

# TAX POLICY AND ORGANIZATIONAL FORM: ASSESSING THE EFFECTS OF THE TAX CUTS AND JOBS ACT OF 2017

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*We provide historical context to assess the implications of the Tax Cuts and Jobs Act of 2017 (TCJA) on organizational form. We review the Tax Reform Act of 1986 (TRA86) to assess the extent of organizational form changes in response to changing tax incentives and the effects of those organizational form changes on business operations. We develop a simple analytic model to provide insight into the incentives created by the TCJA and briefly summarize practitioner observations regarding the incentives affecting organizational form decisions. Results suggest that an array of factors make the organizational form decision more difficult and less predictable than in 1986.*

*Keywords:* organizational form, pass-through, corporate tax, tax rates

*JEL Codes:* H25, K34

## I. INTRODUCTION

The number and scope of changes in the tax code brought about by the Tax Cuts and Jobs Act of 2017 (TCJA) have the potential to influence organizational form choices to an extent unparalleled since 1986.<sup>1</sup> In this paper, we examine the implications of the TCJA on organizational form decisions in three ways. First, we revisit firms' behavior in response to the Tax Reform Act of 1986 (TRA86) to inform our analysis of the TCJA. Second, we develop a simple analytic model of the tax factors affecting organizational form choice to estimate the magnitude of the changing incentives that could influence

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<sup>1</sup> For technical reasons, the legislation is officially named "Public Law No. 115-97, An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." For simplicity, we refer to the act formerly known as the Tax Cuts and Jobs Act of 2017 using the unpronounceable acronym TCJA.

behavior. Third, we draw from practitioner literature and conversations with tax advisors to gain a sense of how the law is currently influencing behavior.

In the next section, we highlight aspects of the TRA86, review the evidence of changes in businesses' organizational form following its passage, and provide an analysis of aggregate trends in business activity following the TRA86. In Section III, we present a stylized analytic model to examine the changes in incentives following the enactment of the TCJA, emphasizing the array of factors that make the organizational form decision more difficult, and likely less predictable, than in 1986. Supporting those observations, Section IV provides a brief survey of the practitioner literature since the passage of the TCJA to evaluate the guidance provided to businesses as they evaluate their options. We present our conclusions in Section V.

## II. THE TRA86

### A. Provisions Affecting Organizational Form

To gain an understanding of the potential effects of the TCJA on fundamental business decisions, we begin by reexamining the effects of the TRA86 to provide historical context. For closely held businesses, the TRA86 dramatically affected organizational form decisions owing to a number of significant changes in the Internal Revenue Code (IRC). While both individuals and C corporations saw their marginal tax rates fall, the TRA86 inverted the maximum rates between the two, setting the maximum corporate rate higher than the maximum individual rate (34 versus 28 percent). Dividends distributed from C corporations remained subject to a second layer of taxation at the individual level (at ordinary income rates), increasing the effective tax rate on corporate income. The rate inversion created strong incentives for eligible businesses to opt out of the double-taxed C corporation form and convert to an S corporation, a pass-through entity whose earnings are subject to tax at only the individual-owner level. Other TRA86 changes that increased incentives to use S corporations were the elimination of the preferential treatment for long-term capital gains, the reduction in the benefits of deferral of income earned in C corporations due to the individual-versus-corporate tax rate inversion, and the creation of the alternative minimum tax (AMT) for C corporations.

### B. Changes in Organizational Form and Firm Characteristics after the TRA86

Empirical evidence has shown that tax incentives, such as those brought about by the TRA86, influence organizational form choice. The reduction in the individual tax rate relative to the corporate tax rate resulted in both a larger number of pass-through entities and a larger share of economic activity held within pass-through entities.<sup>2</sup>

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<sup>2</sup> Plesko (1995a), Plesko and Henry (2012), Plesko and Toder (2013), and Nelson (2016) examine the trends in both business organization and the economic activity within each organizational form prior to and following the TRA86.

Plesko (1994) documents a dramatic increase in S conversions after the enactment of the TRA86. Plesko (1995a) reports that S corporations sustained the largest growth rate of any organizational form from 1986 to 1990, while the number of C corporation tax returns declined. Further, the S corporation share of net income, deficits, and net income less deficits dramatically increased following the TRA86.

Several studies also examine the determinants of organizational form choice, including the changing incentives arising from the TRA86. Using a sample of C corporations prior to the TRA86, Plesko (1995b) models the choice to operate as a C versus an S corporation following the TRA86 as a function of various firm characteristics and finds organizational form choice is generally consistent with tax minimization incentives. Ayers, Cloyd, and Robinson (1996) study a sample of firms in 1988 and 1989 to assess the extent to which tax and non-tax factors jointly influence the organizational form choice. Their analysis suggests that non-tax factors, such as business risk, ownership structure, firm size, and firm age, are salient to the organizational form choice. Finally, Omer, Plesko, and Shelley (2000) examine the influence of tax considerations on conversions to S corporation status in the natural resource industry.

### C. Using the TRA86 to Inform the Analysis of the TCJA

We build upon the literature above by descriptively examining changes in financing, payout policy, and compensation mix decisions following a change in organizational form. We utilize corporate tax return data from the Statistics of Income (SOI) corporation file from 1984 to 1990 to generate four subsamples: (1) C corporations prior to and following the TRA86; (2) C corporations prior to the TRA86 that switched to S corporation status following the TRA86; (3) S corporations prior to and following the TRA86; and (4) S corporations prior to the TRA86 that switched to C corporation status following the TRA86. We compare business decisions of firms that convert from a C to an S corporation (“conversions” or “converting corporations”) to those of non-converting C corporations because the non-tax costs associated with such conversions are virtually zero. As a result, our analyses focus on *tax costs* associated with an organizational form change and the effects of tax-motivated choices on firm decisions.

SOI does not collect data for the entire population of corporate tax returns; rather, it collects return data for a subset of corporations using a stratified probability sampling procedure intended to increase the probability the same firms are included from year to year.<sup>3</sup> To generate our sample, we exclude real estate investment trusts and regulated investment companies (i.e., firms filing form 1120-RIC or 1120-REIT) and personal service corporations from the SOI corporation file. We also exclude corpora-

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<sup>3</sup> See U.S. Internal Revenue Service (IRS), Statistics of Income – 2013 Corporation Income Tax Returns, SOI’s complete report on corporation income tax returns for 2013, for further details on the IRS’s sampling and weighting procedures. Available at <https://www.irs.gov/pub/irs-soi/13coccr.pdf>.

tions reporting greater than 35 shareholders in 1988.<sup>4,5</sup> Finally, we drop firms that do not appear in each year's SOI corporation file to create a balanced sample of C and S corporation return observations spanning 1984–1990. To generate our tabulations, we rely on weighted SOI data to ensure that our disclosure of federal tax return information complies with IRC §6103(j).

Our sample, described in Table 1, represents a total of 604,500 corporations and 4,807,990 corporation-years.<sup>6</sup> Approximately 15 percent of all pre-TRA86 C corporations in our sample became S corporations following the TRA86. Our data suggest that corporations' organizational form decisions were made quickly following passage of the TRA86, as 70 percent of C to S conversions occurred in 1987 and 1988.

We evaluate the economic magnitude of corporate business activity for converting and non-converting corporations through total assets and tax net income (TNI). We also separately examine mean TNI for firms with positive versus negative TNI, as individuals have incentives to shift negative TNI to an S corporation because losses, to the extent they are active rather than passive, can be used to offset other sources of an individual owner's taxable income. This is in contrast to C corporation losses, which are carried back/forward to offset previous/future C corporation taxable income.

We capture compensation mix by examining several line items from corporations' Form 1120: salaries and wages (line 13), compensation of officers (line 12), the deduction for pension and profit sharing plans (line 23), and the deduction for employee benefits (line 24).<sup>7</sup> All compensation-related variables are scaled by total deductions (line 27). Payout policy is computed as the sum of total cash and property distributions as reported on Schedule M-2 of a corporation's Form 1120, scaled by total assets from Schedule L. We capture related-party financing decisions with loans to and from shareholders, each as a percentage of firms' total debt from Schedule L of the Form 1120. Finally, we examine the debt-to-equity ratio. We winsorize all variables at 1 and 99 percent to mitigate the effect of outliers.

