Pepper Hamilton LLP
Attorneys at Law

Choice of Entity Considerations Post-Tax Reform: Corporation or Flow-Through Entity?

Tax Update | Volume 2019, Issue 4

Morgan Klinzing | klinzingm@pepperlaw.com

Choosing the appropriate type of entity is a multifaceted analysis and is necessarily dependent upon a variety of factors, including business objectives, type of business, desire for cash distributions, and ease of obtaining new capital. The Tax Cuts and Jobs Act (TCJA), enacted at the end of 2017, included many changes that impact that analysis. One of the TCJA's headline changes was to lower the corporate income tax rate from 35 percent to 21 percent. Although many predicted this change would lead to a surge of partnerships and S corporations (flow-through entities) converting into C corporations, such a surge has not occurred. This article discusses the major factors to consider when making a choice of entity decision post-TCJA.

THIS PUBLICATION MAY CONTAIN ATTORNEY ADVERTISING

The material in this publication was created as of the date set forth above and is based on laws, court decisions, administrative rulings and congressional materials that existed at that time, and should not be construed as legal advice or legal opinions on specific facts. The information in this publication is not intended to create, and the transmission and receipt of it does not constitute, a lawyer-client relationship. Please send address corrections to phinfo@pepperlaw.com.

© 2019 Pepper Hamilton LLP. All Rights Reserved.

Tax Rates

Benefits and Burdens of C Corporation Structure: The TCJA reduced the federal corporate tax rate from 35 percent to 21 percent. The TCJA did not change the tax rate on distributions from a corporation to its shareholders. Dividends received by noncorporate taxpayers are still taxed at a maximum rate of 20 percent (plus an additional 3.8 percent for taxpayers subject to the net investment income tax). The combined effective federal tax rate for noncorporate shareholders on distributions from a C corporation is 39.8 percent.

Benefits and Burdens of Flow-Through Structure: The TCJA also provided a rate reduction for noncorporate taxpayers on income from flow-through entities. Income of flow-through entities is not taxed at the entity-level, but is instead included by the owners on their tax returns. The TCJA reduced the top noncorporate tax rate on ordinary income from 39.6 percent to 37 percent. In addition, the TCJA provides a 20 percent deduction for certain business income for noncorporate taxpayers that own flow-through entities. This 20 percent deduction reduces the effective federal tax rate on flow-through income from 37 percent to 29.6 percent. To the extent the owners of a flow-through entity have included these amounts as taxable income, the amounts can be distributed from the flow-through entity without additional tax.

Individual partners in a partnership may also be subject to self-employment taxes or the 3.8 percent net investment income tax, depending on their involvement with the business. In addition, shareholders of S corporations who work in the business are required to pay themselves reasonable compensation, which is taxable at ordinary income rates. This compensation is not eligible for the 20 percent deduction for certain business income. The S corporation is responsible for paying half of the employment taxes, and the S corporation shareholder pays the other half. Accordingly, the effective rate of tax on income from a flow-through entity will depend on whether the income is subject to self-employment taxes, employment taxes or the net investment income tax.

Planning Considerations: When comparing different effective tax rates, it is important to consider whether the entity plans to make distributions. If a business plans to reinvest all after-tax proceeds and not make any distributions, a C corporation likely provides a greater opportunity for growth because the after-tax proceeds (which are subject to federal tax at a 21 percent rate) generally are higher than those of a flow-through entity (assuming the flow-through entity makes distributions to enable its owners to pay taxes). Conversely, if a business plans to distribute all of its income, a flow-through entity likely is more efficient.

While beyond the scope of this article, significant issues arise under various state and local tax and/or foreign country tax systems that would need to be factored into any choice of entity analysis.

