The 'S' Is a Mess: A Case for Eliminating Subchapter S

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In this article, the authors discuss the history of passthrough taxation and the relevance of the S corporation form, exploring the benefits of a more careful and neutral consideration of passthrough income and the elimination of subchapter S.

Since its passage in December, the Tax Cuts and Jobs Act (P.L. 115-97) has provided tax professionals with six months of analysis, speculation, and frenzied planning. Congress debated tax legislation for several weeks at the end of 2017, with several major proposals focused on lowering tax rates for businesses.[1] Lowering the tax rate for C corporations was just part of the debate because passthrough entities like partnerships and S corporations (which account for 80 percent of all business returns[2]) would be affected by any new legislation. Those entities pay no income tax, instead passing profits through to their owners, who are subject to ordinary individual income tax rates that are much higher than the rate proposed and eventually passed for corporate income. Thus, to create equitable treatment of business profits between passthrough entities and C corporations, the House of Representatives initially proposed a maximum passthrough tax rate of 25 percent, while the Senate proposed a deduction for passthroughs of 23 percent of business profits.

Along with permanently cutting the C corporation tax rate to 21 percent, Congress passed section 199A — a provision allowing individuals to deduct up to 20 percent of their so-called qualified business income (QBI) from a passthrough entity (subject to income thresholds and effective December 31, 2017, through January 1, 2026). However, Congress was incorrect to think there was a great inequity between tax on S corporation income and C corporation income, or that if the corporate tax rate were lowered to 21 percent, the inequity would be exacerbated. In fact, S corporation owners enjoyed a tax advantage before, and section 199A has created additional complexity and will likely increase abuse of S corporation status for tax avoidance.

Consider a scenario, depicted in Appendix 1, in which the tax rate on C corporation income was reduced to 21 percent and passthrough rates were left unchanged. A C corporation earning $500,000 would pay tax at an effective rate of 31.68 percent, while a passive investor in a partnership or an S corporation would pay tax at an effective rate of 30.55 percent. Even at the highest 2017 individual income tax rates, as assumed for our example, a passive partner's effective tax rate is lower than that of a C corporation. Clearly, an adjustment to tax rates or a special deduction was simply unnecessary to create equity between passthrough entities and C corporations. In fact, if we assume the proposal by the House of a top tax rate on passthrough income of 25 percent, the effective tax rate for an active participant in an S corporation drops to 28.06 percent.

Under those rules — a top passthrough rate of 25 percent — that same active participant earning

[1] "Roadmap to House and Senate Tax Reform Plans," *Bloomberg Tax*, Nov. 16, 2017.

[2] Scott Greenberg, "Pass-Through Business: Data and Policy," Tax Foundation (Jan. 17, 2017).

$500,000 from a partnership would pay tax at a 31.73 percent effective rate, including self-employment tax. Again, the S corporation counterpart pays an effective rate of just 28.06 percent on the same income. How? The key difference is the self-employment tax — an S corporation owner must take only a "reasonable salary," and unlike an active participant in a partnership, isn't required to pay self-employment tax on business profits. While we assumed a reasonable salary of $100,000, this calculation is extremely subjective and could be easily changed to support the desired tax liability for the current year. This is a loophole that should be closed, and Congress would be wise to review the inequities that lie solely within the realm of passthrough entities.

Perhaps somewhat ironically, in the 1950s Congress created S corporations to increase fairness of entity choice by allowing small businesses to access the legal benefits of incorporation, such as limited liability, and to allow the flexibility of the passthrough taxation of partnerships. That was a noble goal, but in that regard, S corporations have outlived their usefulness. Since the 1950s limited liability companies were created and are now permitted in every state, offering legal benefits similar to corporations and the ability to operate as any form of business under the tax code.[3]

Because there is no longer a legal purpose for their existence, S corporations serve no purpose other than to allow shareholders to avoid Social Security and Medicare taxes on business profits — an open secret used in advertising and education by many CPAs and lawyers.[4] Further, the IRS spends considerable resources examining the underlying assumptions of what constitutes a reasonable salary paid to owners, and even more resources challenging those assumptions in court, often turning to valuation experts to calculate reasonable compensation based on industry, job duties, and time spent on the business activity.[5] And while a few tax court cases have established more objective tests and guidelines for determining those calculations, evaluating reasonable salary still consumes a large amount of scarce IRS audit resources.[6]