In Table 2, we present weighted means by year of the various firm characteristics of converting C corporations and non-converting C and S corporations. Consistent with

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<sup>4</sup> Such firms are unable to elect S status. Thus, our analysis of the effect of organizational form change on business decisions is conditional on the ability to change organizational form. This design choice resulted in the exclusion of less than 1 percent of our sample. The excluded firms are larger, on average, than sample firms but represent less than 1 percent of total corporation assets for 1988.

<sup>5</sup> Ideally, we would exclude firms reporting greater than 35 shareholders prior to the TRA86. The number of corporate shareholders is not available until 1988; therefore, we assume that the number of shareholders from a corporation's 1988 return approximates the number of shareholders in years prior to the TRA86.

<sup>6</sup> Because we examine how organizational form choice influences business decisions, we require detailed information about firm characteristics before and after an organizational form change. As a result, our sample does not include newly formed businesses and does not address the role of tax law changes in their choice of organizational form.

<sup>7</sup> This is a different measure than that used by Nelson (2016), who provides a detailed analysis of S corporation compensation and wages over a long time period and through multiple changes in the tax provisions affecting S corporations. She concludes that the ability of owners to change the characterization of payments to themselves has implications for quantifying the amount of income owners receive from S corporations.

**Table 1**  
Number of C and S Corporations 1984–1990

<i>Panel A: Number of Corporations by Entity Type Pre- and Post-TRA86</i>		
Pre-TRA86	Post-TRA86	Weighted <i>N</i>
C Corporation	C Corporation	400,045
C Corporation	S Corporation	70,613
S Corporation	S Corporation	129,945
S Corporation	C Corporation	3,897
<i>Panel B: C Corporation to S Corporation Conversions by Year Post-TRA86</i>		
	Weighted <i>N</i>	
1987	33,388	
1988	21,865	
1989	17,593	
1990	6,080	
Total	78,926	

Notes: In this table, we present weighted counts for the four subsamples that comprise our full sample of corporation observations: (1) C corporation entities prior to and following the TRA86; (2) C corporation entities prior to TRA86 that switched to S corporation status following the TRA86; (3) S corporation entities prior to and following TRA86; and (4) S corporation entities prior to TRA86 that switched to C corporation status following the TRA86. Sample weights applied to an individual corporation observation change from year to year in the SOI data. In Panel A, we apply sample weights from 1984, the first year of our sample, to obtain the weighted number of firms represented by our sample. In Panel B, we use sample weights corresponding to each year presented.

prior studies (e.g., Plesko, 1995b), we find that larger corporations, in terms of assets or TNI, tended to remain C corporations.<sup>8</sup> The data in Table 2 suggest that firms' compensation mix remained relatively stable both pre- and post-TRA86 for both converting and non-converting corporations. However, we observe significant changes in the economic activity, payout policy, and related-party financing decisions within converting corporations relative to non-converting C corporations. The changes we observe are consistent with firms using the S corporation organizational form after the TRA86 to minimize personal taxes of individual business owners and distribute corporate capital to them in a tax efficient manner.

Figure 1 presents the growth rates in positive and negative TNI with 1984 as the base year. Growth rates in average positive TNI for converting and non-converting corporations were nearly identical throughout our sample period. However, average negative

<sup>8</sup> Although not shown in the table, but also consistent with prior research, industries in which businesses were most likely to convert were manufacturing, transportation and public utilities, and retail trade.

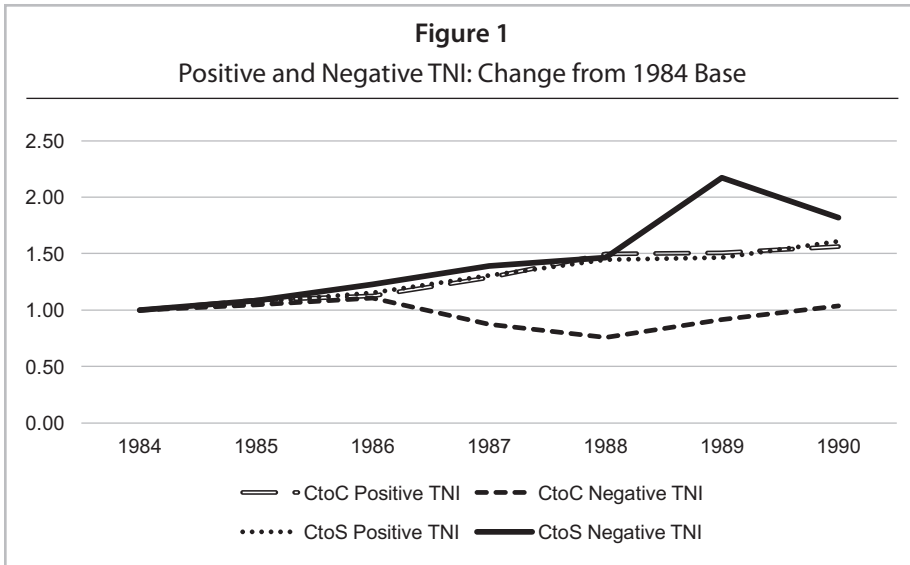
**Table 2**  
**Weighted Means of Firm Characteristics for Converting versus Non-Converting Corporations (\$Millions)**

	<i>Panel A: Firms That Converted from C to S Corporation Status after the TRA86</i>									
	Full Sample	1984	1985	1986	1987	1988	1989	1990		
Total assets	1.0944	0.8899	1.0248	1.0975	1.0880	1.1202	1.1995	1.1849		
TNI	0.0767	0.0710	0.0757	0.0863	0.0853	0.0840	0.0707	0.0651		
Positive TNI	0.1326	0.1026	0.1095	0.1184	0.1342	0.1482	0.1503	0.1648		
Negative TNI	-0.0495	-0.0316	-0.0342	-0.0388	-0.0439	-0.0463	-0.0686	-0.0575		
Salaries and wages	0.1856	0.1748	0.1744	0.1760	0.1844	0.1891	0.2003	0.1950		
Compensation of officers	0.1808	0.1688	0.1785	0.1801	0.1780	0.1851	0.1939	0.1784		
Pension, profit-sharing, etc. plans	0.0149	0.0186	0.0177	0.0160	0.0150	0.0149	0.0125	0.0111		
Employee benefit programs	0.0131	0.0136	0.0129	0.0122	0.0122	0.0124	0.0142	0.0143		
Total distributions	0.0175	0.0012	0.0010	0.0014	0.0070	0.0214	0.0345	0.0462		
Loans to shareholders	0.1577	0.0922	0.1151	0.1833	0.1786	0.2092	0.1439	0.1696		
Loans from shareholders	0.1265	0.1637	0.1335	0.0997	0.1048	0.1134	0.1325	0.1383		
Debt-to-equity ratio	2.5941	4.0009	2.7753	2.3168	2.2632	2.4501	2.1950	2.3509		
<i>Panel B: Non-Converting C Corporations</i>										
Total assets	7.4545	6.2634	7.3331	7.5128	7.8041	7.3388	7.7676	7.9513		
TNI	0.1693	0.1258	0.1378	0.1409	0.1764	0.2044	0.1946	0.1845		
Positive TNI	0.3501	0.2669	0.2909	0.3007	0.3435	0.4000	0.4020	0.4169		
Negative TNI	-0.1354	-0.1417	-0.1483	-0.1566	-0.1242	-0.1072	-0.1296	-0.1471		
Salaries and wages	0.1585	0.1586	0.1586	0.1615	0.1601	0.1585	0.1559	0.1573		
Compensation of officers	0.1409	0.1410	0.1387	0.1390	0.1426	0.1459	0.1410	0.1372		
Pension, profit-sharing, etc. plans	0.0075	0.0092	0.0086	0.0086	0.0085	0.0069	0.0063	0.0052		
Employee benefit programs	0.0119	0.0114	0.0098	0.0103	0.0116	0.0115	0.0134	0.0146		
Total distributions	0.0026	0.0020	0.0020	0.0023	0.0023	0.0028	0.0028	0.0037		
Loans to shareholders	0.1142	0.0786	0.0969	0.1109	0.1137	0.1336	0.1355	0.1187		
Loans from shareholders	0.1510	0.1498	0.1403	0.1493	0.1481	0.1478	0.1546	0.1646		
Debt-to-equity ratio	4.1558	5.2241	4.1208	4.2079	4.1668	3.5271	3.9409	4.1191		

