Avoiding the 21 percent tax after the Tax Cuts and Jobs Act

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ABSTRACT

The Tax Cuts and Jobs Act has been widely publicized as a business-friendly amendment to the income tax law. This legislation has been very favorable for large businesses but is not beneficial for small corporate businesses with a taxable income of less than $50,000. Their tax rate has increased from 15 percent to 21 percent. This paper presents a case that provides evidence that there is not an acceptable way for these corporations to avoid this increase in their tax liability. The annual income tax liability of the corporation in the case study is computed under the new tax law and then recomputed under the proposition that the corporation elects S Corporation status or liquidates The results demonstrate that electing S Corporation status or liquidating will not reduce the corporation's and its shareholders' taxes to pre-Act status.

Key words: Tax Cuts and Jobs Act, flat tax rate, S Corporation election, complete liquidation

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INTRODUCTION

On December 22, 2017, President Trump signed H.R. 1, the Tax Cuts and Jobs Act (the Act) [1], into law. The Act is the most comprehensive tax reform in over thirty years and contains significant tax rate reductions for both individuals and corporations. One of the primary goals of the Act is to stimulate the economy through business tax reform that will provide American businesses a competitive edge resulting in job creation and higher wages. The most important pro-growth component of the Act is the permanent reduction in corporate tax rates from 35 percent to 21 percent. Instead of the previous graduated tax rates that ranged from 15 percent on the first $50,000 to 35 percent, the Act imposes a flat 21 percent rate on all taxable income. This tax rate reduction is substantial for large corporations. However, for small corporations with no more than $50,000 of taxable income, the tax rate has increased from 15 percent to 21 percent. Only small corporations are impacted negatively by the 21 percent flat rate. The breakeven is taxable income of $90,380. Using the former corporate rates in Appendix 1, the tax on $90,380 is $18,980 [$13,750 + 34% X ($90,380 - $75,000)]. The tax on taxable income of $90,380 under the current flat rate of 21 percent is $18,980.

After giving a brief overview of the extensive economic literature on the corporate income tax, the focus of this study will be to evaluate scenarios that would possibly avoid the unexpected tax increase for small corporations. The study will evaluate two possible solutions that small businesses could explore to avoid the higher tax: S Corporation election and Corporation liquidation

In completing this case, students should be able to:

1. Discuss the basics of how economists think about taxes
2. Evaluate if the new corporate income tax law is efficient in the narrow context of its treatment of smaller incorporated businesses
3. Describe S Corporations and compare S Corporations to C Corporations
4. Evaluate the effect of the new corporate tax rate upon an individual owner of a business operated as a C corporation.
5. Evaluate the effect of the newly qualified business income deduction upon a single owner of a business operated as an S corporation, partnership (including LLCs) or sole proprietorship.

LITERATURE REVEIW

There exists a vast literature on the economics of the corporate income tax. Since the corporate income tax's beginning in 1909, it has been one of the most studied topics in all of economics. Economists have not come to a consensus on either the economic effects of the tax or if it is wise economic policy to have the tax at all (Stigletz 1976).

The economics literature has studied the corporate income tax in several different contexts. Perhaps the most explored topic of corporate income is who pays the tax. Economic theory differentiates between the legal incidence of the tax (who writes the check to the government) and the economic incidence of the tax (who is harmed by the tax). Economists believe that the economic incidence of the tax is split between shareholders (owners), workers, and consumers (Auerback, 2006; Clemens, Peichl, and Siegloch, 2018; and Cochrane 2017).

[1] Tax Cuts and Jobs Act, P.L. 115-97, December 22, 2017

The second area of research concerning the corporate tax policy is how the tax impacts a nation's international competitiveness. Tax policy, mainly corporate tax policy, has implications for business location decisions and the flow of capital, labor, and goods. A significant reason tax reform is discussed is that many policymakers and economists think the tax policy in the U.S. adversely affects the ability of U.S. companies and workers to compete with the rest of the world (Summers, 1988). Corporate taxes have been falling in the world, and the U.S. continues to have among the highest corporate tax rates (Bunn 2018).

The focus of this paper is not the competitiveness of the U.S. tax sector or the incidence of the corporate tax. Instead, this paper is concerned with the potential welfare effects of the decision of a firm to incorporate or not given the tax incentives the firm faces. Like other topics, economists have studied this topic extensively.