Eliminating subchapter S of the tax code would solve many of these issues. If S corporations were abolished, active participants in businesses would achieve perfect equity. For example, in our scenario of a business earning $500,000, each shareholder or partner would pay an effective rate of 35.37 percent. That would remove tax considerations from the choice of entity and put all entities on a level playing field. Further, there would be no possibility for abuse by high wage earners, and thus no need for complex antiabuse rules. The recent changes from the TCJA, which further favor S corporation status, expire in 2026. As that date approaches — or as other tax reform is proposed — Congress should reconsider the misguided notion that it needs to alter the tax rate on passthrough income to create equity across business formation choices.

I. History of Passthrough Taxation

The history of passthrough taxation began with the implementation of the first corporate tax of 1 percent in 1909, followed a few years later with the passage of the 16th Amendment and a tax on all individuals, including business income, regardless of entity.[7] Interestingly, partnerships were disregarded in early tax legislation — individuals were liable for tax on their share of the partnership profits, but there was no formal reporting mechanism until subchapter K was created as part of the Tax Reform Act of 1954.[8] Subchapter K not only established reporting requirements for partnerships, it also provided a

[3] A single-owner LLC defaults to a sole proprietorship but can elect status as an S corporation or C corporation, while an LLC with two or more members will default to a partnership but could also elect status as an S corporation or C corporation.

[4] *See, e.g.*, Jason Watson, "Reasonable S Corp Salary," Watson CPA Group (Feb. 19, 2018).

[5] *See Spicer Accounting v. United States*, 918 F.2d 90 (1990); *Davis v. United States*, No. 93-C-1173 (D. Colo. 1994); *JD & Associates Ltd. v. United States*, No. 3:04-cv-59 (D.C.N.D. 2006); *Watson v. Commissioner*, 668 F.3d 1008 (8th Cir. 2012); and *Sean McAlary Ltd. Inc. v. Commissioner*, T.C. Summ. Op. 2013-62.

[6] *See Owensby & Kritikos Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987); *Label Graphics Inc. v. Commissioner*, T.C. Memo. 1998-343; and *Brewer Quality Homes Inc. v. Commissioner*, T.C. Memo. 2003-200.

[7] Revenue Act of 1913, ch. 16, 63rd Cong., 1st Sess., 38 Stat. 114 (Oct. 3, 1913).

[8] Bradley T. Borden, Sandra Favelukes, and Todd E. Molz, "A History and Analysis of the Co-Ownership-Partnership Question," *Tax Notes*, Mar. 7, 2005, p. 1175.

framework for partnership operation and taxation that was a model for subchapter S, passed in 1958.

The intention behind subchapter S was to provide small businesses with another entity choice — one that provided the limited liability of a C corporation with the passthrough characteristics of partnerships.[9] Initially, an S corporation was limited to 10 shareholders — this was gradually increased to 35 in 1982, 75 in 1995, and finally 100 shareholders as of 2005. Two other important changes occurred during the development of passthrough entities. First, Social Security taxes on self-employed persons and Medicare taxes were established in 1951 and 1966, respectively. Second, passive activity loss limits restricted the losses investors could deduct on their returns if they did not materially participate in the activity. Losses for passive investors in an activity are limited to that investor's passive gains.

Except for those two substantial changes, the basic rules of passthrough entities look much like they did in the 1950s. Generally, owners of passthrough entities pay tax on their share of the entity's profits, and self-employment (Social Security and Medicare, also known as FICA) taxes are assessed on owners who provide services to a partnership. As mentioned above, S corporation owners escape FICA taxes on business profits but must take a reasonable salary. Finally, income from passthrough activities is subject to the tax rates of individuals, unlike the income from C corporations, which is taxed under different rules.