**Table 2 (Continued) Weighted Means of Firm Characteristics for Converting versus Non-Converting Corporations (\$Millions)**

	Full Sample	1984	1985	1986	1987	1988	1989	1990
Total assets	0.3109	0.2769	0.3055	0.3151	0.3185	0.3072	0.3238	0.3207
TNI	0.0232	0.0209	0.0226	0.0231	0.0239	0.0253	0.0233	0.0223
Positive TNI	0.0605	0.0607	0.0606	0.0588	0.0600	0.0603	0.0580	0.0654
Negative TNI	-0.0252	-0.0223	-0.0245	-0.0253	-0.0259	-0.0270	-0.0264	-0.0248
Salaries and wages	0.1403	0.1294	0.1387	0.1361	0.1373	0.1462	0.1453	0.1451
Compensation of officers	0.1177	0.1119	0.1117	0.1192	0.1183	0.1176	0.1178	0.1250
Pension, profit-sharing, etc. plans	0.0038	0.0027	0.0045	0.0042	0.0049	0.0041	0.0035	0.0026
Employee benefit programs	0.0075	0.0074	0.0066	0.0072	0.0068	0.0079	0.0077	0.0085
Total distributions	0.0465	0.0069	0.0198	0.0376	0.0341	0.0459	0.0785	0.0831
Loans to shareholders	0.0850	0.0739	0.0892	0.0659	0.0772	0.1229	0.0936	0.0647
Loans from shareholders	0.3214	0.3190	0.3123	0.3144	0.3350	0.3083	0.3325	0.3264
Debt-to-equity ratio	7.1429	11.4664	7.2345	8.9430	8.8316	5.7023	5.3557	4.0671

Notes: This table presents weighted means of various firm characteristics for converting and non-converting corporate entities for both the full sample of firms and by year from 1984 to 1990. Firm data are obtained from the SOI yearly corporate income tax return datasets. Each annual SOI file contains selected items from approximately 90,000 corporate income tax returns. From the SOI corporate files, we exclude personal holding and personal service corporations and any corporation ineligible to elect S status (greater than 35 shareholders in accounting year ended in 1988). Firm characteristics include total assets from Schedule L of Form 1120 and TNI from Line 28 of page 1 of Form 1120. We present means separately for observations with positive TNI and negative TNI. Salaries and wages (Line 13 from page 1 of Form 1120), compensation of officers (Line 12), the deduction from pension and profit sharing plans (Line 23), and the deduction for employee benefits (Line 24) are all presented as a share of firms' total deductions (Line 27 from page 1 of Form 1120). Total distributions, computed as the sum of total cash and property distributions listed in Schedule M-2, are scaled by total assets. The debt-to-equity ratio is computed by summing individual debt and equity components on Schedule L. We winsorize variables at the 1<sup>st</sup> and 99<sup>th</sup> percentile each year to mitigate the influence of outliers.

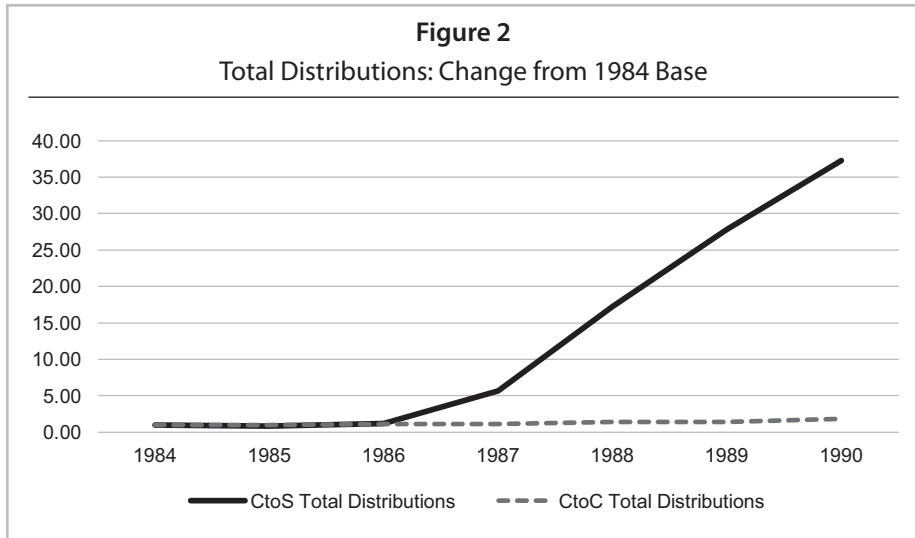


TNI significantly increased for converting corporations, while average negative TNI significantly decreased for firms that remained C corporations. This suggests that C corporations with significant losses converted to S corporations in order to pass tax losses through to shareholders.

Figure 2 presents growth rates in total distributions with 1984 as the base year. Distributions from non-converting C corporations to their shareholders remained fairly constant over our sample period. However, distributions sharply increased after the TRA86 for firms that converted to S corporations. Unlike C corporations, S corporation distributions are not subject to a second layer of individual taxation, provided distributions do not exceed the owner's basis in S corporation stock. Thus, our results are consistent with the C corporation "double tax" discouraging dividend distributions to owners. When the double tax is removed by conversion to S corporation status, the corporation's payout policy responds fairly dramatically.

To examine the role of related-party capital structure decisions, we plot in Figures 3A and 3B growth rates in loans to and loans from stockholders. We find that loans from stockholders for converting corporations decreased relative to those for non-converting C corporations in the years surrounding the TRA86. Prior to the TRA86, C corporations had incentives to borrow from stockholders in order to both reduce pretax corporate income and return income to shareholders in the form of interest payments, thereby avoiding the double tax on shareholder distributions. Upon conversion, S corporations are able to distribute income without additional tax consequences for owners, thereby reducing the incentive for owners to issue loans to the corporation.



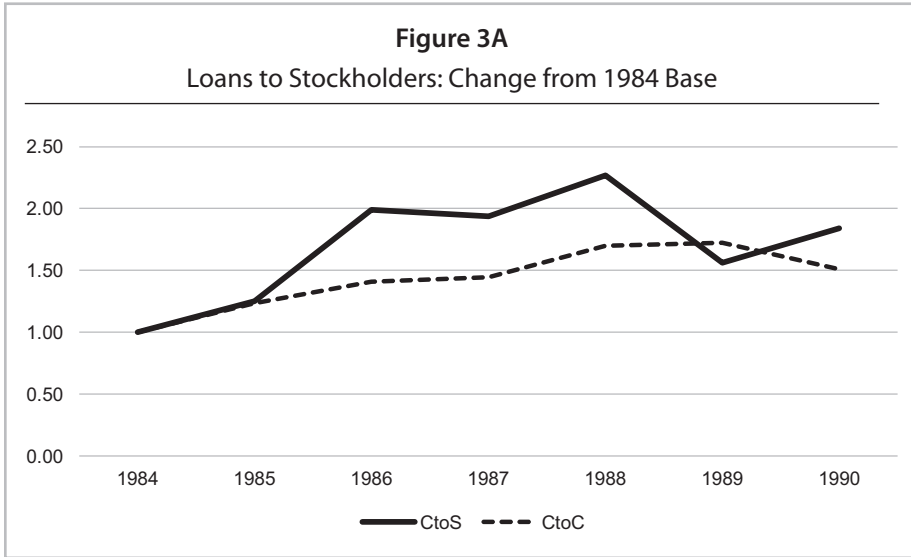


Our observations about the TRA86 provide a baseline from which we can evaluate the potential organizational form response to the TCJA. Overall, we find the behavioral responses to the TRA86's changes to corporate and individual tax rates were swift, fairly dramatic, and economically significant. A large number of C corporations converted to pass-through form and the majority of converting corporations did so in the years immediately following the enactment of the TRA86. Our descriptive evidence also suggests that the conversion to S corporation induced changes in firm behavior. The likely effects of the TCJA, then, depend on the changes in relative tax rates across organizational forms and the importance of distributions to a given firm.