Goolsbee (1998) reports that economists believe that there is a substantial impact of taxes on the decision to incorporate. His paper gives an excellent primer on the advantages of incorporation and brief historical perspective in the corporate income tax.

The empirical estimates in Goolsbee (1998) found that the impact on changing the corporate tax does indeed have an impact on the decision to incorporate, but the reported estimates are smaller than in the previous literature. Goolsbee's paper suggests that the impact that the corporate tax has on incorporation decisions should not be of primary concern for policymakers. Gravelle and Kotlikoff (1989), also find that the tax code has an influence on a business' decision to incorporate, but their estimates are much larger than Goolsbee's.

Chen, Qi, and Schlagenhauf (2018) looked at the effects that corporate tax cuts have on employment. A reduction in corporate income taxes encourages firms to organize as C corporations. C corporations have the fewest legal restrictions on how they can allocate capital and thus Chen, Qi, and Schlagenhauf (year) believes that an economy with more C corporations will allocate capital more efficiently increasing economic output and employment.

Firms can be discouraged; however, from forming into a C corporation because income from C corporations is ultimately taxed twice. Corporate profits are taxed. Shareholders then must pay personal income taxes on the remaining after-tax profits that are distributed to them by the firm.

So on one hand firms are encouraged to form a C corporation because they have more legal freedom to allocate capital and fewer constraints on ownership (they can have more shareholders, be owned by other corporations, foreign investors and intuitional investors, for example.)

Chen, Qi, and Schlagenhauf's (year) paper estimates that a reduction in the corporate income tax rate would lead to modest gains in employment. Specifically, the authors estimate that "the non-employed population would decrease from 34.1 percent to 31.7, about a 7 percent fall in the relative non-employment rate" (272).

Mackie-Mason and Gordon (1997) also investigate the effects of tax law on incentives to incorporate. If corporations are double taxed, then there is a disincentive to incorporate. Econ literature has mostly ignored the question of the decision to incorporate or not in response to tax? Economists think that there are many non-tax factors, but why not tax? This article provides a good summary of all the non-tax factors as well.

Mackie-Mason and Gordon's (1997) paper estimates the impact that taxes have on the decision of firms to incorporate or not. Taxes should induce profitable firms to shift out of the corporate sector when the tax increases. This paper finds strong evidence that firms do respond to tax incentives. However, non-tax factors still dominate the choice of organizational form.

This paper fits into the existing literature in economics by providing a numerical example of how a small business might select an organization form based on the tax code. The literature and economics courses generally do not include numerical examples that illustrate ideas presented in the research.

S CORPORATION ELECTION

One option for a small corporation is to elect S Corporation status. The majority of small businesses in the US are not C corporations but pass-through entities such as partnerships, S corporations, or sole proprietorships that are taxed at the individual rates. Although the Act did lower the individual tax rates, upper-income levels are taxed at higher rates than the new corporate tax rate. To provide relief to these small businesses, another component of the business tax reform in the Act provides a deduction equal to 20 percent of qualified business income (QBI) for all pass-through entities below specific thresholds. Although it may seem counterintuitive to transition from a C corporation to an S corporation when the corporate tax rate has decreased, it depends on the facts and circumstances of each entity as to whether such a move would lower income taxes.

In order to transition, an eligible corporation must make an affirmative election under I.R.C. §1362(a) to become an S corporation.[2] The requirements under I.R.C. §1361(b) are:

- The corporation must be a domestic corporation that was created in the United States;
- The corporation may not be an ineligible corporation - certain financial institutions, insurance companies and others;
- The corporation must have only one class of stock.
- The shareholders are limited to:
- U.S. citizens or residents;
- Estates;
- Certain trusts;
- Certain tax-exempt organizations.
- S corporations may have no more than 100 shareholders. Family members and their estates count as one shareholder. [3]

The election to become an S corporation is made on Form 2553 and must be signed by every person that was a shareholder any time during the year. The election for the current year must be made in the prior tax year or on or before the 15th day of the third month of the current year.

