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Tax Reform Alert: Entity Choice: C Corporations vs. Flow-Thru's

The Tax Cuts and Jobs Act made changes to the "Choice of Entity" tax landscape by lowering the C corporation tax rate to 21% and adding a new "pass-thru" deduction for non-C corporations among other provisions. Since 1986, given the "double tax" associated with C corporations, S corporations became the entity of choice, although in recent years the S corporation was perhaps surpassed by the limited liability company (partnership).
The following summarizes the changes from the tax law that impact "choice of entity" for a business in 2018:

Federal Tax Rates

1. C corporations are now taxed at a flat 21%, down from a top rate of 35%. This represents a significant decrease in federal tax rates (permanent, not set to expire).
2. Flow-thru entities (income taxed at the individual level) also saw rates decline and brackets widen. The stated top individual rate dropped from 39.6% to 37%. Therefore, at the highest income levels there is a 16% spread (37%-21%) between flow-thru's and C corporations. At the margin, an extra $100,000 of income would suffer a $16,000 additional federal tax for a flow-thru.
    a. There is a new pass-thru deduction that has the potential to lower tax individual brackets by 20%. Therefore, the top rate for an individual could be as low as 29.6% (37% x 80%). However, this still represents an 8.6% advantage for the C corporation, or $8,600 per $100,000 of income. This serves to cut the benefit by about half.
    b. Certain types of specified service businesses (health, law, accounting, consulting, investing, trading, etc.) AND any business where the principal asset of the business is the skill or reputation of one or more employees or owners may be ineligible for this pass-thru deduction.
    c. The pass thru deduction is set to expire in the year 2026.

Summary: Overall, there is a clear advantage to a C corporation in evaluating current federal taxes on income, particularly given the uncertainty of the new 20% pass-thru deduction.

State Income Tax Matters (Illinois)

1. At the individual level, state income taxes associated with flow-thru income are limited. In total, property and state income tax deductions are capped at $10,000. For most residents of Illinois then, state income taxes associated with business income are non-deductible. The state income tax rate is 4.95%, but again is effectively nondeductible.

2. In contrast, Illinois corporate state income and replacement taxes remain deductible, albeit at a higher 9.5% combined rate. Note: the Illinois entity level replacement tax applicable to flow-thru's remains at 1.5% and is deductible.
3. The total after-tax difference has been narrowed to about 1.5%, but still favors the flow-thru business.

   Summary: Overall, there still is a slight advantage to a flow-thru in this area, given the state rate difference – although the gap has closed.

Capital Gains Rate – Sale of Assets

1. In the past, one of the major disadvantages of a C corporation was the lack of a (lower) long term capital gains rate if capital assets were sold. Now with the 21% flat rate, all income including capital gains are taxed at 21%. This compares to either a 15% or 20% capital gains rate based on individual's taxable income.

   Summary: While the gap has closed, the flow-thru still has a slight advantage in the capital gain arena.

Net Investment Income Tax – Sale of Stock

1. Capital gain from the sale of C corporation stock would be subject to the net investment income tax if taxable income exceeds certain thresholds. The tax is effectively a 3.8% surtax on investment (passive) income, which includes gain from the sale of C corporation stock.
2. In contrast, capital gains from S corporation stock would not be subject to the surtax if the owner was actively involved in the business.

   Summary: For most business owners, the C corporation is a disadvantage here because of the extra surtax, although a stock sale is not all that common of an exit strategy, so the point may be moot.

Dividends or Distributions

1. This has long been the main disadvantage for the C corporation, and this factor remains under the new tax law-the "double tax." Payments to shareholders from retained earnings ("dividends") are considered qualified dividends and are therefore taxable to the shareholders. This is the second layer of tax and is problematic if earnings are not needed to be retained in the business. The tax rates for dividends are the same as for long term capital gains, therefore a 15% or 20% rate depending on taxable income plus the potential for the extra 3.8% surtax since dividends are considered investment income.
2. In contrast, payments to shareholders or owners ("distributions") of retained earnings from flow-thru entities are not subject to the second layer of tax. Flow-thru earnings are taxed to the individual whether distributed or not.

3. The level of future growth for the business and usage of debt are the main factors that could help to defer the problem of the C corporation double tax. If owners understand the restrictions and plan to use earnings to significantly grow the business or pay down debt, the double tax penalty can be pushed far in to the future. The value of the annual tax savings of a C corporation could outweigh the present value of the future dividend tax liability.

   Summary: There is a clear advantage to the flow-thru entity if dividends or distributions are expected to be paid to owners currently.

Liquidation Consequences Generally

1. Similar to the dividend discussion above, since earnings build up in a C corporation, once the corporation is liquidated, the double tax will be triggered. Again, if this can be pushed far in to the future, the impacts of this can be mitigated somewhat.
2. Stock inherited at death does receive a step up in basis which has the potential to eliminate the double tax if liquidation occurs shortly after death. Future earnings after death would be subject to the second layer of tax if the C corporation were not liquidated.
3. In contrast, an S corporation does not suffer an extra layer of tax when liquidated.

   Summary: The C corporation is subject to a second layer of tax on liquidation, which is a clear disadvantage.

Liquidation Consequences – Qualified Small Business Stock (C corporations only)

1. For certain C corporations formed after September 27, 2010, there are some very favorable rules regarding stock sales and liquidations for a narrow set of corporations. These rules have the potential to make an exit event for an individual owning C corporation shares almost entirely tax free.
2. In order to be considered "Qualified Small Business Stock", generally the following stipulations apply:
   a. Stock must be held for five years and received on original issue after September 27, 2010, for the possible 100% exclusion. There are also partial exclusions for stock issued after August 10, 1993 and through September 27, 2010, contact our office for more information.
   b. The business cannot generally be a (1) personal service corporation (health, law, accounting, consulting, etc.), (2) banking, insurance, leasing, financing, investing, or similar business, (3) farming business, (4) a business where depletion is allowable, or (5) hotel, restaurant, or similar business.
   c. In addition, any business where the principal asset of the business is the skill or reputation of one or more of its employees is ineligible.
   d. The corporation cannot have more than $50 million of assets (adjusted basis) during the holding period of the stock. This is not adjusted for inflation.
3. The capital gain exclusion cannot be more than the greater of $10 million or 10 times original stock basis (equity) of the corporation. These limits are not adjusted for inflation.

4. The exclusion applies to the capital gain on the sale of C corporation stock BUT ALSO to a sale of assets followed by a liquidation of the corporation. **Therefore, the capital gain on liquidation of the corporation to the owners would be eligible for the exclusion. This has the potential to eliminate the double tax problem cited several times above.**

   Summary: If your business fits into the narrow category of businesses that may be eligible for the qualified small business stock exclusion, it could tip the scales to the C corporation form of organization.

Overall Summary:

Our office has calculators that can help quantify the tax consequences of a flow-thru vs. a C corporation, please contact us to discuss more specifics of your situation. Of course, there are many other non-tax considerations that will need to be considered as well.