### III. THE TCJA

#### A. Stylized Model

In this section, we develop a stylized model of the choice between C corporation, S corporation, and partnership organizational forms. We use our model to evaluate organizational form choice both pre- and post-TRA86 to substantiate the conclusions presented in Section II. We then use our model to evaluate potential organizational form choice in response to the TCJA. In our model, we assume the business entity is closely owned (e.g., by a sole owner, husband/wife, family, etc., where a group of related parties controls major firm decisions) and the owners are actively engaged in the business. As



a result, passive activity loss rules do not apply.<sup>9</sup> We also assume the personal service corporation rules and the accumulated earnings tax do not apply.<sup>10</sup>

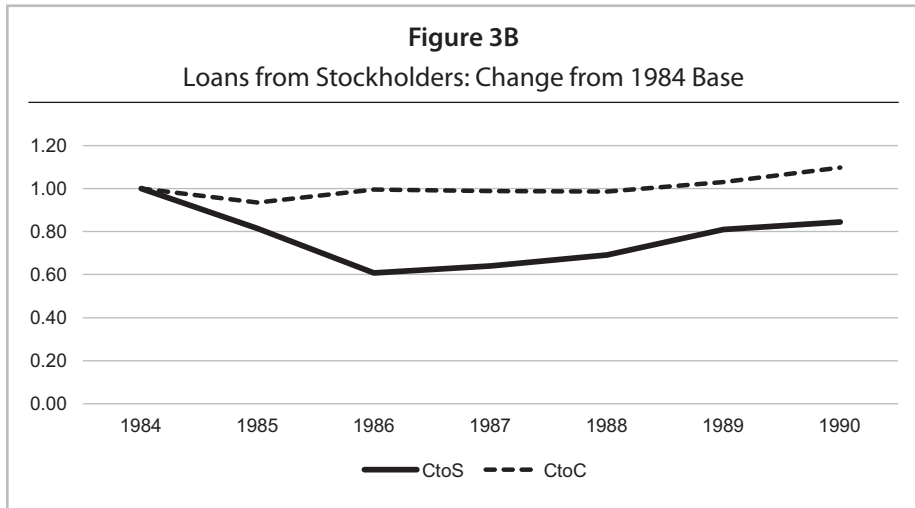
We begin with the simple model presented in prior literature where non-corporate or pass-through form (S corporation or partnership) is preferred over corporate form (C corporation) if the following inequality holds (e.g., Graham, 2003; Scholes et al., 2015):

$$(1) \quad (1 - \tau_p) > (1 - \tau_c)(1 - \tau_E).$$

In Equation (1),  $\tau_p$  equals the personal (i.e., individual ordinary) income tax rate;  $\tau_c$ , the corporate income tax rate; and  $\tau_E$ , the preferential tax rate on income from equity ownership (e.g., dividends and capital gains). This equation states that if the after-tax return from non-corporate (or pass-through) entities, which is only subject to the personal tax, exceeds the after-tax return on corporate entities subject to double taxation, businesses should organize as partnerships. If the inequality does not hold, businesses prefer the corporate form.

<sup>9</sup> We analyze the taxes of the firm's owner-employees, rather than passive investors who face a different tax burden.

<sup>10</sup> Prior to the TCJA, personal service corporations ("PSC," C corporations owned by employees working in certain professional fields, e.g., law, that met certain ownership thresholds) were subject to a flat 35 percent tax rate. The TCJA imposes a flat 21 percent tax rate on all corporations. However, services that previously led to classification as a PSC may now be relevant in determining pass-through entities' eligibility for the pass-through deduction under IRC §199A. The accumulated earnings tax imposes a 20 percent tax on C corporation retained earnings above a certain threshold if the accumulation of earnings seems unreasonable (e.g., earnings retained to avoid double taxation rather than invest in the business).



The TCJA potentially changed the preferred organizational form by changing both  $\tau_p$  (slight reduction) and  $\tau_c$  (major reduction). At the simplest level, this makes corporate form more appealing under the TCJA relative to the treatment of corporate form under prior law.<sup>11</sup> However, our analysis of the response to the TRA86 suggests payout policy is an important component of organizational form choice.<sup>12</sup> An entity can return earnings to owners as salary, subject to individual ordinary income tax rates, or dividends and retained earnings (which translate into long-term capital gains) subject to preferential tax rates. Certain methods of owner distributions are also subject to self-employment tax, while others are not, further complicating the computation of the after-tax return for a given organizational form.<sup>13</sup> To better evaluate organizational form decisions under the TCJA, we extend Equation (1) by incorporating the tax effect of the form of distribution into the organizational form decision.

<sup>11</sup> Considering only federal income taxes, immediately prior to the TCJA's enactment, the after-tax return to the partnership (corporate) form equaled 60.4 (52) percent. TCJA results in an after-tax return to the partnership (corporate) form equal to 63 (63.2) percent, not including the IRC §199A deduction for pass-through income.

<sup>12</sup> Prior research also identifies several additional factors, including salary/dividend mix, that warrant consideration (e.g., Plesko and Toder, 2013; Borden, 2018; Repetti, 2018; Williamson, Rivera, and Staley, 2018).

<sup>13</sup> Throughout this paper, we use the term "self-employment tax" to refer to the Social Security and Medicare taxes imposed under both the Self-Employment Contributions Act of 1954 and the Federal Insurance Contributions Act (FICA) because these taxes are virtually identical, aside from the identity of the payer. FICA taxes are payroll taxes paid by the employer, partially through a withholding from employee wages (the "employee's share") and partially through a direct tax borne by the employer (the "employer's share"). Self-employed individuals pay both the employee's and employer's share of the tax.

Similar to Scholes et al. (2015), we assume owners of a firm invest capital,  $\$I$ , which generates a return on capital of  $R$ . In our model,  $R$  represents return before salary paid to owners in order to allow firms to choose the salary paid.<sup>14</sup> In a one period model, we can write the tax due on the returns of the three alternative organizational forms as detailed below. The after-tax return to the owner of a C corporation, accounting for salary versus equity payouts, equals

$$(2) \quad (R - S(1 + \tau_{SE}))(1 - \tau_C)[D(1 - \tau_D) + (1 - D)(1 - \tau_{CG})] + S(1 - \tau_P - \tau_{SE}).$$

The first term represents distributions of corporate profit, after the corporate income tax and tax on corporate payouts.  $S$  represents the salary paid to the owners.<sup>15</sup>  $D$  represents the portion of profits paid out currently as dividends, and  $(1 - D)$  represents the portion of profits retained and ultimately subject to long-term capital gains taxes. Although rates on long-term capital gains taxes and dividends are currently equal, we set them as two separate rates,  $\tau_{CG}$  and  $\tau_D$ , to allow for periods when the rates differ and to allow the capital gains rate ( $\tau_{CG}$ ) to account for deferral of the capital gains tax (e.g., Feldstein, Poterba, and Dicks-Mireaux, 1983). The second term represents the after-tax salary received by the owners, where  $\tau_{SE}$  equals the employee's or employer's share of self-employment (or FICA) tax.<sup>16</sup> As previously noted,  $\tau_P$  equals the personal tax rate and  $\tau_C$  equals the corporate tax rate.

The after-tax return to the owner of an S corporation, accounting for salary versus equity payout, equals

$$(3) \quad (R - S(1 + \tau_{SE}))(1 - \tau_{PT}) + S(1 - \tau_P - \tau_{SE}).$$

We include  $\tau_{PT}$  in Equation (3) to represent the tax on pass-through income, which often equals  $\tau_P$ . We allow for an alternative pass-through rate because the TCJA allows certain taxpayers a deduction of up to 20 percent of their pass-through business income, subject to limitations.<sup>17</sup> For simplicity, we treat this deduction as a direct reduction to the tax rate on pass-through income and ignore the requirement that, in some cases, the busi-

<sup>14</sup> Our model excludes the tax effect of fringe benefits, which are excluded from (included in) owner-employee income when provided through the C corporation (pass-through) form. However, one of the largest of these fringe benefits, health insurance, is then deductible on pass-through owner-employees' personal tax returns. As such, the net effect of fringe benefits on our conclusions is unlikely to be substantial.

