SMALL BUSINESS WEEK

C-corporation or pass-through entity – the choice is yours

The new Tax Cuts & Jobs Act has made the task of choosing an entity type a little more complicated. Whether to set up your business as a C-corporation or as a pass-through entity, depends on your circumstances.

A C-corporation, so called because it is governed by the rules and regulations of Subchapter C of the tax code, is well known for its double taxation. Profits are taxed at the corporate-level, and dividends are too taxed to shareholders at their individual tax rates when distributed. But after passage of the new tax law, corporate taxation has been reduced to a flat rate of 21 percent from a high of 35 percent. Also, the corporate alternative minimum tax has been repealed, effective the beginning of the year.

If a C-corporation does not make distributions to its owners, and its profit is either paid in salary or benefits with the remainder reinvested in the business, the C-corporation could result in lower taxation. If the company is to be sold, double taxation may be a disadvantage. However, if the stock of a deceased shareholder is sold, there would be a step-up in tax basis to lessen the tax burden.

Some companies may consider converting an existing S-corporation to a C-corporation, but there is a five-year waiting period before you could convert back and the decision needs to be carefully evaluated.

Stephen Aton

A pass-through entity is not subject to entity level income taxation like the C-corporation. Instead, the owners are taxed individually for the income, usually based on their percentage of ownership. For example, if a pass-through entity had net income of $300,000, and there were three equal owners, then each owner would pay income tax on $100,000 on their individual tax return.

Pass-through entities would include sole proprietorships, partnerships, S-corporations, and limited liability companies that are taxed as partnerships.

The favored entity today is the LLC. It is simple and easy to operate. There are no annual meetings, no minutes, no stockholders and no annual report. In Missouri, there is no ongoing requirement to file periodic documents. However, the entity should have an operating agreement that details the governance. Transfer restrictions in the manner of a shareholder's agreement with a corporation also are often included in the operating agreement.

For the pass-through entities, the Tax Cuts & Jobs Act creates a 20 percent deduction on qualified business income, which reduces the top tax bracket to an effective rate of 29.6 percent. Qualified business income includes revenue from self-employment, S-corporations and partnerships.

It does not include dividends, interest income not attributable to a business and capital gains. Nor does it include wages earned as an employee or guaranteed payments from a partnership or LLC taxed as a partnership. Note that the income must be made from a trade or business within the United States.

The deduction reduces taxable income but not adjusted gross income. If an individual has taxable income over $157,500 or a couple has income over $315,000, the deduction is limited by the greater of half of W-2 wages paid by the business or a quarter of W-2 wages, plus 2.5 percent of unadjusted basis of all qualified property.

» The favored entity today is the LLC. **It is simple and easy to operate.**

If taxable income of a single filer exceeds $157,500 but not $207,500, the deduction is reduced ratably. If taxable income exceeds $207,500, the deduction is unavailable. If the taxable income of a joint filer exceeds $315,000, but not $415,000, the deduction is also ratably reduced. If taxable income exceeds $415,000, the deduction is unavailable. The full deduction is available for service income under the limits ($157,500 for single and $315,000 for joint filers).

The deduction also is limited for certain service businesses, including health, law, consulting, financial and brokerage services, and any business in which the reputation or skill of the owner of the business has special rules. Basically, as the income of a single or joint taxpayer increases, the percentage deduction for which the taxpayer qualifies decreases.

When a single taxpayer in a service business reaches the top limit of $207,500, or a joint taxpayer reaches $415,000, the deduction is gone.

Entity selection is more complicated than in the past and is not a decision to be made without consulting your tax adviser. Many factors, not all of which were discussed here, can affect the decision on which entity is best for your company.

Attorney Stephen Aton runs a private practice in corporate law and estate planning. He can be reached at steve@atonlaw.com.