CFO.com

Will Tax Cuts Lead to More C Corporations?

A 21% income tax rate might sound appetizing to some pass-through entities, but C-corporation status doesn't suit every organization.

Joseph J. Perry and Michael D'Addio, Contributors

January 29, 2018 | CFO.com | US

An important question resulting from the passage of the Tax Cuts and Jobs Act (TCJA) is whether it is better to conduct business operations through a pass-through entity (i.e., a sole proprietorship, partnership, limited liability company, or S corporation) or a C corporation. Unfortunately, there is no correct answer for all circumstances, and a number of factors need to be considered before making a final decision.

In 2018, the highest corporate rate of 21% will be 16 percentage points lower than the highest individual tax rate of 37%. This suggests significant tax savings for businesses that operate in corporate status. Additionally, since corporations can fully deduct state income taxes, which is limited for individual owners of pass-through entities, the benefit would appear even larger.

Three factors counter this seemingly overwhelming advantage of a being classified a C corporation: 1) the multiple individual rates and new brackets; 2) the new deduction for pass-through income; and 3) the “double taxation” on funds withdrawn from a C corporation.

It is common to discuss tax comparisons of business entities using the top tax rates. However, not every business will allocate to its owners business income of $600,000 for joint return filers or $500,000 for single and head-of-household filers -— the levels of taxable income at which the 37% rate applies. Consequently, pass-through income is frequently subject to the lower individual rates of 10%, 12%, 22%, 24%, 32%, or 35%.

The TCJA also creates a new deduction for pass-through entities of up to 20% of qualified business income. This deduction lowers the effective rate of tax on pass-through income to an amount closer to or lower than the new 21% corporate rate. (See middle column in schedule, below.)

Joseph J. Perry

The deduction for pass-through qualified business income is subject to several rules which can reduce or eliminate the amount of the deduction. The amount of the deduction generally cannot exceed the greater of: a) 50% of wages; or b) 25% of wages plus 2.5% of the adjusted basis of depreciable property used in the business for its recovery period. Furthermore, the deduction does not generally apply to specified services businesses. However, many of these exclusions apply when the taxpayer has less than $315,000 of total taxable income ($157,500 for single and head-of-household filers). Consequently, the amount of income generated and the nature of the business both affect the C-corporation comparison.

The historic concern with operating as a C corporation involves a second shareholder-level tax on funds distributed from the corporation as a dividend or as part of the capital gain produced on the sale of shares. Qualified dividends and long-term capital gains are subject to preferential rates (either 15% or 20%, depending upon taxable income) and potentially subject to the 3.8% net investment income tax.

Stated Individual Rate (without 20% deduction)	Pass-Through Rate (with 20% deduction)	Corporate Double Tax*
10.0%	8.0%	32.85%
12.0%	9.6%	32.85%
22.0%	17.6%	32.85%
24.0%	19.2%	35.85%
32.0%	25.6%	35.85%
35.0%	28.0%	39.80%
37.0%	29.6%	39.80%

(*Applies 20% dividends and capital gains tax to 24% bracket and higher.)

For businesses that cannot utilize the new pass-through deduction, the results are close for those in the 35% and 37% individual tax brackets. The results are brought even closer when the deductibility of state taxes for the C corporation are considered.

If the C corporation does not want to distribute its after-tax proceeds (i.e., the 79% remaining after the 21% corporate-level tax) nor is required to (e.g., it does not create accumulated earnings tax or personal holding company tax issues), then these net proceeds can be invested by the corporation and grow with only the 21% rate applying to the earnings, regardless of the type of income produced. This 21% rate would be lower than the ordinary income rate for high-earning individuals (though about the same as qualified dividends or long-term capital gains).

Michael D'Addio

A C corporation must take into consideration the accumulated earnings tax, however, which taxes a corporation for retaining funds beyond its reasonable needs. A C corporation is permitted to accumulate up to $250,000 of funds without question. However, it must be able to demonstrate that amounts retained beyond this threshold are for the reasonable needs of the business.

That may be easily done for some businesses — e.g., contractors (who need to retain earnings for bonding purposes), manufacturers (which may have large capital needs), or companies involved in significant research and development. However, service businesses may have a problem demonstrating the need to retain funds and will be forced to distribute their after-tax cash.

In addition, the tax consequences on the sale of the business must be considered in selecting the appropriate entity.

If the equity of the business can be sold to a purchaser, then there is no disadvantage to the C corporation versus a partnership or a limited liability company. The corporate stock will generally produce a capital gain subject to a preferential tax rate if held for more than one year. Additionally, under Internal Revenue Code section 1202, a portion of the gain on the sale of stock may be exempt from federal income tax if certain conditions are satisfied. Use of corporate status also permits the utilization of tax-free reorganization structures for the sale (e.g., a merger or certain stock-for-stock exchanges).

The major disadvantage to a C corporation occurs where the buyer insists on an asset acquisition. The corporation will recognize a gain subject to a 21% federal rate and a second tax on a distribution of the net funds to the shareholders. This double tax will generally produce higher overall taxes than a sale of assets from the pass-through entity, where the assets qualify for long-term capital gains treatment.

Given the number of factors which must be considered, it is not clear that the new tax law will cause a rush to operate businesses in corporate form.

Joseph J. Perry, CPA, is tax & business services leader and Michael D'Addio is principal, tax & business services, at Marcum LLP, a national accounting and advisory firm.