[2] I.R.C. §1362(a)

[3] I.R.C. §1361(b)

REASONS TO ELECT S CORPORATION STATUS

The most common reason to elect S corporation status is to avoid double taxation. The Act has added two new reasons for a small corporation to elect S Corporation status:

- Avoid the 21 percent flat corporate tax, and
- The new qualified business income for flow-through entities under I.R.C. §199A

No Double Taxation

C Corporations and their shareholders are subject to double taxation. The corporation computes taxable income and pays income taxes on that income. The shareholders pay a tax on dividends received if the distributions are out of earnings and profits of the corporation.

S Corporations and their shareholders are not subject to double taxation. The S corporation computes ordinary income and separately reported items. It does not pay income taxes, other than the built-in gains tax. Ordinary income and separately stated items are reported to shareholders on Schedule Ks. The shareholders pay the only income tax.

Avoid the 21 Percent Corporate Tax

Since S corporations do not pay a corporate level income tax, these corporations will never pay the 21 percent income tax enacted by the Act.

Qualified Business Income Deduction for Flow-Through Entities

The Act added a new deduction under I.R.C. §199A for flow-through entities and sole proprietorships. It is generally 20 percent of qualified business income (QBI) from partnerships, S corporations and sole proprietorships. The new deduction is available from January 1, 2018, to December 31, 2025. The deduction for QBI is equal to the lesser of:

- Combined QBI, or
- Twenty percent of the excess (if any) of:
- Taxable income for the tax year, over
- Net capital gain[4]
- The deduction is for income generated through sole proprietorships, partners or shareholders, not for partnerships and S corporations. QBI does not include:
- Capital gains and losses;
- Dividends;
- Interest income not related to the trade or business;
- Reasonable compensation paid to the taxpayer; or
- Guaranteed payments made to a partner.

Under I.R.C. §199A(e)(2) there are significant limitations if taxable income (not considering the QBI deduction) exceeds $315,000 for married couples filing jointly or $157,500

[4] I.R.C. §199A(a)(1)

for single individuals.[5] Taxpayers in these income levels must limit the deduction based on a wage/capital investment limitation and based on certain "specified service" businesses. At this income level, the QBI deduction cannot exceed the greater of:

- 50 percent of W-2 wages related to that trade or business, or
- The sum of
- 25 percent of W-2 wages related to that trade or business, and
- 2.5 percent of the unadjusted basis of all qualified property.[6]
- Under I.R.C. §199A(d)(2) the service professions excluded at this income level include:
- Health
- Law
- Accounting
- Consulting
- Investment advising, and
- Brokerage services.[7]

If the taxpayer has a qualified business loss, no QBI deduction is allowed, and the loss is carried over to the next year to reduce QBI.

REASONS NOT TO ELECT S CORPORATION STATUS

S corporations also have some potentially harmful aspects. There are at least two reasons not to elect S Corporation status: excess passive income causes the end of S Corporation status and built-in gains tax may be imposed

S corporation Income from Passive Sources

Under I.R.C. §1375 and Treas. Reg. §1.1375-1 an S Corporation with passive income of 25 percent of gross receipts is subject to a 21 percent penalty tax.[8] The tax is applied to the lesser of excess net passive income or taxable income.

Also, under I.R.C. §1362(d)(3) the corporation's S Corporation status will be terminated if it has C Corporation accumulated earnings and profits at the end of three consecutive years and has a passive income of more than 25 percent of gross receipts for each of those years. [9]
Under I.R.C. §1375(d) an S Corporation can avoid the penalty tax and termination by distribution all of its C Corporation earnings and profits before the end of the taxable year. The corporation must show, to the satisfaction of the IRS, that it had no accumulated earnings and profits at the close of the taxable year.[10]

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[5] I.R.C. §199A(e)(2)
[6] I.R.C. §199A(a)(2)
[7] I.R.C. §199A(d)(2)
[8] I.R.C. §1375 and Treas. Reg. §1.1375-1
[9] I.R.C. §1362(d)(3)
[10] I.R.C. §1375(d)

Built-In Gains Penalty Tax

Under I.R.C. §1374(d)(3) a corporate level penalty tax is imposed on any corporation that elects S Corporation after 1986. Any net unrealized gain (value in excess of basis) of the corporation is computed upon the date of election. The penalty is imposed at the highest corporate rate – now 21 percent – if the unrealized gain is recognized within five years of the election.[11]

Under I.R.C. §1374(c)(1) the built-in gains tax is not imposed on a corporation that was never a C Corporation. There is no penalty tax for an S Corporation that distributes all of its C Corporation earnings and profits.[12]

COMPLETE LIQUIDATION

The most common reason to completely liquidate a corporation is to avoid double taxation. The Act has added two new reasons for a small corporation liquidate: to avoid the 21 percent flat corporate tax and the new qualified business income for flow-through entities under I.R.C. §199A.