A plethora of rules and tax rates apply to different activities, and the decision to form a business entity as an S corporation instead of a partnership or C corporation can have major tax benefits. The recent reduction of the tax rate on C corporations from 35 percent to 21 percent only serves to increase the tax effect on entity choice, and is further exacerbated by the section 199A deduction, which effectively lowers the top tax rate on qualifying passthrough entities to a rate that is below top individual tax rates. Also, operating as an S corporation still allows an escape from FICA taxes on business profits. Thus, the recent tax reform will put additional pressure on already overextended enforcement mechanisms.

For a glimpse of some unintended consequences that could result from these new rules, we turn to Kansas, the most recent state to experiment with passthrough taxation. In 2012 Kansas reduced the tax rate on individuals and businesses, including cutting tax rates on passthrough entities to zero. Initial estimates in 2012 indicated that 191,000 taxpayers would benefit from a zero tax rate on passthrough entities, but by 2015 almost 400,000 taxpayers filed passthrough entity returns and the effect on Kansas was devastating: the passthrough exemption resulted in estimated lost revenue of between $200 million and $300 million per year. Scott Drenkard of the Tax Foundation testified before the Kansas House Committee on Taxation that "the passthrough carveout is primarily incentivizing tax avoidance, not job creation."[10] Faced with a $900 million budget gap, Kansas rolled back the legislation at the end of 2016.[11]

Perhaps this information wasn't available to Congress during the debate over taxes at the end of 2017, as House Republicans proposed lowering the top passthrough tax rate to 25 percent and Senate Republicans proposed a 23 percent deduction for passthrough entities. Presidential candidate Trump's tax plan proposed lowering the top passthrough rate to 15 percent, and then 25 percent in the tax plan released after he was elected. Further, Rep. Vern Buchanan, R-Fla., proposed decoupling the individual rate from the passthrough rate and instead tying the passthrough rate to the corporate rate.[12] And while the final legislation passed by Congress and signed by Trump was not as extreme as the Kansas passthrough rate of 0 percent, the outcome could be similar unless Treasury writes detailed regulations to interpret the new legislation.

[9] David R. Sicular, "Subchapter S at 55," 68 *Tax Law*. 185-238 (Fall 2014).

[10] Scott Drenkard and Joseph Bishop-Henchman, "Testimony: Reexamining Kansas' Pass-Through Carve-Out," Tax Foundation (Jan. 19, 2017).

[11] Jeremy Hobson, Dean Russell, and Samantha Raphelson, "As Trump Proposes Tax Cuts, Kansas Deals With Aftermath of Experiment," *NPR*, Oct. 25, 2017.

[12] Greenberg, "Should the Corporate Rate and the Pass-Through Rate Be Identical?" Tax Foundation (June 13, 2017).

II. Taxation of Passthrough Entities After TCJA

The U.S. top tax rate of 35 percent on C corporations, long viewed as anti-competitive relative to the rest of the developed world and an incentive for corporations to reorganize or shift capital outside the United States, was reduced to 21 percent with the passage of the TCJA. Believing that the rate reduction would give C corporations an advantage over passthrough entities, Congress enacted section 199A to further lower the effective rate on passthrough earnings.[13] We will illustrate that changes to passthrough income tax rates were unnecessary, and that subchapter S still contains easily exploited loopholes that should be closed.

The two major changes in entity taxation — reduction of the C corporation tax rate and creation of the section 199A deduction — especially complicate the small business owner's decision of entity choice. Many tax experts are focusing on the reduction of the C corporation tax rate to 21 percent and how it gives taxpayers incentive to choose a C corporation as an initial business structure[14] or for shareholders of an S corporation to revoke the S election and reorganize as a C corporation.[15] However, the section 199A deduction creates a different set of incentives. Because of the way the deduction is calculated, S corporations have a motivation to reduce the salaries of the shareholder-employees and increase QBI to expose more profits to the deduction.[16] This incentive increases pressure on the reasonable salary requirement of S corporation shareholder-employees. The IRS already has a difficult time enforcing this subjective rule, and section 199A fans the flames of abuse.

