
Section 199A deduction 20%	200	Corporate tax rate	21.00%
Taxable qualified business income	800	Entity level tax	$ 210
Personal tax rate	12%		
Tax	96	Available and paid as dividends 100%	$ 790
Available to the shareholder	$ 904	Dividend or personal tax rate	0.00%
Effective tax rate	9.60%	Dividend tax	0
		NIIT rate	0.00%
		NIIT tax	0
		Total shareholder level tax	0
		Total tax burden	$ 210
		Available to the shareholders	$ 790
		Effective tax rate	21.00%

In Table 6, where pass-through income is taxed in the 22 percent tax bracket, the dividend tax rate is 15 percent, and the NIIT is zero because taxable income of the shareholder is below the threshold amount.

TABLE 6
PERSONAL TAX RATE 22%; DIVIDEND TAX RATE 15%, SECTION 199A DEDUCTION 20%

	S Corp		C corp
Qualified business income	$ 1,000	Qualifed business income	$ 1,000
Section 199A deduction 20%	200	Corporate tax rate	21.00%
Taxable qualified business income	800	Entity level tax	$ 210
Personal tax rate	22%		
Tax	176	Available and paid as dividends 100%	$ 790
Available to the shareholder	$ 824	Dividend or personal tax rate	15.00%
Effective tax rate	17.60%	Dividend tax	$ 119
		NIIT rate	0.00%
		NIIT tax	0
		Total shareholder level tax	$ 119
		Total tax burden	$ 329
		Available to the shareholders	$ 672
		Effective tax rate	32.85%

In Tables 7 and 8, pass-through income is taxed in the 24 and 32 percent tax brackets, the dividend tax rate is 15 percent, and the NIIT is 3.8 percent assuming the taxable income of the shareholder it is above the threshold amounts.

TABLE 7
PERSONAL TAX RATE 24%, DIVIDEND TAX RATE 18.8%, SECTION 199A DEDUCTION 20%

	S Corp		C corp
Qualified business income	$ 1,000	Qualifed business income	$ 1,000
Section 199A deduction 20%	200	Corporate tax rate	21.00%
Taxable qualified business income	800	Entity level tax	$ 210
Personal tax rate	24%		
Tax	192	Available and paid as dividends 100%	$ 790
Available to the shareholder	$ 808	Dividend or personal tax rate	15.00%
Effective tax rate	19.20%	Dividend tax	$ 119
		NIIT rate	3.80%
		NIIT tax	$ 30
		Total shareholder level tax	$ 149
		Total tax burden	$ 359
		Available to the shareholders	$ 641
		Effective tax rate	35.85%

TABLE 8
PERSONAL TAX RATE 32%, DIVIDEND TAX RATE 18.8%, SECTION 199A DEDUCTION 20%

	S Corp		C corp
Qualified business income	$ 1,000	Qualifed business income	$ 1,000
Section 199A deduction 20%	200	Corporate tax rate	21.00%
Taxable qualified business income	800	Entity level tax	$ 210
Personal tax rate	32%		
Tax	256	Available and paid as dividends 100%	$ 790
Available to the shareholder	$ 744	Dividend or personal tax rate	15.00%
Effective tax rate	25.60%	Dividend tax	$ 119
		NIIT rate	3.80%
		NIIT tax	$ 30
		Total shareholder level tax	$ 149
		Total tax burden	$ 359
		Available to the shareholders	$ 641
		Effective tax rate	35.85%

In Tables 9 and 10, when pass-through income is taxed in the 35 and 37 percent tax brackets, and the dividend tax rate is 20 percent. The NIIT is now 3.8 percent because taxable income of the shareholder is above the threshold amount of $250,000 for married filing jointly. Using the 2018 tax rate schedules for married filing jointly, the 24 percent bracket ranges from $165,000 - $315,000.