No Double Taxation

As discussed above, C Corporations and their shareholders are subject to double taxation. The corporation computes taxable income and pays income taxes on that income. The shareholders pay a tax on dividends received if the distributions are out of earnings and profits of the corporation.

Individual taxpayers are not subject to double taxation. These individuals pay only the income tax.

Avoid the 21 Percent Corporate Tax

As discussed above, since individual taxpayers do not pay a corporate level income tax, these taxpayers will never pay the 21 percent income tax enacted by the Act.

Qualified Business Income Deduction for Flow-Through Entities

As discussed above the Act added a new deduction under I.R.C. §199A for flow-through entities and sole proprietorships. It is generally 20 percent of qualified business income (QBI) from partnerships, S corporations and sole proprietorships. The new deduction is available from January 1, 2018 to December 31, 2025.
The deduction for QBI is equal to the lesser of:

- Combined QBI, or
- Twenty percent of the excess (if any) of:
- Taxable income for the tax year, over

[11] I.R.C. §1374(d)(3)
[12] I.R.C. §1374(c)(1)

- Net capital gain[13]
- The deduction is for income generated through sole proprietorships, partners or shareholders, not for partnerships and S corporations. QBI does not include:
- Capital gains and losses;
- Dividends;
- Interest income not related to the trade or business;
- Reasonable compensation paid to the taxpayer; or
- Guaranteed payments made to a partner.

Under I.R.C. §199A(e)(2) there are significant limitations if taxable income (not considering the QBI deduction) exceeds $315,000 for married couples filing jointly or $157,500 for single individuals.[14] Taxpayers in these income levels must limit the deduction based on a wage/capital investment limitation and based on certain “specified service” businesses. At this income level, the QBI deduction cannot exceed the greater of:

- 50 percent of W-2 wages related to that trade of business, or the sum of
- 25 percent of W-2 wages related to that trade of business, and
- 2.5 percent of the unadjusted basis of all qualified property.[15]

Under I.R.C. §199A(d)(2) the service professions excluded at this income level include:

- Health
- Law
- Accounting
- Consulting
- Investment advising, and
- Brokerage services.[16]

If the taxpayer has a qualified business loss, no QBI deduction is allowed. The loss is carried over to the next year to reduce QBI.

REASONS NOT TO COMPLETELY LIQUIDATE A C CORPORATION

Two reasons not to liquidate a C corporation are the loss of limited liability and recognition of unrealized gains and losses upon liquidation under Sec. 336.

Loss of Limited Liability

One of the primary reasons to operate in the corporate form is to avoid unlimited liability for the actions of representatives of the corporation. Complete liquidation of the entity will

[13] I.R.C. §199A(a)(1)
[14] I.R.C. §199A(e)(2)
[15] I.R.C. §199A(a)(2)
[16] I.R.C. §199A(d)(2)

result in unlimited liability for the eventual owners of the business formerly operated by the corporation.

Recognition of Unrealized Gains and Losses

Another reason not to liquidate a C corporation is that, under I.R.C. §336, any unrealized gains and losses on corporate assets must be recognized upon liquidation. The corporation would pay taxes at 21 percent on net gains.[17]

A CASE STUDY

A case study will be used to evaluate an S Corporation election and complete liquidation for a C Corporation currently earning less than $50,000 annually. Names have been changed to protect the identities of the owners of the corporation.

George and Lizzie Smith own a C Corporation. The Smiths created their corporation in the 1960s by placing the assets of the farm into the corporation and receiving all of the stock of the corporation.