Of course, the application and enforcement of the section 199A deduction largely depends on the (as of now) unwritten Treasury regulations. There were a few specific limitations written into the law: First, the deduction for QBI is limited for upper-income taxpayers — those with adjusted gross income exceeding $157,500, or $315,000 for a joint return — based on either W-2 wages or capital assets. While those thresholds could exclude many business owners from taking the deduction, it might also encourage reducing the salaries of the owners and increasing QBI, with the double benefit of qualifying for the deduction and reducing FICA taxes. Finally, at specific income levels the deduction is denied to those in particular industries (using the language of section 1202(e)(3)(A)[17]) — most notably accountants, lawyers, and financial advisers.[18] Unmentioned in the law — and likely to be addressed by the regulations — is whether the deduction will be disallowed, or at the very least closely scrutinized, if paid to shareholders who reach a specific threshold of ownership.

A numerical example depicted in Appendix 2 illustrates why this scrutiny might be necessary. As mentioned, the ability of S corporation shareholders to avoid FICA taxes on business profits continues to give them a strategic advantage over similarly situated partnerships and sole proprietors. An S corporation shareholder-employee with salary of $130,000 and QBI of $170,000 will pay roughly the same amount of tax as a partner with $300,000 of QBI. However, as profits of the S corporation increase, and salary of the shareholder-employee decreases, the total tax paid goes down. Of course, this balance is subjective and entirely based on what is considered reasonable compensation. For example, if that S corporation shareholder instead had a salary of $50,000 and QBI of $250,000, the shareholder will pay nearly $16,000 (22 percent) less tax than a partner with QBI of $300,000.

We can conclude two things. First, a rate reduction or additional deduction for passthrough business profits was unnecessary to generate horizontal equity across varying types of

[13] William A. Bailey, "Mechanics of the New Sec. 199A Deduction for Qualified Business Income," *J. Acct.* (May 1, 2018).

[14] Matthew Melone, "The Deduction for Pass-Through Income and Its Effect on Choice of Entity," *100 Practical Tax Strategies* 4 (2018).

[15] Christopher D'Avico, Lauren Pope Stalls, and Ed Decker, "Converting From S Corp to C Corp: Select Issues for Consideration," *The Tax Adviser*, Apr. 1, 2018.

[16] Because partnerships don't have this option, it also creates an incentive for eligible partnerships to reorganize as S corporations.

[17] Section 1202(e)(3)(A) defines this as "any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees" or owners.

[18] For a more detailed and nuanced discussion of this deduction, see Bailey, *supra* note 13.

business entities. In fact, the section 199A deduction will reduce horizontal equity because effective rates on passthrough income will decrease further below those paid by C corporation shareholders. It has also created opportunities for abuse by higher wage earners, who could reorganize as passthrough entities and lower their taxes with little effort.

Second, we can see that the S corporation is a superior entity choice for lowering tax paid by active shareholder-employees. Unlike partnerships and sole proprietorships, profits of an S corporation are not subject to self-employment taxes, but shareholder-employees must take a reasonable salary that is subject to FICA tax. The S corporation is used as a business entity today almost exclusively for avoiding FICA tax — a tax classification with no separate legal status. That is a considerable loophole — one that was famously exploited by John Edwards and Newt Gingrich[19] — that should be closed. S corporation shareholder-employees should not be allowed to escape FICA tax, while a similarly situated partner pays a higher tax on the same income. This loophole can be closed by removing subchapter S, which would ease administrative and enforcement burden on the IRS by removing the highly subjective reasonable salary requirements. Most importantly, it would lead to greater equity among small business owners and a simpler tax code.

III. Eliminating Subchapter S Is Good Tax Policy

The American Institute of CPAs advocates for good tax policy through its tax policy concept statements. Statement 1 provides what the AICPA believes should be the 12 guiding principles used to evaluate any current or proposed tax policy.[20] While much of the discussion in the preceding section focused on the horizontal equity across entity classification for federal tax purposes, there are other principles to consider when evaluating whether eliminating subchapter S is good tax policy. In this section, we consider the six most relevant principles.

