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Tax Notes

Should Your Business Be a C Corporation?

By Joseph R. Bodan, CPA, Partner

In light of the recent federal tax legislation that lowered the C corporation tax rate to 21%, reduced the top individual rate to 37%, and provides qualifying business owners a 20% deduction on their share of pass-through income, business owners are wondering whether a C corporation is the most tax-efficient form of entity.

The answer is not as obvious as it may appear to be by just looking at the top tax rates. Let's compare some of the factors that must be considered when deciding how to structure your company.

Proceed with Caution

When deciding on a choice of entity structure, there are other factors to consider besides a tax rate differential, including:

- type and number of anticipated shareholders;
- ability to have more than one class of stock;
- type of business;
- level of owner compensation;
- will profits be distributed to the owners or be re-invested in the business;
- need for flexible profit allocations;
- whether you expect operating losses (recent tax legislation added new loss limitations to both corporations and individuals); and,
- exit strategy for owners.

These and other factors should be discussed with your tax advisors so they can recommend the best form of business for your particular facts, circumstances and goals. The potential for double taxation may very well be the deciding factor against converting to a C corporation.

However, since choice of entity has re-emerged as a relevant issue because of the new 21% C corporation tax rate, we will illustrate the tax rate differential between various forms of businesses.

Illustrative Assumptions

For purposes of this exercise in determining most advantageous entity structure for your business, let's assume the following:

- Business net income of $1,000 before taxes and owner compensation
- State corporate and individual tax rate of 6%
- Individual owners in the top 37% federal tax bracket
- Individual owners materially participate in the business
- Owner compensation of $200

In this scenario, the partnership does not qualify for the 20% pass-through deduction. [***Note:*** The criteria to qualify for the 20% pass-through deduction (which results in a 29.6% effective tax rate for owners in the 37% tax bracket) are complex and will be covered in a separate Thought Leadership article.]

Effective individual tax rates for each category of income are:

- ordinary and not qualifying for 20% deduction (37%+6%=43%),
- qualifying for 20% deduction (29.6%+6%=35.6%); and
- qualified dividend (20%+3.8%+6%=29.8%).

No consideration of FICA tax is considered in our illustrative tables.

Illustrative Results: Profit Distribution

The following tables represent tax-effected profit distribution results for the designated corporate entity structure:

	C Corporation	S Corporation	Partnership	Sole Proprietor
Qualify for 20% pass-through deduction	N/A	Yes	No	Yes
Profit before tax and owner salary	$ 1,000	$ 1,000	$ 1,000	$ 1,000
Owner salary/guaranteed payment	(200)	(200)	(200)	N/A
Entity state tax (6%)	(48)	N/A	N/A	N/A
Entity taxable income	$ 752	$ 800	$ 800	$ 1,000
Entity federal tax	$ (158)	N/A	N/A	N/A
Remaining entity profit	**$ 594**	**$ 800**	**$ 800**	**$ 1,000**
Total Taxes:				
Salary/GP	$ (86)	$ (86)	$ (86)	N/A
Flow-through income	N/A	$ (285)	$ (344)	$ (356)
Distribution of remaining profit	$ (177)	N/A	N/A	N/A
Total individual tax	$ (263)	$ (371)	$ (430)	$ (356)
Entity tax	$ (206)	N/A	N/A	N/A
Combined tax	$ (469)	$ (371)	$ (430)	$ (356)
Effective tax rate	**46.9%**	**37.1%**	**43.0%**	**35.6%**

Illustrative Results: No Profit Distribution

For our illustrative example, the following table provides the individual and entity federal and state **tax** by entity type when there is no profit distribution:

	C Corporation	S Corporation	Partnership	Sole Proprietor
Total individual tax	$ (86)	$ (371)	$ (430)	$ (356)
Entity tax	$ (206)	N/A	N/A	N/A
Total tax	$ (292)	$ (371)	$ (430)	$ (356)
Effective tax rate	**29.2%**	**37.1%**	**43.0%**	**35.6%**

The Takeaway

Considering the results from the illustrative examples above, it may be concluded that a C corporation can be the most — or least — tax-efficient form of business depending on whether profits are distributed to the owners or re-invested back into the business (at least in those years). However, the accumulated earnings and personal holding company tax provisions, if applicable, will tax a C corporation if it does not distribute a sufficient amount of profits.