The Smiths moved away from the corporation shortly after that so George could pursue other work. They continued to operate the farm on weekends and during the summer. They placed most of the land into the Conservation Reserve Program (CRP) about 20 years ago. George retired at about the same time. The corporation has never had an annual income of more than $50,000.

For years the corporate form seemed advantageous for estate planning purposes and benefitted from the lowest graduated tax rate. However, under the Act, the small corporation will be taxed at a higher rate.

The case study facts are contained in Figure 1.

Figure 1: Case Facts

Assets	Basis	Value
Land	116,500	300,000
Investments	183,000	270,000
Annual Income and Deductions – Corporation		
CRP Payments	46,000	
Dividends and Capital Gains	11,000	
Salary	-5,000	
FICA on Salary	-383	
Other Expenses	-13,000	
Federal Income Tax-Last Year	-8,044	
Annual Income-George and Lizzie		
Salary from Corporation	5,000	
FICA on Salary	-383	
Social Security	33,000	
Dividends and Capital Gains	40,000	
Interest Income	3,000	
Retirement Plan Distributions	40,000	

[17] I.R.C. §336

The total income taxes with no change in the C corporation status are contained in Figure 2.

Figure 2: Annual Income Taxes With No Change in C Corporation Status		
Corporation		
CRP Payments	46,000	
Dividends and Capital Gains	11,000	
Other Expenses	-13,000	
Taxable Income Before Salary	44,000	
Salary	-5,000	
FICA on Salary	-383	
Taxable Income	38,617	
Income Tax at 21%		8,109
George and Lizzie		
Salary From Corporation	5,000	
Social Security at 85%	28,050	
Dividends and Capital Gains	40,000	
Interest Income	3,000	
Retirement Plan Distributions	40,000	
	116,050	
Basic Standard Deduction	-24,000	
Additional Standard Deductions	-2,600	
Taxable Income	89,450	
Tax Computation		
Taxable Income	89,450	
Dividends and Capital Gains	-40,000	
Ordinary Taxable Income	49,450	
Tax on Ordinary Taxable Income		5,553
Tax on Capital Gains and Dividends		
Threshold for 22% Rate	77,200	
Ordinary Taxable Income	-49,450	
Taxed at 0%	27,750	
Dividends and Capital Gains	40,000	
Taxed at 0%	-27,750	
Taxed at 15%	12,250	1,838
Total Income Taxes		15,550

The total income taxes with S corporation status elected are contained in Figure 3.

Figure 3: Annual Income Taxes After S Corporation Election			
Social Security at 85%		28,050	
Dividends and Capital Gains		40,000	
Interest Income		3,000	
Retirement Plan Distributions		40,000	
Salary from Corporation		5,000	
S Corporation Income Before Salary		44,000	
Salary		-5,000	
FICA on Salary		-383	
AGI		154,667	
Basic Standard Deduction		-24,000	
Additional Standard Deductions		-2,600	
QBI Deduction at 20%			
CRP Payment	46,000		
Other Expenses	-13,000	-6,600	
		128,067	
Tax Computation			
Taxable Income		128,067	
Dividends and Capital Gains		-51,000	
Ordinary Taxable Income		77,067	
Tax on Ordinary Taxable Income			8,867
Tax on Capital Gains and Dividends			
Threshold for 22% Rate – Sec. 1(j)(5)		77,200	
Ordinary Taxable Income		-77,067	
Taxed at 0%		134	
Dividends and Capital Gains		51,000	
Taxed at 0%		-134	
Taxed at 15%		50,866	7,630
			16,497

Total taxes with no election are	$15,500
Total taxes with the election are	16,497
The annual tax increase would be	$ 997

The annual effect of converting to an S Corporation is an increase in tax and would not allow the taxpayers to avoid the 21 percent tax.

Long-term Effects on the Case Study – S Corporation

It would be necessary to liquidate the investments and distribute all of the corporation's earnings and profit to avoid the passive income problems in the present case. Liquidation would be very expensive and would negate any annual savings in taxes.

Current cost of liquidating investments to distribute C Corporation E&P

Sale of Investments - 270,000 - 183,000 = 87,000.00 X 21% = $18,270

Distribution to Smiths = 270,000 – 18,270 = 251,730 X 15% = 37,760

Total cost $56,030

In the present case electing S Corporation status would not reduce annual income taxes paid.