A. Equity and Fairness

The first principle, of equity and fairness, establishes that "similarly situated taxpayers should be taxed similarly." As illustrated above and in Appendix 1, eliminating S corporations would ensure that every remaining passthrough entity would pay the same amount of tax on the same amount of business income. Active participants in the business would be treated similarly, and passive investors would also be treated similarly. One inequity that may remain is between C corporations and other passthrough entities for passive investors. The new law has reduced the C corporation rate to 21 percent, and in that scenario a corporation and its passive investor pays a higher rate than a passive investor in a passthrough entity. Interestingly, this is somewhat unintentionally progressive because the horizontal inequity creates some vertical equity. C corporations are generally larger, have more profits, and generate significantly more in tax revenue for the government than passthrough entities, and thus have a greater ability to pay tax than smaller passthrough entities.[21] Further, a C corporation can defer the second level of tax paid on dividends by electing not to pay all its profits in dividends. Tax on capital gains — the other source of a second level of tax — can also be deferred until the stock is sold by the shareholder.

B. Effective Tax Administration

The principle of effective tax administration provides that "costs to collect a tax should be kept to a minimum for both the government and taxpayers." Eliminating subchapter S relieves the IRS of the administrative burden of auditing an S corporation shareholder-employee's "reasonable salary." This is a subjective test that is often stretched and abused. Taxpayers have an incentive to estimate on the low side when deciding their wages. Because nearly every S corporation uses this tactic, and S corporations make up 13.1 percent of the business entities in the United States,[22] the IRS has difficulty keeping

[19] Laura Saunders, "Concerns Mount Over the Pass-Through Tax Cut," *The Wall Street Journal*, Nov. 3, 2017.

[20] For the full text of all concept statements, see American Institute of CPAs, "Tax Policy Concept Statements."

[21] Frank Sammartino, "Taxation of Pass-Through Businesses," Urban-Brookings Tax Policy Center (Jan. 29, 2017). Kyle Pomerleau, "An Overview of Pass-Through Businesses in the United States," Tax Foundation (Jan. 21, 2015).

[22] *Id.*

up with enforcement. Eliminating S corporations removes the administration and enforcement of a subjective test that is easily stretched or abused.

C. Simplicity

The idea behind the principle of simplicity is that "Simple tax laws are necessary so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner." Removing an entire subchapter from the IRC would certainly reduce the length of the tax code, but would it make the tax laws simpler? Subchapter S contains some of the most complicated provisions and limitations in the code. In fact, some of the more complicated provisions relate to who can elect S corporation status — there are strict limits on who can be a shareholder and how many shareholders an S corporation can have, and convoluted attribution rules also apply to ensure that counting shareholders is not a simple task. C corporations converting to S corporations are subject to a complicated calculation regarding the built-in gain tax. Once the S corporation exists, the calculation of reasonable salary, and now the section 199A deduction, creates an enormous amount of complexity. Thus, removing subchapter S would result in simpler tax laws.

D. Neutrality

A neutral tax proposal should serve to "minimize the effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction." While many items in our federal tax code are designed to nudge taxpayers toward one action over another, we do not believe this was the initial intent of subchapter S. The larger point of our proposal is to remove tax considerations from the taxpayer's choice of business entity. We illustrated how the S corporation is purely a vehicle used for avoiding FICA taxes. Eliminating subchapter S, and thus the S corporation, removes a major tax incentive for choosing one type of entity over another. Rather, a business owner would be more likely to make that decision based on the legal structure of the entity.

E. Economic Growth and Efficiency

A tax proposal that promotes economic growth and efficiency "should not unduly impede or reduce the productive capacity of the economy." Currently, the tax rates are structured to give passthrough entities an advantage over C corporations. However, now that the corporate tax rate has been cut from 35 percent to 21 percent, that advantage has shunk significantly. Passthrough entities are then not at a competitive advantage or disadvantage to C corporations. No further adjustment to tax rates is required to ensure that the tax code is not impeding productive capacity of the economy. In other words, adjusting the maximum tax rate for passthrough entities would give some entities an advantage over others, and could stifle innovation and make growth more challenging for those entities at a disadvantage. Eliminating subchapter S achieves this by not making any adjustment to passthrough rates when given a lower corporate tax rate.