<sup>15</sup> Technically, a salary paid to a partner in a partnership is known as a guaranteed payment (IRC §707(c)). For simplicity, we ignore this distinction and use the term salary across all organizational forms.

<sup>16</sup> Following the Affordable Care Act, an additional self-employment (or FICA) tax of 0.9 percent is levied on employees with income above certain thresholds, but not on employers. For simplicity, we assume that employers and employees face the same self-employment (or FICA) tax rate.

<sup>17</sup> Sullivan (2018a) describes the complicated rules of the TCJA's IRC §199A pass-through deduction and has made available a spreadsheet detailing his calculations. In general, the TCJA's individual provisions, such as tax rates and the pass-through deduction, are temporary and set to expire at the end of 2025. The TCJA's corporation provisions are generally permanent.

ness must pay a certain amount of salary and/or hold tangible depreciable property to qualify for the deduction. One important aspect of Equation (3) is that the tax on profits is limited to  $\tau_{PT}$ , as there is no additional tax on distributions to owners as in Equation (2).

Finally, we turn to the after-tax equation for owners of partnerships, which equals

$$(4) \quad (R - S(1 + \tau_{SE}))(1 - \tau_{PT} - 1.75\tau_{SE}) + S(1 - \tau_P - \tau_{SE}).$$

The partnership calculation is similar to the S corporation calculation, except that partnership profits are subject to self-employment tax. That is, partnership profits, in contrast to both C and S corporation profits, are subject to both the employer's and employee's shares of self-employment tax ( $2 \times \tau_{SE}$ ). However, the employer's share is deductible against the partner's taxable income. Therefore, the effective self-employment tax rate is  $\tau_{SE} + \tau_{SE}(1 - \tau_P)$ . To avoid complications in our model, we simplify this to  $1.75\tau_{SE}$  by assuming a personal tax rate of 25 percent and ignoring possible differences between the personal and pass-through rates.

For each organizational form, we use our models to estimate effective tax rates paid by representative taxpayers at varying income levels. We assume the following: (1) the taxpayers operate identical businesses (unless otherwise specified); (2) the taxpayers are married filing jointly with no children or dependents; (3) all taxpayers and types of income are subject to a flat state income tax rate of 6 percent, which we include in the personal, preferential, and corporate rates; (4) the taxpayers have no tax credits; (5) the taxpayers are not subject to the AMT; and (6) the taxpayers have itemized deductions, excluding state income taxes, exceeding the maximum standard deduction. We vary the firm's income ( $R$ ) between low (\$250,000) and high (\$750,000) and use three alternative levels of distributions: 0, 50, and 100 percent. For the two scenarios with distributions, we vary the salary portion at two levels: 50 and 100 percent, with dividends making up the remainder of the distribution in each case. We use the actual federal corporate, preferential, and personal tax rate schedules in effect and compare the effects of the changes in after-tax return for each organizational form pre- and post- both TRA86 and TCJA.<sup>18</sup> However, for ease of presentation, we assume the tax rate from the tax schedule is a flat tax rate (i.e., a constant marginal tax rate) for these scenarios. In subsequent analysis, we relax this assumption.

The TRA86 reduced the maximum corporate (personal) rate from 46 (50) percent to 34 (28) percent. In untabulated analyses, we generally find that the corporate form, prior to the TRA86, produces similar tax rates to other organizational forms when dividend

<sup>18</sup> Self-employment (or FICA) taxes consist of the employee's and employer's shares of Social Security and Medicare taxes. Because the 6.2 percent Social Security tax only applies up to a certain income level, we ignore this tax in our model. As income increases, this tax rate effectively approaches zero. We focus on the 1.45 percent (2.35 percent for high-income taxpayers) Medicare tax in our model analyses. Also, note that a taxpayer's payments into Social Security can affect how much the taxpayer draws out of the system. Thus, the true marginal tax rate for Social Security is the net difference between the tax payments and the present value of the expected marginal benefits from these contributions (e.g., Feldstein and Samwick, 1992).

distributions are relatively low. As dividend distributions increase, the cost of double taxation increases, putting C corporations at a disadvantage. Following the TRA86, C corporations are tax disadvantaged in almost every setting, consistent with the massive increase in S corporations and other pass-through businesses following the TRA86 discussed in Section II. The one exception to this is the case where the firm pays all profits out as salary because salary is treated the same across all organizational forms. Finally, we note that, in virtually all cases, the S corporation is preferred over the partnership because of the ability to avoid a portion of self-employment tax.

Next, we address the changes to the organizational form choice as a result of the TCJA. In the period before the TCJA, C corporations are generally disadvantaged relative to other forms, with the disadvantage increasing in dividend distributions. By contrast, following the TCJA, the gaps between tax rates of operating as a C corporation versus a pass-through narrow significantly, in some cases reversing so that the C corporation form is preferable.

Table 3, Panel A presents estimates of effective tax rates for a low-income firm distributing 50 percent of income, split evenly between salary and dividends. While the C corporation is disfavored both prior to and after the TCJA, the difference between C corporation and pass-through rates narrows after the TCJA. Panel B shows the case where the 20 percent pass-through deduction is fully phased out for a high-income firm (e.g., a service firm). It is clear that a service firm at this income level planning to retain a significant portion of earnings is better off in C corporation form following the TCJA. Firms not involved in professional services (e.g., manufacturers) do not phase out of the 20 percent deduction. Panel C presents results for a high-income firm eligible for the IRC §199A deduction and shows that, even with the pass-through deduction, C corporation form is preferable after the TCJA.<sup>19</sup>

Table 4, Panel A presents estimates of effective tax rates for a low-income firm distributing 100 percent of income, where half of the distribution is in the form of salary and half of the distribution is dividends. For the low-income firm, we find little change in the incentives to choose C corporation form. Tax rates decrease, but the relative gap between C corporation and pass-through form changes very little. Panel B presents results for a high-income firm not eligible for the pass-through deduction. At this income range and distribution style, pass-through firms receive no tax rate cut from the TCJA, while corporations receive a small tax rate cut. Panel C presents the results for a high-income firm that remains eligible for the pass-through deduction. Similar to Panel A, we find that all firms receive a small tax cut, but the gap between C corporation and pass-through form shows little change. In general, results in Table 4 suggest a preference for pass-through form in terms of tax rates both before and after the TCJA.

To summarize our analytic results, the TRA86 provided a clear and significant incentive for many businesses to organize as S corporations and, to a lesser extent,

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<sup>19</sup> The pass-through deduction phaseout is based on income thresholds. The low-income firm falls below these thresholds so it faces no phaseout, regardless of its type of business activity (e.g., services versus manufacturing).

partnerships, a result consistent with prior analytic and empirical studies. However, this incentive was lower for C corporations planning to retain earnings. By contrast, the results of the TCJA are much less clear. Depending on the specific circumstances of the firm (income level, business type, distribution policy, etc.), either the C corporation or pass-through form may be beneficial.

One caveat to this analysis is that we focus on profitable firms. In general, both the TRA86 and TCJA reduced the corporate tax rate, reducing the value of losses generated in the C corporation form. We also focus on active businesses not subject to passive activity losses; these entities have strong incentives to shift to non-corporate form to enable immediate use of losses, consistent with the results in Figure 1.<sup>20</sup> Thus, the TCJA appears to provide clear incentives for loss firms to change their organizational form to the pass-through one, similar to the TRA86.

