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Under New Tax Law, Should Your Business Restructure as a C Corporation?

Hundreds of pass-through businesses are planning to re-organize in 2018, in order to access the lower corporate tax rate of 21 percent. Here's what you need to know.

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Edward Reitmeyer, a partner at the Philadelphia accounting firm Marcum LLP, typically prepares between 800 and 1,200 tax returns for small business clients each year. Generally, very few are for C corporations--Reitmeyer completed just four such returns in 2016--but he now anticipates filing hundreds, as businesses across the country react to sweeping tax reform.

"There are many positive aspects to this tax law for small businesses," Reitmeyer says. But the most eye-catching, in terms of financial relief? The new maximum corporate tax rate of just 21 percent, a substantial drop from the current 35 percent.

The new tax legislation, which President Trump is expected to sign into law in coming days, becomes effective January 1. That means many business owners--like Reitmeyer's clients--are now considering whether to reorganize themselves as C corps.

Here's why: Most U.S. small businesses currently don't qualify for the reduced corporate tax rate. The majority of small enterprises are structured as pass-through entities such as limited liability companies or S corporations, where profits are taxed according to the owner's personal rate. While there is some tax relief in the bill for those pass-through firms--including a temporary ability to deduct up to 20 percent of income--many could access the permanent cut by converting to full-blown C corporations.

It may technically be an escape clause, but experts say it's one that startups are smart to take advantage of in 2018.

"I do believe it's an amazing loophole," says Anne Zimmerman, founder and CEO of the Cincinnati-based small businesses accounting firm Zimmerman and Co., who is recommending that some of her clients convert to C corps.

For those who wish to move quickly, the process of converting to a C corporation could theoretically take less than a week, provided your company is based in a state that allows for "statutory," or streamlined, conversions. (The roughly 15 U.S. states that do not permit statutory conversions include Arizona, New York, and Pennsylvania.) There may be a number of hassles that could slow things down, though. Generally, you need to file a set of articles of incorporation with the secretary of state's office; draft a series of corporate bylaws; and elect corporate officers and directors. You also need to hold annual board meetings and issue stock certificates.

Of course, owners are wise to consult lawyers and accountants before converting, which makes the process not so cheap. For that reason, it's a good idea to measure out your potential savings ahead of time, or risk losing more money than if you retained pass-through status. "If you end up paying your lawyer bigger fees than your tax savings, you'll wish you hadn't done it," warns Daniel Shaviro, a professor of taxation at New York University Law School. "Suppose there is only $20,000 at stake. If you convert to a C corporation, you'll still only save a couple thousand dollars at most," he adds. "On the other hand, if you're playing with $100,000, 20 percent savings [is worth it.]"

Anticipating that small business owners--and pass-throughs, in particular--would have questions about the new tax legislation, Shaviro and a dozen colleagues last week published a paper including potential tax-avoidance steps that firms could take. Since then, it has been downloaded more than 34,000 times.

Most tax experts agree that the decision to convert to a C corp shouldn't be taken lightly -- and it can depend more on how you make money than the amount you bring in on an annual basis.

Keep in mind that C corporations may be double taxed--once on the 21 percent preferential rate, and again if and when the owners pay dividends. William Kambas, a partner with the international law firm Withers Worldwide, does not generally recommend converting to a C corporation in the short term. "The two levels of tax would make a corporate operation less advantageous than a partnership," he tells *Inc*. However, if you do not pay out dividends--and are rather planning to re-invest a majority of profits back into the business as part of a long-term strategy--"then I like the C corporation option," he says.

Meanwhile, under the new tax code, "professional services"--which could encompass legal counsel, financial consulting or freelance design work, say--do not qualify for the pass-through deduction. If this applies, you should consider taking the time to re-organize, and there are workarounds to avoiding being double taxed, experts say.

Zimmerman says some may even consider a somewhat unusual tack: breaking into two separate businesses to take advantage of the reduced corporate rate and other aspects of the new law. For instance, "I could move my consulting to become a C corp," she says, referring to her own company, "while leaving my accounting income in an S-corporation so as not to be double taxed."

Some suggest that if your business generates income of less than $315,000, you are already insulated from having to pay higher taxes, since the pass-through deduction will generally apply. "If your annual gross income [AGI] is less than that, there's probably very little you need to do as far as re-structuring," Marcum's Reitmeyer says. "You'll have no [deduction] limitations."

Another consideration: While the reduction to the maximum corporate tax rate is written as permanent, it could change, Reitmeyer points out. For instance, Democrats could retake a Senate majority, and vote through changes to the law. If that happens, it would be far more complicated to convert back to an S corporation or an LLC than the other way around.

Most experts agree that the legislation, for better or for worse, is going to lead to a lot more tax maneuvering. "What Congress has done is created a world where anyone who isn't an employee is going to be looking for angles to pay the least amount of tax," says Shaviro.