Long-term Effects on the Case Study – Complete liquidation

The results from liquidating the corporation would be worse. All of the assets would be treated as sold for fair market value, resulting in substantial taxable income up front.

The total income taxes after complete liquidation are contained in Exhibit 4.

Figure 4: Annual Income Taxes After Liquidation			
Social Security at 85%		28,050	
Dividends and Capital Gains		40,000	
Interest Income		3,000	
Retirement Plan Distributions		40,000	
Former Corporation Income Before Salary		44,000	
AGI		155,050	
Basic Standard Deduction		-24,000	
Additional Standard Deductions		-2,600	
QBI Deduction at 20%			
CRP Payment	46,000		
Other Expenses	-13,000	-6,600	
		128,450	
Tax Computation			
Taxable Income		128,450	
Dividends and Capital Gains (40,000 + 11,000)		-51,000	
Ordinary Taxable Income		77,450	
Tax on Ordinary Taxable Income			8,918
Tax on Capital Gains and Dividends			
Threshold for 22% Rate – Sec. 1(j)(5)		77,200	
Ordinary Taxable Income		-77,450	
Taxed at 0%		0	
Dividends and Capital Gains		51,000	
Taxed at 0%		0	
Taxed at 15%		51,000	7,650
			16,568

Total taxes with no election are	$15,500
Total taxes with the election are	16,568
The annual tax increase would be	$ 1,058

The annual effect of a complete liquidation is an increase in tax and would not allow the taxpayers to avoid the 21 percent tax.

The effect of the complete liquidation is:

Gain on Investments - 270,000 - 183,000 = 87,000 X 21% =	$18,270
Gain on Land - 300,000 – 116,500 = 183,500 X 21% =	35,535
Distribution to Smiths = 270,000 + 183,000.00 – 18,270 - 35,535 = 164,730 X 15% =	24,710
Total cost	$81,515

DICUSSION AND CONCLUSION

The example in the paper has highlighted the vast differences in the way the tax code treats income from non-incorporated and incorporated firms. This differential treatment is a concern for economists because there are often significant benefits and costs to incorporation independent of the tax code. That is, due to the nature of the firm and the markets, it is "natural" for some firms to incorporate and others do not. Economists would want a business to organize along with those natural tendencies.

If the tax code changes and that causes firms to change their organizational structure, there would be a loss to the overall economy; there would be a loss of efficiency if tax policy caused firms to alter incorporation plans. The new tax law is a massive tax increase for small firms. What harm will come to an economy if firms disincorporate when they should otherwise remain incorporated?

The calculations in this case have demonstrated that under the current tax code, there is no way for owners of small firms to lower their tax liability by disincorporation. When the corporate tax rates were changed from a graduated rate schedule of 15 and 35 percent to a flat rate of 21 percent, small firms with less than 91,000 of profit saw their tax liability go up. Firms can avoid the 21 percent flat rate by disincorporation, but due to the relationship between the personal and corporate tax rate, no level of profit exists that would yield a lower personal income tax liability than corporate liability.

Discussion for Economics Students

Questions

1. The economic incidence of a tax is who bears the economic burden of a tax while the legal incidence of a tax is who must write the check to the government. Economists think about the economic incidence of a tax as not necessarily being the same as the legal incidence. Accountants are interested in the legal incidence of the tax. Why is this? Would accountants ever be interested in the economic incidence of a tax? Explain.
2. Economists think that the economic incidence of a tax will either be on firm owners through lower profits/stock values, on firm workers through lower wages, or on consumers through higher prices. How could the design of the tax influence which of these three groups bear the actual economic burden of the tax? Explain.
3. There is no level of profit that exists that would allow the small firms represented in this article to avoid a tax increase. Assuming that the government wanted to cut corporate taxes for all corporations, what policy changes could be made to remedy this and give even small businesses a tax cut?
4. Most economists who think that corporate income tax should be zero believe that intermediate goods should not be taxed. Why do you think governments tax corporations, then? What are some of the reasons that corporations should be taxed? In other words, why should governments single out consumers of goods taxed by corporations, those who work for corporations, and those who own corporations with a special tax?
5. A significant concern in the literature is the impact that the tax code has on incorporation. If the tax code causes a business entity to change its incorporation status, there is

a loss of efficiency. Given the scenario in this case, would there be a loss of economic efficiently in this context?