## B. Simulation Results

In this section, we relax several assumptions of the stylized model and present effective tax rates calculated under more realistic assumptions for a wide range of incomes. First, we relax the assumption that flat federal income tax rates apply, and now account for the effect of the separate tax brackets for both corporations and individuals.<sup>21</sup> Second, we account for the Social Security portion of self-employment (or FICA) taxes, which we ignore in the simple model. Third, we explicitly allow the taxpayer \$25,000 of deductions, aside from state income taxes, to operationalize our assumption that the taxpayer has sufficient deductions to itemize pre- and post-TCJA. We conduct this analysis using the scenario in Table 3, where 50 percent of income is distributed and the distribution is split evenly between salary and dividends. In general, we calculate lower tax rates under these assumptions than we present in Table 3 due to the effect of separate tax brackets. We calculate effective tax rates for pre-salary distribution incomes ranging from \$50,000 to \$1,000,000 in \$25,000 increments.

Figure 4A presents the effective tax rates for C corporations, S corporations, and partnerships in the pre-TCJA period. Consistent with Table 3, the S corporation form is generally preferred to the partnership form, which is preferred to the C corporation form, with the exception of very low incomes. Note that the spike in the C corporation tax rate at about \$200,000 of income is due to all preferential income switching from a zero percent tax rate to a 15 percent tax rate (similar spike in Figure 4B). Fully accounting for separate brackets of income would lead to a similar, but slower, increase in the tax rate over the next several increments of income. As income increases, the tax

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<sup>20</sup> We note that the TCJA limits the amount of allowable flow-through losses to \$500,000 for married filers, providing a cap on the benefits of operating loss firms as pass-through entities.

<sup>21</sup> The one exception to this is for the preferential tax rates, which, for relatively narrow income ranges, can fall across two brackets (0 and 15 percent, 15 and 18.8 percent, or 18.8 and 23.8 percent). We apply the marginal preferential rate to all preferential income. This does not affect the tenor of our results, as we discuss later.

**Table 3**  
**Estimated Tax Rates across Alternative Organizational Forms — 50% Distribution — 50% Dividend, 50% Salary**

	C Corporation		S Corporation		Partnership	
	Pre	Post	Pre	Post	Pre	Post
<i>Panel A: Low-Income Firm (\$250,000)</i>						
Effective corporate rate, incl. state taxes (%)	37.96	25.74	NA	NA	NA	NA
Effective personal rate, incl. state taxes (%)	29.50	28.00	32.32	30.00	32.32	30.00
Self-employment tax rate (%)	1.45	1.45	1.45	1.45	1.45	1.45
Effective pass-through rate, incl. state taxes (%)	NA	NA	32.32	25.20	32.32	25.20
Effective dividend tax rate, incl. state taxes (%)	19.50	21.00	NA	NA	NA	NA
Effective capital gains rate, incl. state taxes (%)	19.50	21.00	NA	NA	NA	NA
Capital gains assumed realized (%)	2.5	2.5	NA	NA	NA	NA
Effective capital gains rate (%)	4.9	5.3	NA	NA	NA	NA
After-tax income from firm (\$)	104,363	123,870	126,287	139,572	121,552	134,837
After-tax income from salary (\$)	43,156	44,094	41,394	42,844	41,394	42,844
Total income available (\$)	147,519	167,964	167,680	182,416	162,946	177,681
Total taxes paid (\$)	102,481	82,036	82,320	67,584	87,054	72,319
Effective tax rate (%)	41	33	33	27	35	29
<i>Panel B: High-Income Firm (\$750,000) — Service Business</i>						
Effective corporate rate, incl. state taxes (%)	37.96	25.74	NA	NA	NA	NA
Effective personal rate, incl. state taxes (%)	37.02	38.00	43.22	43.00	43.22	43.00
Self-employment tax rate (%)	1.45	1.45	1.45	1.45	2.35	2.35
Effective pass-through rate, incl. state taxes (%)	NA	NA	43.22	43.00	43.22	43.00
Effective dividend tax rate, incl. state taxes (%)	22.82	24.80	NA	NA	NA	NA
Effective capital gains rate, incl. state taxes (%)	22.82	24.80	NA	NA	NA	NA
Capital gains assumed realized (%)	2.5	2.5	NA	NA	NA	NA
Effective capital gains rate (%)	5.7	6.2	NA	NA	NA	NA
After-tax income from firm (\$)	307,266	363,632	317,821	319,075	294,800	296,054
After-tax income from salary (\$)	115,369	113,531	103,736	104,156	102,049	102,469
Total income available (\$)	422,635	477,163	421,558	423,232	396,849	398,523
Total taxes paid (\$)	327,365	272,837	328,442	326,768	351,151	351,477
Effective tax rate (%)	44	36	44	44	47	47



**Table 3 (Continued) Estimated Tax Rates across Alternative Organizational Forms — 50% Distribution — 50% Dividend, 50% Salary**

	C Corporation		S Corporation		Partnership	
	Pre	Post	Pre	Post	Pre	Post
Effective corporate rate, incl. state taxes (%)	37.96	25.74	NA	NA	NA	NA
Effective personal rate, incl. state taxes (%)	37.02	38.00	43.22	43.00	43.22	43.00
Self-employment tax rate (%)	1.45	1.45	1.45	1.45	2.35	2.35
Effective pass-through rate, incl. state taxes (%)	NA	NA	43.22	35.60	43.22	35.60
Effective dividend tax rate, incl. state taxes (%)	22.82	24.80	NA	NA	NA	NA
Effective capital gains rate, incl. state taxes (%)	22.82	24.80	NA	NA	NA	NA
Capital gains assumed realized (%)	25	25	NA	NA	NA	NA
Effective capital gains rate (%)	5.7	6.2	NA	NA	NA	NA
After-tax income from firm (\$)	307,266	363,632	317,821	360,499	294,800	337,478
After-tax income from salary (\$)	115,369	113,531	103,736	104,156	102,049	102,469
Total income available (\$)	422,635	477,163	421,558	464,655	396,849	439,947
Total taxes paid (\$)	327,365	272,837	328,442	285,345	353,151	310,053
Effective tax rate (%)	44	36	44	38	47	41

Notes: This table presents estimated after-tax income and total taxes paid, based on the models developed in Section III, for varying income levels, business activities, and organizational forms. In this table, we assume the entity distributes approximately half of its income to owners, split evenly between salary and dividends. We assume all tax rates applied are flat tax rates. We assume a 6% state tax rate. This is deductible before the TCJA but not deductible after for pass-through income taxed at the personal level. It remains deductible for corporations. Post-TCJA pass-through income is eligible for the 20% IRC §199A deduction in Panels A and C but not in Panel B. Panel B presents a service business (a “specified service trade or business”) where we assume the IRC §199A deduction fully phases out. Following Feldstein, Poterba, and Dicks-Mireaux (1983) and Plesko and Toder (2013), we assume that 25% of capital gains are realized in the current period.