F. Minimum Tax Gap

"Structuring tax laws to minimize noncompliance" is key to minimizing the tax gap — or the difference between what taxes are owed and what taxes are paid. Eliminating subchapter S would remove the wiggle room inherent in the requirement for S corporation shareholder-employees to take a reasonable salary. Currently, there is opportunity for considerable abuse, and the IRS isn't equipped to enforce current law. By removing this loophole and requiring all business owners to pay FICA tax on their business profits, the government would limit the amount of gray area in the law and would bring more taxpayers into full compliance. The result would be a Social Security and Medicare Trust Fund that is closer to closing its deficit. An estimate from 2011 found that the payroll taxes paid by single-shareholder S corporations were $5.7 billion less than the self-employment taxes that would have been imposed if the taxpayers were sole proprietors.[23] The Government Accountability Office estimated in 2009 that wages were understated in 2003 and

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[23] Tony Nitti, "S Corporation Shareholder Compensation: How Much Is Enough?" *The Tax Adviser*, Aug. 1, 2011.

2004 by $23.6 billion, costing the Social Security and Medicare Trust Fund an estimated $3 billion.[24]

IV. Discussion and Conclusion

Our proposal to eliminate subchapter S would result in S corporations reorganizing their businesses as C corporations, partnerships, or sole proprietorships. In the process, the shareholder-employees would lose their breaks on FICA taxes and be forced to pay them in some fashion on all business profits. For years, this loophole has given them a tax advantage over other types of entities, and there is no doubt that shareholder-employees of S corporations will take issue with the proposal to eliminate this tax advantage.

Before the passage of the TCJA, the S Corporation Association of America (SCAA) advocated for lower rates for passthrough entities,[25] saying that C corporations would have an advantage over passthrough entities if the rate on C corporations were reduced. That was in response to a Tax Foundation article[26] that reviewed the fairness of the treatment of passthrough entities and arrived at a conclusion similar to ours: Tax rates on passthrough entities do not need to be adjusted to achieve fairness among business entities. The SCAA argued that the second layer of corporate tax (paid by investors) is often not paid, or deferred, because dividends aren't necessarily paid by all corporations and capital gains are deferred until sale, or avoided if the stock is inherited. They also argued that foreign shareholders pay less on the second level of C corporation earnings. Tax-exempt entities and retirement plans also defer or avoid tax on the second layer of corporate tax for a long time. Thus, they estimate that the effective rate on C corporation's second layer of tax is about 6 percent — although this isn't supported by any numerical data.

These arguments are flawed because they fail to make appropriate comparisons with a similarly situated passthrough entity. The comparison with foreign investors and tax-exempt investors is of little merit. S corporations are barred from being owned by either type of entity. Further, C corporations commonly distribute dividends to their shareholders. If they retain the dividends, they grow their companies and the tax is collected through the resulting capital gains. The accumulated earnings tax is also designed to prevent excessive deferral of either dividends or capital gains for investors. The SCAA's assessment of the effective rate on the second layer of tax is based on the tax that government collects on that income from any type of taxpayer.

The lower effective rate for the second level of C corporation taxation may be relevant when planning for government revenue, but the relevant comparison is to a C corporation that has shareholders similar to that of an S corporation and is earning a similar amount of profit. Reviewing an effective rate that involves other taxpayers not similarly situated isn't useful when it comes to making decisions about a single business. If a policy is to achieve horizontal equity and neutrality, we must consider the world of possibilities for only one situation at a time.

The TCJA was created to make the U.S. tax system more competitive on an international stage, provide relief to taxpayers, and to close loopholes. If simplicity and closing loopholes was the true intent of the act, elimination of the S corporation is one loophole that was left behind. It is a missed opportunity by our lawmakers to do the right thing and accomplish that objective.

[24] GAO, "Report to the Committee on Finance, U.S. Senate Tax Gap — Actions Needed to Address Noncompliance With S Corporation Tax Rules," GAO-10-195 (Dec. 2009).

[25] S Corporation Association of America, "Flaws in the Tax Foundation's Review" (Nov. 20, 2017).

[26] Jared Walczak, "Are Pass-Through Businesses Treated Fairly Under the Senate Version of the Tax Cuts and Jobs Act?" Tax Foundation (Nov. 17, 2017).