TABLE 9
PERSONAL TAX RATE 35%, DIVIDEND TAX RATE 23.8%, SECTION 199A DEDUCTION 20%

	S Corp		C corp
Qualified business income	$ 1,000	Qualifed business income	$ 1,000
Section 199A deduction 20%	200	Corporate tax rate	21.00%
Taxable qualified business income	800	Entity level tax	$ 210
Personal tax rate	35%		
Tax	280	Available and paid as dividends 100%	$ 790
Available to the shareholder	$ 720	Dividend or personal tax rate	20.00%
Effective tax rate	28.00%	Dividend tax	$ 158
		NIIT rate	3.80%
		NIIT tax	$ 30
		Total shareholder level tax	$ 188
		Total tax burden	$ 398
		Available to the shareholders	$ 602
		Effective tax rate	39.80%

TABLE 10
PERSONAL TAX RATE 37%, DIVIDEND TAX RATE 23.8%, SECTION 199A DEDUCTION 20%

	S Corp		C corp
Qualified business income	$ 1,000	Qualifed business income	$ 1,000
Section 199A deduction 20%	200	Corporate tax rate	21.00%
Taxable qualified business income	800	Entity level tax	$ 210
Personal tax rate	37%		
Tax	296	Available and paid as dividends 100%	$ 790
Available to the shareholder	$ 704	Dividend or personal tax rate	20.00%
Effective tax rate	29.60%	Dividend tax	$ 158
		NIIT rate	3.80%
		NIIT tax	$ 30
		Total shareholder level tax	$ 188
		Total tax burden	$ 398
		Available to the shareholders	$ 602
		Effective tax rate	39.80%

In Tables 11 through 13, we examine $1,000 of qualified business income taxed at the top three personal tax brackets for married filing jointly. We assume that the business entity is a specified service corporation and the 20 percent Section 199A deduction has been completely phased out. In Tables 11 and 12, where pass-through income is taxed in the 32 percent and 35 percent brackets, the dividend tax rate is 15 percent, and the NIIT is 3.8 percent because taxable income of the shareholder is above the threshold amounts discussed above. In Table 13, where pass-through income is taxed in the 37 percent tax bracket, the dividend tax rate is 20 percent, and the NIIT is 3.8 percent.

TABLE 11
PERSONAL TAX RATE 32%, DIVIDEND TAX RATE 18.8%, NO SECTION 199A DEDUCTION

	S Corp		C corp
Qualified business income	$ 1,000	Qualifed business income	$ 1,000
Section 199A deduction 20%	-	Corporate tax rate	21.00%
Taxable qualified business income	1,000	Entity level tax	$ 210
Personal tax rate	32%		
Tax	320	Available and paid as dividends 100%	$ 790
Available to the shareholder	$ 680	Dividend or personal tax rate	15.00%
Effective tax rate	32.00%	Dividend tax	$ 119
		NIIT rate	3.80%
		NIIT tax	$ 30
		Total shareholder level tax	$ 149
		Total tax burden	$ 359
		Available to the shareholders	$ 641
		Effective tax rate	35.85%

TABLE 12
PERSONAL TAX RATE 35%, DIVIDEND TAX RATE 23.8%, NO SECTION 199A DEDUCTION

	S Corp		C corp
Qualified business income	$ 1,000	Qualifed business income	$ 1,000
Section 199A deduction 20%	-	Corporate tax rate	21.00%
Taxable qualified business income	1,000	Entity level tax	$ 210
Personal tax rate	35%		
Tax	350	Available and paid as dividends 100%	$ 790
Available to the shareholder	$ 650	Dividend or personal tax rate	20.00%
Effective tax rate	35.00%	Dividend tax	$ 158
		NIIT rate	3.80%
		NIIT tax	$ 30
		Total shareholder level tax	$ 188
		Total tax burden	$ 398
		Available to the shareholders	$ 602
		Effective tax rate	39.80%

