Model Review: Corporate Conversions (adjustment to PIT model and CIT model)

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Model Purpose	Describe the extent to which pass-through entities in the Washington tax base have converted to C corporations. If appropriate, adjust models for the personal income tax (PIT) and the corporate income tax (CIT) accordingly.
Data Sources	Not applicable. This document discusses possible methods but does not list data sources.
Requirements Model Used to Fulfill	This would be a supplemental analysis, to support development of the models for a personal income tax and a corporate income tax, as required under ESHB 1109 (2019), Sec. 137(B) (c)(vii).
Questions for Technical Advisory Group	We welcome suggestions relating to data sources, background reading, and methods.
Questions from Technical Advisory Group	Text goes here – captured and meeting and recorded here

Overview

As we mentioned during the February meeting of the Technical Advisory Group, we have explored the potential for adjusting models for the personal income tax and the corporate income tax to reflect taxpayer responses to 2017 federal tax reforms. One area we have examined is an apparent trend of conversion by S corporations and partnerships into C corporations for the purpose of federal taxes.

We have explored possible methods for describing this trend, if it exists, for Washington businesses and individuals. Based on this work, we concluded that using the methods we considered, results would be indeterminate.

We will still consider adjusting models for corporation conversion. However, we will first build the main components of the models, such as required credits and deductions. We plan to revisit this question in July.

Background

Most US businesses pay federal taxes as pass-through (or flow-through) entities that, unlike C corporations, are not subject to the corporate income tax or any other entity-level tax. Instead, their owners include their allocated shares of profits in taxable income under the individual income tax. Pass-through businesses include sole proprietorships, partnerships, and S corporations.[1]

In the wake of 2017 federal tax reform, some observers predicted that businesses would convert a significant amount of pass-through activities to a C corporation form. Others have analyzed the question and concluded that most pass-throughs would not convert.

In 2018, researchers at the Wharton School estimated that 17 percent of pass-through business activity would convert to a corporate form.

In late 2019, we heard from four other states or jurisdictions who reported an apparent trend of conversion to C corporations. California has adjusted its revenue estimates for 2018 through 2020 to align with the 17 percent conversion rate estimated by the Wharton School.

Factors in the Decision to Convert

Federally, pass-through income is taxable under the individual income tax (at up to 37%).[2]

Under the 2017 Tax Cuts and Jobs Act (TCJA) the new C corporation tax rate fell to 21%. However, C corporation income is also taxed when corporations pay out dividends to shareholders, and as a result the owners of many pass-through entities still maintain a tax advantage over C corporations. Factors that increase the tax benefit of converting from a pass-through entity to a C corporation include:

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[1] https://www.taxpolicycenter.org/briefing-book/what-are-pass-through-businesses

[2] Many types of pass-through entities are eligible for a 20% qualified business income (QBI) deduction, which lowers the effective rate to 29.6%. We rely on the 37% rate in the analysis below because we expect conversions to take place among companies that do not qualify for the QBI deduction as they have the strongest incentive to convert.

- **Business activity not eligible for the qualified business income (QBI) deduction**: If an individual meets IRS requirements, they can claim a 20 percent deduction for pass-through income. This effectively reduces the tax rate on this income to 29.6 percent. Service sector activities are largely ineligible for the deduction (Figure 1).
- **Income levels of shareholders/partners:** High-income individuals are subject to a 37 percent tax rate, but some individuals with pass-through income fall in a lower tax bracket. Companies owned predominantly by high-income individuals will benefit more from the lower C corporation tax rate of 21 percent.

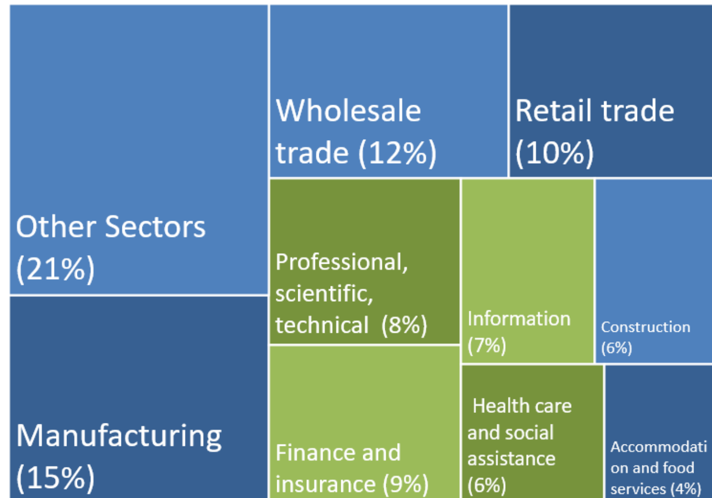

Figure 1. Partnership total income by industrial sector, U.S., tax year 2017. Green indicates sectors largely unable to take the Qualified Business Income deduction.

- **High value given to the ability to retain earnings:** Since pass-through income is not retained by the company, pass-through entities cannot automatically reinvest earnings back into the company. They must obtain the financing through equity (sales of shares) or debt (e.g., bonds or loans). If the flexibility to reinvest earnings is highly valued (e.g., in a high-growth field), the company will have a stronger incentive to convert to a C corporation.
- **Low dividend-to-payout ratio**: Related to the previous point, if a C corporation retains most of its earnings rather than paying out large dividends to shareholders, then taxes on retained amounts are deferred to future years. This is like the C corporation receiving an interest-free loan to use earnings to invest back into the business.
- **High cost of equity**: If potential shareholders view a company as a high risk investment, they will require a high expected return on investment as compensation for the risk of holding its shares as equity. All else being equal, such a company will only be able to raise equity capital by offering more shares of the company. Because of the high cost of obtaining equity, these companies will more heavily discount future net income relative to present net income. The ability to defer taxes on dividends into the future is more valuable for these companies, and so conversion to a C corporation is relatively more attractive.

We anticipate that corporate conversions occurring as a result of TCJA will be concentrated among companies fitting this profile, especially those in industries that do not qualify for QBI deductions.

We are exploring ideas to quantify this effect, including:

- Looking for an uptick in professional service companies changing federal employer identification numbers (FEINs);
- Looking at the relative growth of state corporate income tax receipts among states that require S-Corps to pay corporate income tax, compared to states that recognize pass-through entities;
- Identifying and relying on external research that quantifies corporate conversions.

To date, we do not have clear evidence for how many corporate conversions have occurred within the Washington tax base or how much taxable income is involved.

We welcome your feedback on relevant resources or potential methods, or any other insights you can provide on the issue.

References

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