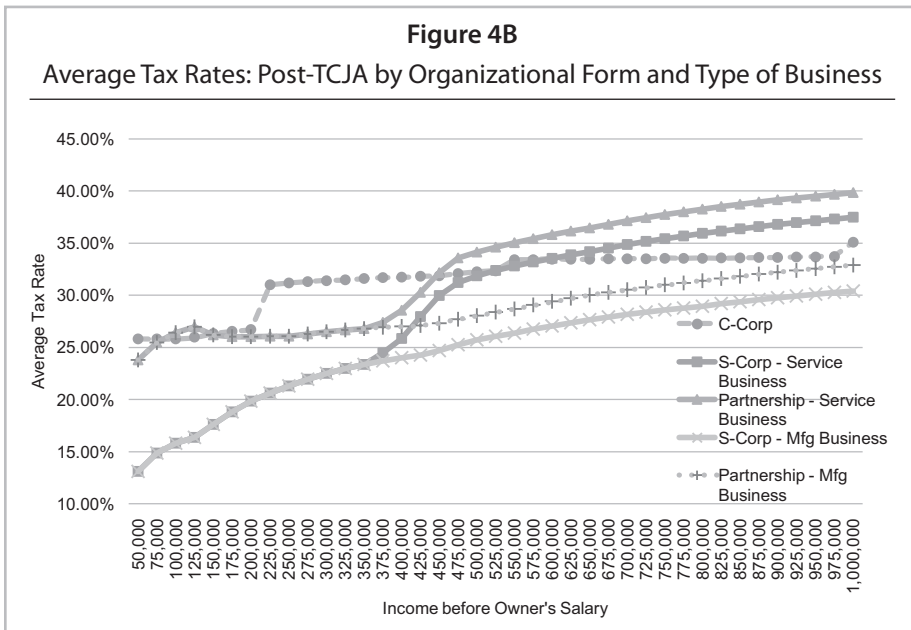
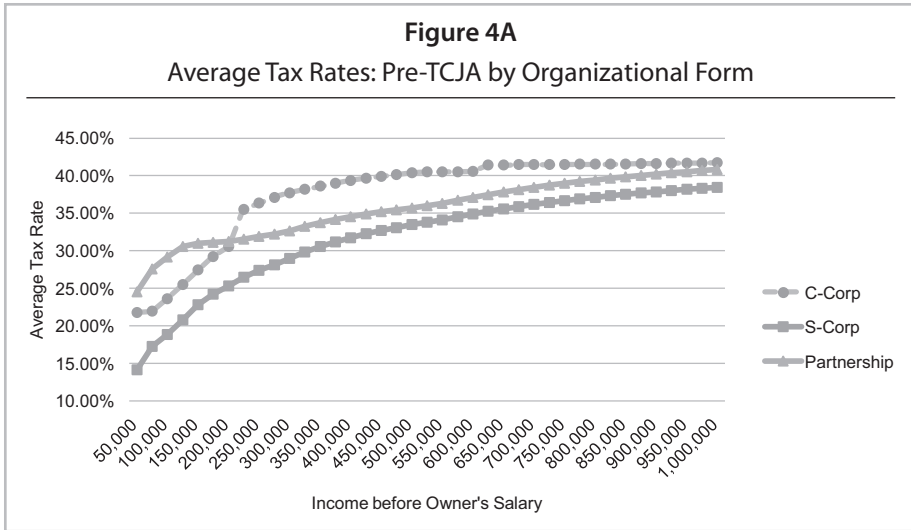
**Table 4**  
**Estimated Tax Rates across Alternative Organizational Forms — 100% Distribution — 50% Dividend, 50% Salary**

	C Corporation		S Corporation		Partnership	
	Pre	Post	Pre	Post	Pre	Post
<i>Panel A: Low-Income Firm (\$250,000)</i>						
Effective corporate rate, incl. state taxes (%)	37.96	25.74	NA	NA	NA	NA
Effective personal rate, incl. state taxes (%)	32.32	30.00	32.32	30.00	32.32	30.00
Self-employment tax rate (%)	1.45	1.45	1.45	1.45	1.45	1.45
Effective pass-through rate, incl. state taxes (%)	NA	NA	32.32	25.20	32.32	25.20
Effective dividend tax rate, incl. state taxes (%)	19.32	21.00	NA	NA	NA	NA
Effective capital gains rate, incl. state taxes (%)	19.32	21.00	NA	NA	NA	NA
Capital gains assumed realized (%)	25	25	NA	NA	NA	NA
Effective capital gains rate (%)	4.8	5.3	NA	NA	NA	NA
After-tax income from firm (\$)	61,660	72,268	83,373	92,144	80,247	89,018
After-tax income from salary (\$)	82,788	85,688	82,788	85,688	82,788	85,688
Total income available (\$)	144,448	157,956	166,161	177,832	163,035	174,706
Total taxes paid (\$)	105,552	92,044	83,839	72,168	86,965	75,294
Effective tax rate (%)	42	37	34	29	35	30
<i>Panel B: High-Income Firm (\$750,000) — Service Business</i>						
Effective corporate rate, incl. state taxes (%)	37.96	25.74	NA	NA	NA	NA
Effective personal rate, incl. state taxes (%)	43.22	43.00	43.22	43.00	43.22	43.00
Self-employment tax rate (%)	1.45	1.45	1.45	1.45	1.45	1.45
Effective pass-through rate, incl. state taxes (%)	NA	NA	43.22	43.00	43.22	43.00
Effective dividend tax rate, incl. state taxes (%)	27.42	29.80	NA	NA	NA	NA
Effective capital gains rate, incl. state taxes (%)	27.42	29.80	NA	NA	NA	NA
Capital gains assumed realized (%)	25	25	NA	NA	NA	NA
Effective capital gains rate (%)	6.9	7.5	NA	NA	NA	NA
After-tax income from firm (\$)	166,400	192,655	209,823	210,651	194,625	195,452
After-tax income from salary (\$)	207,473	208,313	207,473	208,313	204,098	204,938
Total income available (\$)	373,872	400,967	417,295	418,963	398,722	400,390
Total taxes paid (\$)	376,128	349,033	332,705	331,037	351,278	349,610
Effective tax rate (%)	50	47	44	44	47	47

**Table 4 (Continued) Estimated Tax Rates across Alternative Organizational Forms — 100% Distribution — 50% Dividend, 50% Salary**

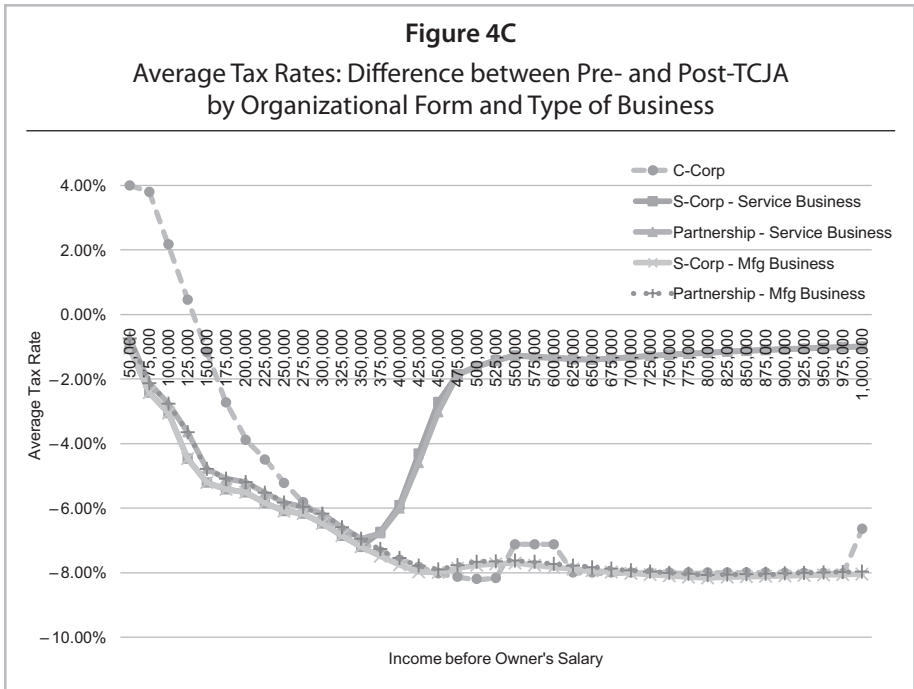
	C Corporation		S Corporation		Partnership	
	Pre	Post	Pre	Post	Pre	Post
Effective corporate rate, incl. state taxes (%)	37.96	25.74	NA	NA	NA	NA
Effective personal rate, incl. state taxes (%)	43.22	43.00	43.22	43.00	43.22	43.00
Self-employment tax rate (%)	1.45	1.45	1.45	1.45	2.35	2.35
Effective pass-through rate, incl. state taxes (%)	NA	NA	43.22	35.60	43.22	35.60
Effective dividend tax rate, incl. state taxes (%)	27.42	29.80	NA	NA	NA	NA
Effective capital gains rate, incl. state taxes (%)	27.42	29.80	NA	NA	NA	NA
Capital gains assumed realized (%)	25	25	NA	NA	NA	NA
Effective capital gains rate (%)	6.9	7.5	NA	NA	NA	NA
After-tax income from firm (\$)	166,400	192,655	209,823	237,998	194,625	222,800
After-tax income from salary (\$)	207,473	208,313	207,473	208,313	204,098	204,938
Total income available (\$)	373,872	400,967	417,295	446,311	398,722	427,737
Total taxes paid (\$)	376,128	349,033	332,705	303,689	351,278	322,263
Effective tax rate (%)	50	47	44	40	47	43

Notes: This table presents estimated after-tax income and total taxes paid, based on the models developed in Section III, for varying income levels, business activities, and organizational forms. In this table, we assume the entity distributes all income to owners, half in the form of salary and half as dividends. We assume all tax rates applied are flat tax rates. We assume a 6% state tax rate. This is deductible before the TCJA but not deductible after for pass-through income taxed at the personal level. It remains deductible for corporations. Post-TCJA pass-through income is eligible for the 20% IRC §199A deduction in Panels A and C but not in Panel B. Panel B presents a service business (a "specified service trade or business") where we assume the IRC §199A deduction fully phases out. Following Feldstein, Poterba, and Dicks-Mireaux (1983) and Plesko and Toder (2013), we assume that 25% of capital gains are realized in the current period.



rates of the various entity types begin to converge, consistent with Table 3, Panels B and C.