TABLE 13
PERSONAL TAX RATE 37%, DIVIDEND TAX RATE 23.8%, NO SECTION 199A DEDUCTION

	S Corp		C corp
Qualified business income	$ 1,000	Qualifed business income	$ 1,000
Section 199A deduction 20%	-	Corporate tax rate	21.00%
Taxable qualified business income	1,000	Entity level tax	$ 210
Personal tax rate	37%		
Tax	370	Available and paid as dividends 100%	$ 790
Available to the shareholder	$ 630	Dividend or personal tax rate	20.00%
Effective tax rate	37.00%	Dividend tax	$ 158
		NIIT rate	3.80%
		NIIT tax	$ 30
		Total shareholder level tax	$ 188
		Total tax burden	$ 398
		Available to the shareholders	$ 602
		Effective tax rate	39.80%

CONCLUSIONS

The Section 199A deduction appears to preserve the favorability of pass-through entity status. Effective January 1, 2018, C corporation income is taxed at a 21 percent flat rate at the entity-level. The shareholder level tax on C corporation dividend distributions, ranges from zero to 23.8 percent. The individual rates have been lowered for tax years 2018-2025, and pass-through entity shareholders/owners may obtain a 20 percent deduction for qualified business income of pass-through entities under Section 199A. The Section 199A deduction lowers the effective personal tax rate on qualified pass-through income.

There continues to be a tax benefit of pass-through entity status over an otherwise identical C corporation. The differences in favor of pass-through entity status will vary depending on several factors including, the amount of W-2 wages paid by the pass-through entity, the amount of qualified property placed in service by the pass-through entity, whether the pass-through entity is a specified service business, or a non-specified service business, and the taxable income of the pass-through entity shareholder/owner, which determines the marginal tax rate applied at the shareholder/owner level. The combined tax burden on the entity and the shareholders/owners will vary with each specific client situation. Even in the 37 percent tax bracket with the Section 199A deduction phased out, the S corporation is taxed at a lower federal rate than an otherwise identical C corporation.

There are some tax planning strategies to lower the tax burden of C corporation status. Shareholder compensation may be increased to lower C corporation taxable income provided the compensation is reasonable. S corporation shareholder compensation must not be unreasonably low as to indicate the avoidance of self-employment tax. Partners and LLC members generally pay 15.3 percent self-employment tax, which includes 12.4 percent Social Security tax on a maximum of $128,400 for 2018, plus the 2.9 percent Medicare tax with no limitation.

C corporations may reduce taxable income by paying fringe benefits to shareholder-employees that are tax deductible to the corporation and excluded from the income of the shareholder. Excludable fringe benefits to C corporation shareholders include employer provided health insurance under Section 106, meals and lodging for the convenience of the employer under Section 119, and employer provided educational assistance under Section 127. Section 132 lists eight types of fringe benefits that are also excluded from employee income. The Section 132 fringe benefits include non-additional cost services, qualified employee discounts, working condition fringe, de minimis fringe qualified employee transportation costs, qualified moving expenses, qualified retirement planning services, and qualified military base realignment and closure benefit payments (I.R.C. Section 132).

The TCJA still allows the employer deduction for employee transportation costs, unless the transportation is necessary for the employee's safety. Employer deductions for transit passes, parking allowances, and other employee transportation expenses are not deductible to the employer but are still excluded by the employee (I.R.C. Section 132(a)(5)). Reimbursements for moving expenses paid to employees or paid directly to third parties from 2018 to 2025 are included in wages., with an exception for armed forces on active duty (I.R.C. Section 132(a)(6)).

For S corporations, the deduction of fringe benefits may be limited. Where an S corporation shareholder constructively owns two percent or more of the S corporation stock are treated similarly to partners in a partnership. Fringe benefits paid to a two percent shareholder are deductible by the S corporation but taxable to the S corporation two percent shareholder (I.R.C. Section 1372).

C corporation may reduce or defer the taxation of dividend distributions to the shareholders depending on the dividend payout ratio. In the above examples, we assumed that the dividend payout ratio was 100 percent.

State and local taxes will reduce cash flow available to the shareholders. State corporate tax rates in the United States range from a low of zero percent in Texas, Ohio, South Dakota, Wyoming, Nevada, and Washington to 12 percent in Iowa. For a list of the top state marginal tax rates, see the Tax Foundation website at https://files.taxfoundation.org/20180212094007/CIT2018-01.png.