




# Behavioral Responses: Income Shifting Across Business Entity Type

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Conventional behavioral feedback 

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*This post is part of a broader series explaining the modeling assumptions underlying our estimates. See [here](#) for other posts on this topic.*

One way business owners can [avoid taxes is by changing](#) entity type. The tax code allows for differential treatment depending on business type:

- C corporations are taxed at the entity level and again at the individual level when dividends are paid or shares are sold. The ability to defer tax by retaining earnings is an additional tax advantage.
- Pass-through businesses are taxed at the owner level based on distributive shares of net income. These entities enjoy certain tax benefits, like the Qualified Business Income (QBI) deduction and, in some cases, the ability to avoid the Net Investment Income Tax (NIIT).

Evidence suggests that owners of businesses are responsive to changes in the relative tax treatment of C corporations versus pass-through entities, reorganizing from one form to another if the tax benefits outweigh nontax costs ([Pearce and Prisinzano, 2018](#)). Income shifting across entity type affects the level of overall tax revenue, its composition (i.e. individual vs corporate taxes), and the timing of receipts. We account for this kind of behavioral feedback when estimating the revenue effects of tax reforms.

We begin by calculating the “tax differential” for all simulated pass-through owners under current law and under a counterfactual policy reform. The tax differential is the difference between the net marginal tax rate on C-corporate form and the net marginal tax rate on pass-through form. The differential will vary at the individual level based on taxable income, whether the NIIT applies, and whether the taxpayer qualifies for the QBI deduction.

Then, we calculate the change in the tax differential relative to current law. To this value we apply a semi-elasticity value of 0.38, generating the implied amount of income shifted across forms. Assumptions about profit distribution behavior for purposes of calculating net tax rates are taken from Pearce and Prisinzano (2018), as is the elasticity value. Net inflows or outflows of corporate net income are taxed at the corporate tax rate, and individual taxes are recalculated using the new values of pass-through income, dividends, and capital gains.

Data limitations prevent us from considering heterogeneity in response by business type or business size. We also do not account for potential cost asymmetries in switching from pass-through form to C-corporate form and vice versa. Rather than estimating the precise number of businesses expected to switch legal form, our approach can be thought of as projecting the total business income shifted and the associated revenue costs.

The code for this behavioral feedback module can be found [here](#).