To C or Not to C, That is the Question

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As Prince Hamlet might wonder aloud: Whether 'tis better to remain a pass-through than switch to a C… ay, there's the rub.

The recently-enacted Tax Cuts and Jobs Act of 2017 adopted what may prove to be a game-changing tax overhaul for businesses beginning in 2018. In particular, the Act makes two fundamental changes to the taxation of business entities that will require business owners and their advisors to rethink the choice-of-entity decision. One provides a historically low tax rate for C corporations, while the other provides a significant new deduction for owners of certain pass-through business entities.

This article summarizes the new rules and considers the principal question posed by it. Oddly enough, had only one of these changes been made, the answer would be clear in most cases. Due to the dual change, however, the decision is less than certain and echoes the pre-Act query, but with at least one very significant difference.

The Act includes a significant tax break for owners of businesses conducted through "pass-through" entities, including S corporations, partnerships (including multi-member limited liability companies) and sole proprietorships (including single-member limited liability companies). Careful planning will be required by the owners of such entities to navigate the governing rules to both determine their eligibility for the break and take maximum advantage of it.

In general, the Act allows the owner of a pass-through business a deduction of up to 20 percent of the owner's share of the "qualified business income" of the business. The availability and amount of the deduction depend upon (i) whether the business is a "specified service business" (SSB) and (ii) the amount of the owner's taxable income. An SSB is any trade or business (i) that involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investment services, investment management services or brokerage services; or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees or owners.

While the question whether a particular activity constitutes an SSB will be easy to answer in many cases, taxpayers will need guidance from their advisors to resolve that issue in a host of situations. For example, is a manufacturing business whose success relies on the "skill or reputation" of its owner(s) an SSB or a non-SSB?

Determining the availability and amount of the pass-through deduction can be complicated. In a nutshell, if an individual owns an interest in a pass-through business entity and the business entity is not an SSB, the individual will get the 20 percent deduction. The precise amount of the deduction requires the application of a tricky statutory formula and will depend upon several factors, including the individual's taxable income, the individual's share of the wages paid by the non-SSB, and the individual's share of the unadjusted basis of the non-SSB's assets. The point is: If an individual owns an interest in a non-SSB, the individual will be entitled to the 20 percent deduction in determining the individual's taxable income, the only question being the amount.

Meanwhile, if an individual owns an interest in an SSB, the individual is not eligible for the 20 percent deduction if the owner's taxable income exceeds (i) $415,000 in the case of a married individual filing a joint return or (ii) $207,500 in the case of an individual filing an individual return. If a joint filer's taxable income is less than $315,000, or an individual filer's taxable income is less than $157,500, the individual is entitled to a deduction equal to 20 percent of the lesser of (i) the qualified business income and (ii) the individual's taxable income.

If taxable income exceeds $315,000 but does not exceed $415,000 in the case of a joint filer, or exceeds $157,500 but not $207,500 in the case of a single filer, the amount of the deduction requires application of a statutory formula that reduces the amount of the deduction. It should be noted that these thresholds are indexed for inflation.

To summarize, the Act offers a significant tax benefit for owners of pass-through business entities. In the case of a taxpayer subject to the Act's highest individual rate (37 percent) that qualifies for the maximum deduction, a 29.6 percent tax rate (i.e., 80 percent of 37 percent) will apply to the individual's qualified business income. In planning for the deduction, owners and their advisors need to be aware that the 20 percent deduction is temporary and will cease to be available after 2025.

In the meantime, with proper planning, owners of both SSBs and non-SSBs can expect to achieve substantial tax savings through this new deduction. Nevertheless, the 20 percent deduction's temporary availability may make it worthwhile to consider whether it might be better to abandon pass-through taxability in favor of C corporation status. This possibility is raised by the Act's second fundamental change to the taxation of business entities.

The Act imposes a 21 percent flat rate on the taxable income of all C corporations. Not since 1938 has the top corporate rate been so low. In contrast, prior to the Act, a C corporation's income was taxed at rates up to 35 percent.

C corporations, sometimes referred to as regular corporations, pay taxes on their taxable income, and their shareholders pay taxes on any dividends they receive, resulting in what is often called "double taxation." Under current law, such dividends may be taxed at rates up to 23.8 percent for federal income tax purposes. Thus, under pre-2018 law, when a C corporation at the top marginal rate paid a dividend, the overall federal income tax rate could exceed 50 percent.

The Act reduces the potential overall rate to 39.8 percent, assuming that 100 percent of after-tax income is distributed as dividends. The Act's overall tax rate can be reduced if less than all the C corporation's after-tax income is distributed to its shareholders. For example, if a C corporation with a calendar year tax year has $1,000,000 of taxable income in 2018, it will pay $210,000 in federal income taxes. If it distributes the remainder, $790,000, to its shareholders as dividends, they will pay up to $188,020 in federal income taxes, leaving them with $601,980. So the overall tax on $1 million is $398,020, or 39.8 percent.

If instead the corporation retains half of its after-tax income and distributes the remaining $395,000, the overall federal income tax rate is cut to 30.4 percent. The overall tax rate can further be reduced if the corporation retains even more of its after-tax earnings.

This illustrative 30.4 percent rate should be compared to the Act's top individual rate of 37 percent (as well as to the 29.6 percent rate applicable to high-bracket individuals with qualified business income). Such a difference in rates could be very attractive in the right circumstances, particularly if the accumulated earnings tax and the personal holding tax can be avoided. Those contemplating using a C corporation to conduct a business will want to consult their tax advisors regarding these matters.

As the foregoing discussion indicates, all else being equal, in most situations, the owners of a pass-through business will not benefit by converting to a C corporation. That being said, the 21 percent corporate tax rate becomes much more attractive when coupled with the benefits of the federal tax code rule that grants an exclusion from federal income tax of up to $10 million of the gain realized on the sale of an individual's stock in a C corporation that meets the requirements of the applicable statute. Given the historically low top corporate tax rate, anyone thinking of forming a business entity (or of converting an existing pass-through entity) should take a close look at that exclusion.

One final point. The Act has no effect on the taxation of business entities under Kentucky law. Thus, unless and until Kentucky adopts the Act's provisions, existing (i.e., pre-Act) Kentucky tax laws will need to be considered in the choice-of-entity decision.

James Nitsche of Wyatt Tarrant & Combs focuses his practice on federal, state and local tax matters, with particular emphasis on the taxation of business entities and business transactions. ■