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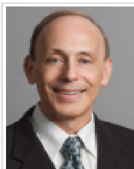
‘To C or not to C?’ is the question under new tax law

The most striking aspect of the new tax law is the corporate tax rate reduction to 21 percent. What does this mean for us and for our clients? Who should take advantage of the new lower corporate tax rate?



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The most striking aspect of the new tax law is the corporate tax rate reduction to 21 percent. Israel is concerned this will damage its high tech industry as companies no longer have as large of an incentive to be there as opposed to in the U.S. Switzerland is contemplating change its tax laws to stay ahead of the U.S.

What does this mean for us and for our clients? Who should take advantage of the new lower corporate tax rate?

Since 1986 most new corporations have been formed as S corporations. One reason for this is the so-called "double tax" in the event of a sale of the business. "Double tax" does not mean two times the amount of tax; it means two levels of tax, one at the corporate level and one at the shareholder level. Why two levels? Because buyers of a closely held business almost always want to buy the assets, not the stock. The buyer is afraid that, with a purchase of the stock, the buyer will inherit the problems the seller created in the corporation, e.g., tax law problems, employment law violations. Also, the buyer cannot deduct the stock price; but the buyer can deduct the price of the purchased goodwill over a 15 year period. Also, the buyer can immediately deduct the price of the hard, depreciable assets.

Assume $10 million of corporate assets sold in 2018 consists of $1 million of equipment and $9 million of goodwill. At a 4 percent effective interest rate, for the buyer the amortization of the goodwill (at a 28 percent state and federal corporate tax rate) is worth $1.9 million dollars in 2018, and the deduction for the price of the equipment is worth another $280,000.

Assume a corporation has $10 million of zero basis assets. The buyer pays $10 million to the corporation. The corporation pays $2.8 million in state and federal tax, leaving $7.2 million. The shareholder liquidates the corporation and pays a combined state and federal tax rate of 37.1 percent (13.3 + 20 + 3.8), or $2,671,200. The total corporate and shareholder tax is $5,471,200, an effective tax rate of almost 55 percent. By contrast, had it been an S corporation, the tax rate would have been (20 percent federal + 13.3 percent state =) 33.3 percent. C corporation status cost the shareholder an extra $2,171,200 in tax (almost 22 percent more).

Another disadvantage of C status occurs if, on audit, corporate expenses are disallowed. Assume the shareholder flies first class to Hawaii, takes along the entire family and stays in a fancy hotel suite, all to attend an industry conference, for $20,000. The IRS determines that coach fare and a $250 per night room for the shareholder alone would have been sufficient, for $3,000. The disallowed $17,000 creates two taxes: a corporate level tax and a dividend to the shareholder. Had it been an S corporation, there would have been no corporate level tax. This same negative result occurs if the shareholder takes "too much" compensation and a portion of it is disallowed because the IRS believes a portion of it should have been a dividend.

Which corporations should revoke their S elections and become C corporations? Which businesses should become C corporations? Those that need to accumulate capital or retire a large amount of debt. For every $1 million of corporate debt, a C corporation will pay a combined state and federal tax 28 percent rate as opposed to the (37 percent federal and 13.3 percent state) 50 percent personal rate for an S corporation's shareholders, saving $220,000 per million. (This assumes the new IRC Section 199A deduction of 20 percent of qualified business income will not apply. More on that in a future article.) In five years the business will be able to pay an extra $1 million of debt per million of corporate taxable income. Another example: a business that must substantially increase its inventory and/or its accounts receivable as it grows.

Another reason for C status involves shareholders who hope to use the IRC Section 1202 100 percent gain exclusion when they sell their shares or liquidate the corporation. The corporation must be a C corporation when the shares are issued and for substantially all the years in which the shareholder owns the shares. (Section 1202 has many other requirements.)

There is a caveat. If the business that needs to increase capital will be sold in a few years, the shareholders must analyze the benefit of the lower C corporation tax rate on increased capital versus the potential double tax in a sale. The double tax will continue to be an issue after the corporation elects S status -- for five years for federal tax purposes and 10 years for California purposes. The higher the value of the business on the date of the S election, the greater the lingering double-tax problem. Of course, if we know the date of the sale, we can mitigate that with planning done one or more years in advance.

Should law firms adopt C corporation status? The answer is probably "no" in most situations. Law firms usually need not dramatically increase capital. If the firm accumulates capital at the combined 28 percent state and federal rate, how will that extra capital ultimately benefit the lawyers that own the firm? Also, some of the owners might be able to use the new, limited IRC Section 199A 20 percent deduction for all or part of their firm income if they use an S corporation, LLP or sole proprietorship.

In conclusion, the new lower corporate tax rate -- 21 percent -- the most striking aspect of the new tax law, will be attractive to many businesses. However, for those that may be sold in the next few years, it will be important to analyze the benefits versus the potential double tax in the event of a sale.