

#28: Choice of Entity Decision After the TCJA--Converting a Pass-Through Entity to a C Corporation

Following enactment of the Tax Cuts and Jobs Act (TCJA) taxpayers may wish to consider the possibility of converting a pass-through entity to a C corporation.

Historically, pass-through entities generally had more favorable tax consequences for businesses than C corporations. The top initial tax rates on operating income were similar: 35% for C corporations versus 39.6% for pass-through entities. However, when the income was distributed to owners or the business was sold, there was a second level of tax for C corporations but not for pass-through entities. Dividends were subject to a second level of tax at rates as high as 23.8%. If a shareholder sold the C corporation stock, income retained in the company increased the value of the stock and the gain recognized on the sale. This second level of tax brought the effective tax rate on C corporation income up to a maximum rate of 50.47% $((.35) + (.65 \times .238) = .35 + .1547 = 50.47\%)$.

By contrast, distributions from S corporations are tax-free to shareholders unless the distribution exceeds the shareholder's basis in the stock⁹⁷ or the S corporation is a former C corporation and the distribution exceeds the S corporation's accumulated adjustment account (AAA).⁹⁸ Moreover, S corporation shareholders increase the basis of their stock by their share of corporate income, in effect eliminating the second level of tax when the stock is sold.⁹⁹ Thus, the difference in rates between C corporations and pass-through entities was generally 10.87 percentage points for taxpayers in the highest tax bracket (50.47% minus 39.6%).

Changed Tax Rates

The most important goal of the TCJA was to lower C corporation tax rates to make American corporations more competitive. This was accomplished by reducing the corporate tax rate from 35% to 21%. If this had been the only rate change, however, it would have made C corporations far more favorable relative to S corporations, partnerships, LLCs and sole proprietorships. This presumably would have led to mass conversion of these latter businesses into C corporations. To prevent this, the TCJA made a comparable reduction in the tax rate for pass-through entities by enacting the 20% IRC § 199A deduction. The following chart shows how the two changes left the spread between the top tax rates for C corporations and S corporations nearly the same when the second level of tax on C corporation income is taken into account.

⁹⁷ IRC § 1368(b). The excess amount is treated as a dividend to the extent of earnings and profits.

⁹⁸ IRC §§ 1368(c) and 1368(e).

⁹⁹ IRC § 1367(a)(1).

	Before TCJA	After TCJA
C corporation total tax rate	50.47% ¹⁰⁰	39.80% ¹⁰¹
S corporation tax rate	39.60%	29.60% ¹⁰²
Spread	10.87%	10.20%

Thus, on the surface it might appear that the TCJA shouldn't change business owners' decisions about whether to operate their business as a C corporation or as a pass-through entity. The chart only shows the maximum rate for each type of entity, however, and assumes that the § 199A deduction can be claimed in full. Because the actual C corporation tax rate could be much lower and actual pass-through tax rate could be much higher for a given business owner, the TCJA might make conversion from a pass-through entity to a C corporation very favorable.

Lower C Corporation Rate

There are five reasons why the top C corporation rate may be substantially lower than 39.8%.

Distributions May Be Deferred. An owner's share of the income earned by a pass-through entity is taxed to the owner in the year it is earned, whether it is distributed or not. By contrast, income earned by a C corporation is taxed to owners only when it is distributed. The second level of C corporation tax may not be paid for a long time after the income is earned because it is deferred until the income is distributed as a dividend or until the stock is sold.¹⁰³

Distributions May Be Totally Eliminated. There may never be a second level of tax at all. If dividends aren't paid and the shareholder dies with the stock, the heirs will receive a step-up in basis, eliminating the increase in the stock's value due to the retained earnings. While retaining earnings will reduce the effective C corporation tax rate, C corporations must be careful to avoid the accumulated earnings tax.¹⁰⁴ IRC § 531 imposes a 20% tax on the "accumulated taxable income" of C corporations that accumulate income beyond the reasonable needs of the business.

IRC § 1202 Gain Exclusion for Qualified Small Business Stock. If the C corporation stock is qualified small business stock (QSBS), qualifying for a 100% IRC § 1202 deduction when it is sold, the second level of tax will also be eliminated. While a detailed discussion of IRC § 1202 is beyond the scope of this series, a basic overview is provided below.

¹⁰⁰ 35% corporate level tax + 28% tax at individual level on qualified dividends, corporate liquidation or sale of the stock by the shareholder. Then, $.35 + (.238 \times .65) = .5047 = 50.47\%$.

¹⁰¹ $.21 + (.238 \times .79) = .398 = 39.8\%$.

¹⁰² 37% top rate $\times .8 = 29.6\%$.

¹⁰³ Note that many closely-held C corporations never pay dividends.

¹⁰⁴ IRC §§ 531-537.

