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Pass-Through-to-Corporate Mass Conversion Unlikely to Materialize

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By Laura Davison

Some lawmakers had predicted that the steep corporate tax cuts in the Republican tax bill could cause pass-through entities to convert to corporations to take advantage of the lower rates.

That's unlikely to come to pass, as S corporations, limited liability companies, and partnerships would likely continue to be advantageous structures for most businesses, despite the proposal to drop the corporate rate to 21 percent from 35 percent, tax practitioners told Bloomberg Tax.

The final conference committee report grants pass-through entities a 20 percent deduction on the business income owners earn, which is then taxed at the individual rate. For high-earning pass-through owners paying the top 37 percent rate, that comes to a 29.6 percent tax rate after accounting for the deduction. (For a road map of where to find key provisions in the final House-Senate tax reform bill, read Bloomberg Tax's analysis.)

"I don't anticipate a wholesale move to C corporation status," said Don Susswein, a principal at RSM US LLP specializing in partnerships.

Corporations would face a lower rate under the GOP tax plan, which is scheduled to pass the House and Senate this week, but corporations face a second level of tax on the dividends distributed to investors. Pass-through status has become the entity of choice in recent decades because of the single layer of tax and a more malleable structure for distributing cash and assets.

The largest determinant of whether to remain a pass-through or become a corporation will be the tax rate at which the business distributes its earnings, said Mel Schwarz, a partner at Grant Thornton LLP.

"A significant part of the calculus is deciding between a higher effective rate with a single level of tax and a lower rate with a potential double level of tax," Schwarz said. "The second level of tax doesn't occur until you distributed the money, so how much are you distributing? How long can you wait to distribute it?"

Directing more tax cuts to pass-through businesses was a key sticking point as the legislation moved through the House and Senate. Tax lobbyists said congressional staff countered arguments that initial versions of the legislation didn't do enough for pass-throughs with assertions the businesses could convert to corporations. But businesses don't want to do that because of the flexible structure pass-throughs provide, said the lobbyists, who requested anonymity because the conversations were private.

The bill sets several restrictions for the type of pass-throughs eligible for the deduction and how much they're allowed to claim, based on the wages the entity pays, the amount of equipment the entity purchases, and how much the owner earns. It excludes many service businesses from the tax break.

Assessing Benefits

Companies, particularly those that won't see much benefit from the pass-through deduction, should consider whether electing to be taxed as a corporation would be more beneficial, but it will likely be a small group of businesses that would see enough upside to warrant a transition, said Michael D'Addio, a principal at Marcum LLP.

Businesses that generate a lot of income, reinvest heavily in their business, and don't foresee a need to pull out the cash could see an advantage at the lower corporate rate, D'Addio said. Corporations also are advantaged in that that they can continue to deduct state and local taxes (SALT). Individual SALT deductions are capped at $10,000, he said.

If you anticipate keeping the company for the long run, moving to a corporate status could be worthwhile, Susswein said. But if you're going to pull money out of the company or sell it, that's easier to do as a pass-through, he said.

Pass-through owners need to consider "what is the prospect for a sale down the line?" D'Addio said. "There are significant negotiations concerning the structure during a deal. A structure where the taxes are so onerous can be a disadvantage."

Buyers typically prefer to buy assets rather than stock, Schwarz said. Buying the assets allows the owners to depreciate the property, which is even more beneficial under the GOP tax plan that expands expensing provisions. Acquiring the assets of a pass-through entity allows the buyer to avoid the second layer of tax they would trigger if they were buying a corporation's assets. Deals involving corporations require the buyers to pay tax on the entity-level gain and for the shareholders to pay tax on the distributed earnings.

Owners looking to move to a corporate structure should also be aware of the accumulated earnings tax, a 20 percent tax on companies holding onto too much cash, and the personal holding company tax, another 20 percent penalty on undistributed passive income earned in a closely-held C corporation.

"This is one area where lawmakers are really creating an entirely new structure" said Brian Riedl, senior fellow at the Manhattan Institute for Policy Research. "And given the millions and millions of pass-throughs affected, I think this is going to need a lot of examination."