While the effective tax rate for C corporations that do not distribute profits annually to shareholders may seem compelling, the potential for double taxation upon the ultimate distribution of the profits, sale of assets and intrinsic goodwill built up over the years could very well make a C corporation less attractive from a tax perspective.

Exit Strategies

Let's examine the tax ramifications of owner exit strategies between the various types of entities:

	C Corporation	S Corporation	Partnership	Sole Proprietor
A. Sale of business assets				
a. Levels of income tax	Two	One	One	One
b. Asset step-up for buyer	Yes	Yes	Yes	Yes
B. Sale of stock				
a. Levels of income tax	One	One	One	N/A
b. 3.8% NII tax applies to gain	Yes	No[1]	No[1]	N/A
c. Inside asset step-up for buyer	No	No	Yes	N/A
C. Gift shares/business				
a. Levels of income tax	N/A	N/A	N/A	N/A
b. Donee gets step-up	No	No	No	No
D. Pass on shares/business at death				
a. Levels of income	N/A	N/A	N/A	N/A
b. Donee gets stock step-up	Yes	Yes	Yes	N/A
c. Donee get asset step-up	No	No	Yes	Yes

Key Points to Exit Strategy Tax Ramifications

Buyers will generally prefer to buy assets rather than stock primarily so they can step-up the inside tax basis of the entity's assets and will pay more to do so. However, when assets are sold, there is double taxation only for C corporations.

When stock of a C or S corporation is sold, there is only one level of income tax at the owner level, but the buyer will not be able to step-up the inside tax basis of the entity assets unless an IRC 338 election is made and an additional level of tax is incurred. [1]Another important factor is that the 3.8% net investment income tax applies to the gain from the sale of C corporation stock but would not apply to the sale of S corporation stock or a partnership interest provided the owner materially participated in the business and based on the composition of the entity's assets. However, when a partnership interest is sold, there is also one level of owner tax but the partnership rules allow for an inside asset step-up by means of an IRC 754 election.

When ownership of a business entity interest is gifted, there is no income tax ramifications and the donee's tax basis in such interest is the same as that of the donor's, plus any gift tax paid by the donor. There is no ability to step-up the inside tax basis of the entity's assets when an ownership interest is transferred by gift.

When an owner transfers a business entity interest at death, the fair market value of such interest is included in the decedent's taxable estate, the heirs who receive the business interest get a step-up in their ownership interest but only a partnership can also step-up the inside tax basis of its assets upon the death of a partner by making a IRC 754 election.

Therefore, if you believe that the ultimate exit strategy is a sale of assets, you may be better off being an S corporation, partnership or sole proprietorship. If you believe a sale of stock is in your future, and you will be reinvesting annual profits back into the business and the personal holding company rules do not apply, serious consideration should be given to being organized as a C corporation. If you think you can sell an ownership interest only if the buyer can get a step-up in the inside tax basis of the business assets, you might want to consider being a partnership.

Finally, if you plan to pass on your business interest to your children, then you might consider being a C corporation if you will be reinvesting the profits in the business. However, if an inside tax basis step-up will be important to your beneficiaries, a partnership will allow for such inside tax basis step-up.

Other factors to consider: The federal tax-free reorganization provisions only apply to C or S corporations. The incremental tax provisions for accumulated earnings and personal holding companies only apply to C corporations. The IRS looks for a significant portion of an S corporation's profits to be paid out to active owners as salaries, but there is no such requirement for partnerships or sole proprietorships. Only partnerships allow an owner to use their share of the partnership's debt as basis to claim losses or receive tax-free distributions. The FICA tax effect of the various business entities should also be considered when evaluating choice of entity.

Summing It Up

The above information demonstrates that there are multiple factors to consider when deciding if your business should convert to a C corporation and, while the top tax rates for each type of business should be considered, the potential for double taxation in a C corporation may very well be the deciding factor. Your PKF O'Connor Davies tax advisor is available to discuss if converting to a C corporation is the right move for your business and supports your financial plan.

Contact Us

For assistance with structuring your business or for help with any other tax matter, please contact the tax partner listed below or your PKF O'Connor Davies tax advisor:

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