Answers

1. Accountants are often the ones who determine the legal tax liability for individuals and businesses. Economists will be more concerned about the real burden that taxes place on different groups, both seen and unseen. Accountants are citizens too, so they may have an interest in what the economic burden of a tax is. It also helps to have a deeper understanding of the practical matters that accountants deal with in their profession.
2. Groups with more inelastic supplies or demands for items being taxed cannot avoid the tax as easily as those with more elastic supplies or demands. So, policymakers can try to levy taxes on groups at points where demand or supply is more inelastic. In practice, this will prove very hard. It is easy to direct certain people to write checks to the government, but it is tough to control how groups react and alter their behaviors in response to a tax.
3. Policymakers could retain the 15% rate for small businesses as it was before.
4. There are perhaps many great answers to this question, and some are bad. Here is a list that includes both. These some examples may themselves spark discussion.
5. It may be popular to tax corporations if voters believe that the corporation pays the taxes instead of the people who represent the owners, workers, and customers.

Many think that taxing corporations is the only way this income, or profit, is taxed at all. If corporations are not taxed, they might retain and reinvest their earnings.

Collecting the tax at the corporate level instead of from the workers, owners, and customers might be administratively efficient.

Owners of corporations might be, on average, quite rich. Taxing corporations might be a way to make the overall tax code progressive.

In this case, no scenario would cause a small business to change their incorporation status in response to the law, so from a pure efficiency standpoint (and in the context of organization form), this law does not impact efficiency for small businesses.

Discussion for Accounting Students

Questions

1. Based on the new tax scenario after the enactment of the Tax Cuts and Jobs Act, what tax status would result in the smallest total tax burden for an individual creating a new small business – a pass-through entity (such as a sole proprietorship, a partnership (including LLCs) or an S corporation) or a C corporation?
2. What are the primary non-tax considerations to be evaluated when forming a new entity?
3. Many small businesses currently operate as C corporations. The new 21% flat tax rate will cause an increase in the income taxes paid by these corporations. Would liquidating one of these corporations be an economically viable solution to this problem for the individual owning the C corporation? What factors should be considered when making this decision?
4. Is the qualified business income deduction a reasonable strategy to give non-corporate taxpayers tax relief equal to the overall rate reduction for corporate taxpayers?

Answers

1. Based on the results of the case study, it is not apparent which tax status would result in the small total tax burden. Each situation should be evaluated by determining the total tax burden on the individual. The answer will depend on the individual's total taxable income from all sources.
2. For a small closely corporation, the primary non-tax consideration when forming a new entity is limited liability. C corporations, S corporations, and Limited liability companies limit the owners' liability to their investment in the entity. Partnerships and sole proprietorships do not protect the owners from liabilities of the entity's creditors.
3. For the present case study, it did not make sense to liquidate the C corporation. The fact that the corporation owned significant property with a low basis makes the liquidation very expensive. There may be situations where liquidating the corporation makes sense. Every situation should be carefully evaluated.
4. In the present case study, the qualified business income deduction significantly reduced the tax cost of doing business as a non-corporate taxpayer, but it did not completely offset the tax savings of the 21% tax rate. There may be situations where this deduction does totally offset the effect of the 21% rate. There are some situations where the deduction would not help – such as when the individual has a high income. Every situation should be carefully evaluated.

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APPENDIX: TAX RATES BEFORE AND AFTER THE TCJA

Table A1: Tax rates for married individuals filing joint returns for 2017 (including surviving spouses)

Taxable income	Tax liability
0-18,650	10%
18,650-75,900	1,865 + 15% of excess over 18,650
75,901-153,100	10,452.50 + 25% of excess over 75,900
153,101-233,350	29,752.50 + 28% of excess over 153,100
233,351-416,700	52,222.50 + 33% of excess over 233,351
416,701-470,700	112,728.50 + 35% of excess over 416,700
Over 470,700	131,628 + 39.6% of excess over 470,701

Table A2: Tax rates for single individuals for 2017 (other than heads of households and surviving spouses)