Under IRC § 1202, non-corporate taxpayers can exclude 100% of the gain realized on the sale of qualified small business stock.¹⁰⁵ Qualified small business stock is stock in a C corporation that meets the following requirements.¹⁰⁶

- (1) The stock was issued after August 10, 1993¹⁰⁷
- (2) The issuer of the stock was a “qualified small business” when the stock was issued¹⁰⁸
- (3) The taxpayer acquired the stock at original issue in exchange for money or property other than stock or as compensation for services to the corporation (other than as underwriter of the stock)¹⁰⁹
- (4) The corporation met an active business requirement and was a C corporation during substantially all of the taxpayer’s holding period for the stock¹¹⁰
- (5) The value of the corporation’s aggregate gross assets doesn’t exceed \$50 million¹¹¹

Finally, to qualify for the exclusion, the qualified small business stock must be held for at least five years.¹¹²

Larger State and Local Tax Deductions. C corporations may be able to claim larger deductions for state and local taxes. The TCJA limits the deduction for state and local taxes to \$10,000 for individuals (\$5,000 for married individuals filing separately).¹¹³ Thus, state or local taxes paid by an individual on income received from a pass-through entity are generally subject to the \$10,000 limitation. The \$10,000 limitation doesn’t apply to C corporations so the state and local income taxes paid by a C corporation are fully deductible, reducing the effective tax rate on C corporation income.

Sale of Ownership Interest. Reduction of the C corporation tax rate to 21% largely eliminated the capital gains disadvantage of C corporations relative to pass-through entities. For C corporations, capital gains are taxed at the same rate as ordinary income. Thus, prior to the TCJA, C corporations paid a 35% tax on capital gains compared with the 15% and 20% long-term capital gain rate paid by the owners of pass-through entities. Following enactment of the 21% C corporation tax rate, the tax rate differential is greatly reduced.

Higher S Corporation Rate

In many cases, owners of pass-through entities won’t receive the full benefit of the 20% § 199A deduction because of the phase-in and phase-out rules. Some entities will lack the W-2 wages or basis in property necessary to provide a significant benefit from the new deduction for their owners.

¹⁰⁵ IRC § 1202(a). Note that this 100% exclusion applies only to qualified small business stock acquired after September 27, 2010. For stock acquired between February 17, 2009 and before September 28, 2010, the exclusion rate is 75%. For stock acquired before February 17, 2009, the exclusion rate is 50%.

¹⁰⁶ IRC § 1202(c)(1).

¹⁰⁷ IRC § 1202(c)(1).

¹⁰⁸ IRC § 1202(c)(1)(A).

¹⁰⁹ IRC § 1202(c)(1)(B).

¹¹⁰ IRC § 1202(c)(2)(A).

¹¹¹ IRC § 1202(d)(1)(A).

¹¹² IRC § 1202(a)(1).

¹¹³ New IRC § 164(b)(6)(B).

Others will be specified service businesses. These limitations might substantially increase the rate of tax paid on pass-through income from 29.6% to as high as 37% or 40.8% if the NIIT applies. For many taxpayers, converting from a pass-through entity to a C corporation will make sense. If the C corporation owner can avoid the second level of tax by dying with the stock or claiming the IRC § 1202 deduction, C corporation income will be taxed at 21% compared with a top rate of 29.6% for income from pass-through entities, 33.4% if the income is subject to the net investment income tax. This produces a very significant spread of 8.6 to 12.4 percentage points in the tax rate. If the pass-through owner can't qualify for the full 20% deduction, the spread could be even greater, perhaps as high as 19.8% (40.8% - 21%). This large tax rate advantage would make converting from a pass-through entity to a C corporation highly favorable in many cases.

To summarize, the most favorable situation for converting from a pass-through entity to a C corporation is the following.

- (1) The entity plans to retain a substantial portion of its earnings, plans to defer distributions of earnings for a significant period of time or can qualify for the IRC § 1202 exclusion on a sale of stock;
- (2) The individuals who own the business don't qualify for the IRC § 199A deduction or qualify for only a very limited deduction; and
- (3) The pass-through income is subject to the NIIT.

Conversely, the least favorable scenario for converting is one in which—

- (1) Retained earnings must be distributed;
- (2) The entity can't qualify for the IRC § 1202 tax exclusion;
- (3) The business can qualify for the full IRC § 199A deduction; and
- (4) The NIIT doesn't apply to pass-through income.

Decision Factors Other Than the Effective Tax Rate

Of course, the choice of entity decision involves factors other than the effective tax rate. While a detailed discussion of these factors is beyond the scope of this topic, note that each type of entity has advantages and disadvantages compared with the other entities. For example, a C corporation can deduct income distributed in the form of wages, fringe benefits and deferred compensation.¹¹⁴ It also has more flexibility in choosing a tax year, is the only corporate entity that can claim charitable deductions¹¹⁵ and has fewer ownership restrictions than S corporations. On the other hand, losses of a pass-through entity can be passed out to owners, but losses of a C corporation can't.

Disclosures

NOT FOR REDISTRIBUTION

<https://www.bloomwoodcapital.com/smdisclosures>

¹¹⁴ The IRS may try to re-characterize these payments as dividends under IRC § 316.

¹¹⁵ Up to 10% of taxable income.