Figure 4B examines the post-TCJA period and also differentiates service versus manufacturing businesses to allow a comparison between pass-through businesses that do, or do not, phase out of the IRC §199A deduction. Consistent with the results in Table



3, C corporations are generally disfavored at relatively low incomes. This disadvantage disappears as income increases, especially for entities phased out of the IRC §199A deduction. In fact, in the income range we examine, C corporations become preferable at high incomes when pass-throughs phase out of IRC §199A.

Finally, Figure 4C summarizes Figures 4A and 4B by examining the *change* in tax rates by entity from pre- to post-TCJA. As expected, most changes are negative because the TCJA provided a large tax cut, with the exception of low-income C corporations, where the TCJA increased the corporate rate from 15 to 21 percent. Consistent with our discussion of the stylized model, high-income pass-through entities that do not qualify for IRC §199A appear to receive only a small tax cut from the TCJA. By contrast, IRC §199A qualifying pass-throughs and C corporations show large drops in the tax rate, with the decrease at higher incomes potentially favoring C corporations over pass-throughs.

**IV. PRACTITIONER GUIDANCE ON ORGANIZATIONAL FORM CHOICE AFTER THE TCJA**

At its simplest, the TCJA’s inversion of the corporate and top individual ordinary income tax rate suggests that C corporations will become the preferred organizational form. However, our analytic model and simulation exercise suggest that organizational form decisions following the TCJA will be significantly more nuanced than those fol-

lowing the TRA86. Consistent with this conclusion, there is little anecdotal evidence of substantial tax-induced organizational form changes currently underway.

Our conversations with practitioners, coupled with a review of popular and practitioner press articles, suggest the reasons for a slower response to the TCJA reduce to the temporary nature of portions of the TCJA and the uncertainty in pending administrative guidance. For example, the pass-through deduction is set to expire at the end of 2025, while the corporate income tax rate cut is permanent. Also, a significant amount of uncertainty remains with respect to the staying power (i.e., likelihood of repeal or correction) of many of the TCJA's relevant provisions, including the pass-through deduction, because of the speed with which the bill was written and the criticisms levied against it (Kamin et al., 2017; Shaviro, 2018). Business owners also face uncertainty with respect to the application of the TCJA's provisions in the years immediately following its passage, as currently there is little IRS or Treasury guidance on the new laws (Kamin et al., 2017; Nitti, 2018).<sup>22</sup> Business owners and their advisors are hesitant to make hasty organizational form decisions given such a high degree of uncertainty surrounding the TCJA and the fact that some organizational form choices cannot be quickly reversed.<sup>23</sup> Finally, questions have been raised about whether fundamental changes to the tax structure will need to be considered as part of any legislative approach to addressing the current budget situation (Sullivan, 2018b).

Even if the provisions of the TCJA are likely to remain intact for the foreseeable future, our analysis and practitioner advice suggest the organizational form choice moving forward depends on a myriad of firm-specific facts and circumstances, any of which could "turn the dial" just enough to prefer one form over the other.<sup>24</sup> In other words, there is no "one size fits all" approach for a particular organizational form in the post-TCJA era. Guidance issued by both KPMG and BDO, two of the largest accounting firms in the world, even advises taxpayers not to dismiss outright a corporate-to-partnership conversion (KPMG, 2018; BDO, 2018).

Anecdotal evidence of firms' initial behavioral responses to the TCJA suggests that the reduction in the tax cost of choosing one organizational form over the other will increase the relevance of *non-tax* costs to the decision. For example, two major publicly traded partnerships in the financial services industry, Ares Management LP and KKR & Co. LP, recently announced their conversion to C corporation status. KKR reported that the conversion will result in a higher tax burden but that the TCJA "made the

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<sup>22</sup> Nitti, Tony, "The New 'Qualified Business Income Deduction' Varies Based on Your Business Type – Or Does It?" *Forbes*, January 4, 2018, <https://www.forbes.com/sites/anthonymitti/2018/01/04/the-new-qualified-business-income-deduction-varies-based-on-your-business-type-or-does-it/#2939cb682076>.

<sup>23</sup> For example, an S corporation that converts to a C corporation has a 5-year waiting period before it is able to elect S status again (IRC §1362(g)). Previous empirical studies also show that individuals are not always responsive to tax incentives to shelter income in C corporation form (e.g., Romanov, 2006; Tazhitdinova, 2016).

<sup>24</sup> Several individual-level tax provisions also changed under the TCJA, such as limitations on certain itemized deductions (e.g., state and local tax deduction), making them now salient to the organizational form decision.

tax hit less painful” and, in turn, the firm gained increased access to potential capital providers via the C corporation form (Franklin, 2018).<sup>25</sup> Thus, it is possible that the non-tax benefit of greater access to capital markets for some partnerships now outweighs the tax cost (now drastically reduced by the TCJA) of using the C corporation form.<sup>26</sup>

## V. CONCLUSION

Similar to the TRA86, enactment of the TCJA produced broad and significant changes in the tax code’s treatment of individuals and businesses, causing many businesses to reassess fundamental decisions about their structure and operations. With respect to organizational form, comparisons with the TRA86 are useful to gauge the extent of potential behavioral responses. Our analyses suggest that, while changes in the factors affecting organizational form are nearly as dramatic as those not seen since 1986, the net effect on organizational form in the aggregate is not likely to be as large as those caused by the TRA86. Further, to the extent businesses as a whole make changes in their form, the decisions will likely take place over a longer period of time than in the aftermath of the TRA86. Our analyses suggest that recent predictions by political, media, and academic commentators related to the incentives created by the 20 percent pass-through deduction may not lead to large-scale changes in organizational form, at least in the short run. Similar to the TRA86, the changes brought about by the TCJA provide an opportunity for researchers to reexamine a broad range of tax-related research questions, and can serve as a foundation for research that will provide additional insight into the role of taxes in individual and business decisions.

## ACKNOWLEDGMENTS AND DISCLAIMERS

We thank Caitlin Bokulic, Bill Gentry (editor), Trent Krupa, Kelly Luttrell, Marty Harris, and John Robinson (Spring Symposium Discussant) for their assistance and/or comments. Henry and Plesko also hold positions as economists with the SOI Division of the IRS; however, the views expressed in this paper are solely those of the authors and do not represent those of the U.S. Department of the Treasury or the IRS. Any and all errors are our own.

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<sup>25</sup> Franklin, Joshua, “Private Equity Firm KKR Opts To Become C-Corp after U.S. Tax Reform,” *Reuters Business News*, May 3, 2018, <https://www.reuters.com/article/us-kkr-results/private-equity-firm-kkr-to-convert-to-a-corporation-after-u-s-tax-reform-idUSKBN1I4164>.

<sup>26</sup> Specifically, Merton (1987) suggests capital market benefits to expanding a firm’s shareholder base. Thus, the non-tax benefits of drawing in more institutional investors, who face additional tax and non-tax burdens from partnership ownership (e.g., Utke, 2018), outweigh the additional tax costs for some firms given the increase in institutional ownership over time (e.g., Gompers and Metrick, 2001). Though beyond the scope of this paper, the TCJA increased the tax burdens of partnership versus C corporation ownership for certain institutional investors.

## DISCLOSURES

The authors have no financial arrangements that might give rise to conflicts of interest with respect to the research reported in this paper.

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