Taxable income	Tax liability
0-9,325	10%
9,326-37,950	932.50 + 15% of excess over 9,325
37,951-91,900	5,226.25 + 25% of excess over 37,950
91,901-191,650	18,713.75 + 28% of excess over 91,900
191,651-416,700	46,643.75 + 33% of excess over 191,650
416,701-418,400	120,910.25 + 35% of excess over 416,700
Over 418,400	121,505.25 + 39.6% of excess over 418,400

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Table A3: Tax rates for heads of households for 2017	
Taxable income	Tax liability
0-13,350	10%
13,351-50,800	1,335 + 15% of excess over 13,350
50,801-131,200	6,952.50 + 25% of excess over 50,800
131,201-212,500	27,052.50 + 28% of excess over 131,200
212,501-416,700	49,816.50 + 33% of excess over 212,500
416,701-444,550	117,202.50 + 35% of excess over 416,700
Over 444,550	149,298 + 39.6% of excess over 444,550

Table A4: Tax rates for marrieds filing separately for 2017	
Taxable income	Tax liability
0-9,325	10%
9,326-37,950	932.50 + 15% of excess over 9,325
37,951-76,550	5,226.25 + 25% of excess over 37,950
76,551-116,675	14,876.25 + 28% of excess over 76,550
116,676-208,350	26,111.25 + 33% of excess over 116,675
208,351-235,350	120,910.25 + 35% of excess over 208,351
Over 235,350	121,505.25 + 39.6% of excess over 235,350

Table A5: Tax for corporations (1993-2017)	
Taxable income	Tax
0-50,000	15%
50,001-75,000	7,500 + 25% of excess over 50,000
75,001-100,000	13,750 + 34% of excess over 75,000
100,001-335,000	22,250 + 39% of excess over 100,000
335,001-10,000,000	113,900 + 34% of excess over 335,000
10,000,001-15,000,000	3,400,000 + 35% of excess over 10,000,000
15,000,001-18,333,333	5,150,000 + 38% of excess over 15,000,000
Over 18,333,333	35%

Table A6: Tax rates for married individuals filing joint returns for 2019 after the TCJA (including surviving spouses)	
Taxable income	Tax liability
0-19,050	10%
19,051-77,400	1,905 + 12% of excess over 19,050
77,401-165,00	8,907 + 22% of excess over 77,400
165,001-315,000	28,179 + 24% of excess over 165,000
315,001-400,000	64,179 + 32% of excess over 315,000
400,001-600,000	91,379 + 35% of excess over 400,000
Over 600,000	161,379 + 37% of excess over 600,000

Table A7: Tax rates for single individuals for 2019 after the TCJA (other than heads of households and surviving spouses)	
Taxable income	Tax liability
0-9,525	10%
9,526-38,700	952.50 + 12% of excess over 9,526
38,701-82,500	4,453.50 + 22% of excess over 38,700
82,501-157,500	14,089.50 + 24% of excess over 82,500
157,501-200,000	32,089.50 + 32% of excess over 157,500
200,001-500,000	45,689.50 + 35% of excess over 200,000
Over 500,000	150,689.50 + 37% of excess over 500,000

Table A8: Tax rates for heads of households for 2019 after the TCJA	
Taxable income	Tax liability
0-13,600	10%
13,601-51,800	1,360 + 12% of excess over 13,600
51,801-82,500	5,944 + 22% of excess over 51,800
82,501-157,500	12,698 + 24% of excess over 82,500
157,501-200,000	30,698 + 32% of excess over 157,500
200,000-500,000	44,298 + 35% of excess over 200,000
Over 500,000	149,298 + 37% of excess over 500,000

Table A9: Tax rates for marrieds filing separately for 2019 after the TCJA	
Taxable income	Tax liability
0-9,525	10%
9,525-38,700	952.50 + 12% of excess over 9,525
38,701-82,500	4,453.50 + 22% of excess over 38,700
82,501-157,500	14,089.50 + 24% of excess over 82,500
157,501-200,000	32,089.50 + 32% of excess over 157,500
200,001-300,000	45,689.50 + 35% of excess over 200,000
Over 300,000	80,689.50 + 37% of excess over 300,000

Table A10: Corporate tax rate for 2019 after the TCJA	
Taxable income	Tax liability
All taxable income	21%