Income, Losses and Reporting Obligations

Benefits and Burdens of a C Corporation Structure: Income and losses of a C corporation do not flow through to its owners. Instead, both the income and the losses remain at the entity level. If losses cannot be used in a current year to offset corporate income, the losses generally are carried forward as net operating losses and are available to offset losses in future years, unless these losses are limited by one or more Internal Revenue Code provisions. Before the TCJA, corporations could carry losses back for two years and carry losses forward for 20 years. Under the TCJA, corporations can no longer carry losses back, but can carry losses forward indefinitely. However, the losses may only offset up to 80 percent of the corporate income.[1]

Corporations file U.S. federal and state income tax returns and pay taxes on their own behalf. The owners of the corporation do not reflect income of the corporation on their personal returns.

Benefits and Burdens of a Flow-Through Entity: Income and losses of a flow-through entity flow through to its owners. The losses may be available to offset income from other businesses, subject to existing loss limitations and with new limitations imposed by the TCJA. The new loss limitation provides that only $250,000 ($500,000 for taxpayers filing jointly) of net losses from all of a taxpayer's trades or businesses can be used to offset nonbusiness income.

Unlike the owners of C corporations, owners of a flow-through entity are required to file U.S. federal income tax returns reflecting the operations of the entity. In addition, these owners must file tax returns in each state and locality in which the business has an income tax liability. This can be quite involved for larger companies operating in all 50 states. In addition, non-U.S. persons frequently do not want to file a U.S. tax return.

Planning Considerations: If a business expects to have losses and the business owners could utilize those losses to offset income, subject to the limitations under the TCJA, it may be more efficient to operate as a flow-through entity. However, if the owners do not expect to be able to use the losses, it may be better (depending on the extent of the losses and the likelihood of potential limitations on the net operating losses) to trap them in a corporation so they remain available to offset future income.

Raising Capital and Exit Planning

For both capital-raising opportunities and sale or exit planning, the structure of the business entity could be driven by the likely investors in a capital-raising effort or likely buyers in an exit event.

For example, many buyers prefer asset acquisitions over stock acquisitions because of the ability of the buyer to obtain a step-up in the tax basis of the assets upon an asset purchase. Accordingly, a flow-through structure that minimizes the impact on the seller with respect to an asset sale may be preferred. The ability to step-up the tax basis of assets upon purchase has increased, to some extent, as a result of changes made by the TCJA, which added generous bonus depreciation rules allowing the buyer to immediately deduct 100 percent of the cost of certain assets. Given these incentives to obtain a tax basis step-up and create more immediate deductions, buyers are typically not willing to pay as much for a stock acquisition.

In contrast to the buyer's motivations in an acquisition, owners of a corporation prefer to sell stock because it results in a single level of tax on any gain realized upon the sale of their stock. Unless a section 338 election is made by the parties, the sale of stock does not provide a basis step-up in the corporation's assets. From the seller's perspective, a sale of corporate assets leads to two levels of tax — one at the corporate level and another at the shareholder level when proceeds from the asset sale are distributed.[2] Thus, owners of a corporation frequently prefer to sell stock, which does not provide a basis step-up in the corporation's assets. However, given the perceived disadvantages to buyers, buyers pay less for the sale of stock than they would for the sale of assets.

In contrast, a flow-through structure may provide more flexibility on exit because owners of a partnership generally are indifferent between an asset sale and a sale of interests in the partnership, as both transactions can provide a step-up in the tax basis of the assets for the buyer. In an S corporation flow-through structure, owners may still prefer to sell stock because it generates capital gain. If an S corporation sells assets, there is only one level of tax, but some of the income may be taxed at ordinary income tax rates, depending on the character of the assets (capital or ordinary) that are sold.

Pepper Perspective

While the changes in tax treatment, tax rates and rules related to losses and income timing of C corporations and flow-through entities were modified by the TCJA, determining the ideal choice of entity remains dependent upon the business needs of the entity, including factors such as what the business does and the type of assets held, who the owners are, the type of income or loss that is expected to be generated, the cash needs of the business and its owners, and the expectations in an exit event.

Endnotes

1 This effectively implements a 20 percent minimum tax in light of the TCJA's repeal of the corporate alternative minimum tax.

2 As an additional incentive for a stock sale, certain gain from qualified small business stock is eligible for exclusion in an amount that is the greater of $10 million or 10 times the shareholder's basis in their stock.