Deciding on the Choice of Business Entity Under TCJA

THE CORNERSTONE OF P.L. 115-97, known as the Tax Cuts and Jobs Act is the reduction of the maximum corporate tax rate of 35% to a flat 21%. For businesses being conducted as flow-through entities, such as S corporations, partnerships and sole proprietorships, the new law permits a deduction of up to 20% of qualified business income (QBI), effectively reducing the top tax rate paid by the individual owner from 37% to 29.6%. The QBI deduction has restrictions and limitations, so not all business owners will be able to claim the deduction. Furthermore, the QBI deduction is temporary and will sunset after 2025, whereas the 21% flat corporate tax rate is permanent. The question now becomes, what is the best choice of entity to take advantage of these new rules?

If a corporation doesn't distribute its profits, it only pays the flat 21%. If the profits are distributed, they are now subject to double taxation; first at the corporate level (21%) and then at the shareholder level as a dividend (up to 23.8%). Thus, for every $1,000 of profit, roughly 40% would go to taxes, leaving $600 for the shareholder. The profits of a C corporation are not eligible for the 20% QBI deduction. Corporations that wish to retain profits have two other considerations. First, the accumulated earnings tax which is assessed when a corporation accumulates earning beyond the reasonable needs of the business ($150,000 for personal service corporations and $250,000 for all others) and the personal holding company tax when the company has a limited number of owners and excess passive income.

In contrast, partnership and S corporation profits flow through to the owners and are only taxed once at the individual level. These profits are eligible for the 20% QBI deduction, subject to various income limitations (beyond the scope of this article). Using the same $1,000 profit, only $800 ($1,000 x 80%) would be taxed to the business owner at his or her marginal rate. Assuming the top rate of 37%, $296 ($800 x .37) would go to taxes, leaving $704 for the shareholder. Partners and LLC members would also have to consider the impact, if any, of self-employment taxes.

The above becomes more complicated under the QBI deduction rules if the business activity involves certain specified services such as healthcare, law, accounting, consulting, investment management and other personal services, the ability to combine business interests under the new rules, as well as the individual's taxable income, requiring a more extensive analysis.

Several considerations also need to be reviewed before converting between C and S status. Certain factors can preclude converting to S status including the rules limiting who can be an eligible shareholder, the limitation on the number of shareholders and the limitation on only having one class of stock. S corporations are also subject to IRS scrutiny under the reasonable compensation rules and the double taxation concept will still apply to net built-in gains on business assets as of the date of conversion if those assets are sold within 5 years of conversion. In addition, certain tax attributes such as net operating loss carryovers would be lost when the S conversion is made. Conversely, if S status is terminated (to take advantage of the 21% rate), it cannot be re-elected for 5 years.

In conclusion, selecting the right entity type under the new tax regime can save considerable federal taxes, but all factors need to be carefully weighed. ■

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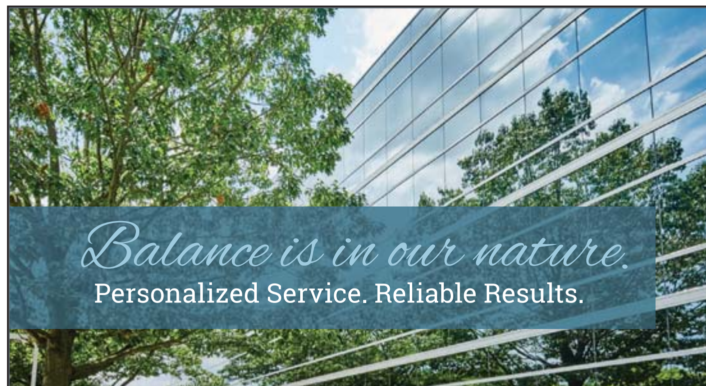

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