Appendix 1. Tax Paid on $500,000 of Business Income

	Active Participants					Passive Investors		
	C Corporation	S Corporation	Partnership	Sole Proprietor	Wage Earner	C Corporation	S Corporation	Partnership
Current rates — 2017								
Entity-level income	$0	$0	$0	$0	$0	$190,000	$0	$0
Investor-level income	$143,231	$143,231	$143,231	$143,231	$143,231	$35,115	$143,231	$143,231
"Payroll" tax — EE and ER, including NIIT	$33,628	$15,300	$33,628	$33,628	$33,628	$2,280	$9,500	$9,500
Total tax	$176,859	$158,531	$176,859	$176,858.80	$176,858.80	$227,395	$152,731	$152,731
Effective tax rate	35.37%	31.71%	35.37%	35.37%	35.37%	45.48%	30.55%	30.55%
If C corporation rate is lowered to 21 percent								
Entity-level income	$0	$0	$0	$0	$0	$105,000	$0	$0
Investor-level income	$143,231	$143,231	$143,231	$143,231	$143,231	$47,865	$143,231	$143,231
"Payroll" tax — EE and ER, including NIIT	$33,628	$15,300	$33,628	$33,628	$33,628	$5,510	$9,500	$9,500
Total tax	$176,859	$158,531	$176,859	$176,859	$176,859	$158,375	$152,731	$152,731
Effective tax rate	35.37%	31.71%	35.37%	35.37%	35.37%	31.68%	30.55%	30.55%
If C corporation rate is lowered to 21 percent and passthrough rate to 25 percent								
Entity-level income	$0	$0	$0	$0	$0	$105,000	$0	$0
Investor-level income	$143,231	$125,000	$125,000	$125,000	$143,231	$47,865	$143,231	$143,231
"Payroll" tax — EE and ER, including NIIT	$33,628	$15,300	$33,628	$33,628	$33,628	$5,510	$9,500	$9,500
Total tax	$176,859	$140,300	$158,628	$158,628	$176,859	$158,375	$152,731	$152,731
Effective tax rate	35.37%	28.06%	31.73%	31.73%	35.37%	31.68%	30.55%	30.55%
Proposal: Remove subchapter S from IRC								
Entity-level income	$0		$0	$0	$0	$105,000		$0
Investor-level income	$143,231		$143,231	$143,231	$143,231	$47,865		$143,231
"Payroll" tax — EE and ER, including NIIT	$33,628		$33,628	$33,628	$33,628	$5,510		$19,000
Total tax	$176,859		$176,859	$176,859	$176,859	$158,375		$162,231
Effective tax rate	35.37%		35.37%	35.37%	35.37%	31.68%		30.55%

These calculations assume combined taxable income for entity and investor of $500,000, 2017 tax rates with filing status of married, filing jointly. Further, active S corporation shareholders take wages equal to $100,000. C corporations with active owners are assumed closely-held, and distribute corporate profits as wages to the owners.

Appendix 2. Tax Paid on $300,000 of Business Income

	C Corporation	S Corporation	Partnership	Sole Proprietor	Wage Earner
Assume wages of $50,000 and qualified business income of $250,000					
Entity-level income	$35,700	$0	$0	$0	$0
Investor-level income	$40,551	$60,579	$60,579	$60,579	$60,579
Tax savings from section 199A deduction	$0	-$8,160	-$14,400	-$14,400	$0
"Payroll" tax — EE and ER	$19,706	$19,706	$26,028	$26,028	$26,028
Total tax	$95,957	$72,125	$72,207	$72,207	$86,607
Effective tax rate	19.19%	14.43%	14.44%	14.44%	17.32%
Assume wages of $130,000 and qualified business income of $170,000					
Entity-level income	$52,500	$0	$0	$0	$0
Investor-level income	$30,045	$60,579	$60,579	$60,579	$60,579
Tax savings from section 199A deduction	$0	-$12,000	-$14,400	-$14,400	$0
"Payroll" tax — EE and ER	$7,650	$7,650	$26,028	$26,028	$26,028
Total tax	$90,195	$56,229	$72,207	$72,207	$86,607
Effective tax rate	18.04%	11.25%	14.44%	14.44%	17.32%
These calculations assume 2018 tax rates with a status of married, filing jointly, and no other income besides the business income. All C corporation profits are assumed distributed as dividends. All business profits are assumed to qualify for the section 199A deduction.					

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