Is Converting to a C-corporation More in line with Your Company Goals?

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The 2017 Tax Cuts and Jobs Act (the Act) contains considerable changes to the federal tax code, including a significant reduction of the federal corporate tax rate from 35 percent, to a flat rate of 21 percent. The newly enacted provision will permanently remain in place, and not scheduled to revert back to a higher rate. This considerable change has caused owners of S-corporations and other pass-through entities (partnerships, limited liability companies, etc. - hereinafter referred to as "S-corporations") to assess and reconsider their entity formations for federal income tax purposes.

After years of paying up to a 40 percent maximum federal income tax rate on S-corporation earnings, the new flat 21 percent rate for C-corporations may be appealing to those who qualify. Many S-corporation shareholders are asking their advisors if converting to a C-corporation would be beneficial to their company goals.

The decrease in tax rates comes in two forms for owners of S-corporations, effective Jan. 1, 2018. First, the maximum statutory rate is reduced from 39.6 to 37 percent. Second, owners of S-corporations are allowed a deduction for up to 20 percent of total S-corporation taxable income (subject to numerous limitations and fine print). This additional deduction – "the new pass-through deduction" – can be worth an additional 7.4 percent tax rate decrease to S-corporation owners, which are made up of most of the small businesses in the U.S. (37 percent tax rate x 20 percent deduction = 7.4 percent).

After both modifications to the law are taken into account, generally, the maximum federal effective tax rate for S-corporation owners can be 29.6 percent, with certain passive shareholders subjected to an additional 3.8 percent Net Investment Income Tax (NIIT) rate.

While the difference in S-corporation maximum tax rates over-corporation maximum tax rates has increased under the new law, it is important to remember a lower effective federal-corporation tax rate has always been in place. Most decisions to elect status as an S-corporation are not made solely on tax rates; rather, the decision may need to be based on strategies for returning cash to shareholders, and strategies for an exit event.

Strategies for Returning Cash to Shareholders

The most well-known disadvantage for shareholders of C-corporations is known as "double-taxation." This comes from the concept that income is subject to tax once at the-corporation level, and then subject to tax again when the-corporation pays a dividend to the shareholders.

The aforementioned principle does not apply for S-corporations, as no federal income tax is paid at the entity level. Instead, the taxable income generated by the S-corporation is "passed through" to the shareholders and reported on the shareholders' individual tax returns. Generally, earnings from the S-corporation can be distributed to the shareholders without federal income tax. Thus, the S-corporation is generally only subject to "single taxation."

For an illustration of this, let's assume a C-corporation generates $100 of income during 2018. The C-corporation would pay a $21 federal income tax under the new law, leaving the C-corporation with $79 in after-tax profits. If the C-corporation paid the $79 as a dividend to its shareholders, the maximum federal tax rate would likely be 23.8 percent (20 percent qualified dividend tax rate plus 3.8 percent NIIT rate). After paying tax on the dividend, the shareholders would have $60.20. This results in an effective tax rate of 39.80 percent for the current year's profits, after taking into account "double-taxation," further outlined below:

$100.00	Pre-tax profit – C-corporation
21.0%	Federal income tax rate
$ 21.00	Federal income tax paid by C-corporation
$ 79.00	Post-tax profit distributed to shareholders
23.8%	Tax rate on dividend to shareholders
$ 18.80	Income tax paid by shareholder
$100.00	Original pre-tax profit by C-corporation
(21.00)	Tax paid by C-corporation
(18.80)	Tax paid by shareholders
$ 60.20	Net cash received by shareholders, after tax

This effective rate is higher than the maximum expected tax rate for an S-corporation, which would be approximately 29.6 percent after the new pass-through deduction.

However, not all companies plan to return cash to their shareholders as quickly as the cash is earned, which is a typical strategy for high growth companies. As the taxes paid from operations can be less for C-corporations, more earnings can be reinvested in the business. If these earnings are reinvested it the business each year – and thus any tax on dividends is deferred – the tax savings would be expected to be used to generate higher returns for the company. In this case, companies must forecast future income and cash flows to determine how long any cash savings must be used within the company to generate a positive return on a net present value basis.

In the example above, the C-corporation could have chosen to not pay a dividend of its $79 post-tax profits, but instead reinvest that in the company. If the $79 was reinvested in the company for the next 10 years, what would be the future value based on the company's expected internal rate of return? Comparatively, what would be the expected future value of the $60.20 net cash received by the shareholder after the same time period?

The answers are much more strategic than absolute, and depend on numerous variables such as cost of capital, expected rate of return within and outside the company, and expected holding period.

Management takeaway

- A company's strategy for returning cash to its shareholders will impact its overall effective tax rate for taxes paid at the entity and shareholder levels.
- A company that plans to return all earnings, in cash, to shareholders (as dividends) as quickly as possible, will likely incur a lower tax liability, in that specific year, as an S-corporation.
- A company that plans to reinvest its earnings in the business will likely incur a lower tax liability, in that specific year, as a C-corporation.

Other considerations

- Wages paid to shareholder-employees of both S and C-corporations are governed by reasonable compensation standards, which have been established through both statutory and case law.
- For income tax purposes, S-corporation taxpayers may be incentivized to pay artificially low wages to shareholder-owners in order to avoid FICA and Medicare payroll taxes.
- For income tax purposes, C-corporation taxpayers may be incentivized to pay artificially high wages (as opposed to dividends) to shareholder-owners to avoid "double-taxation."
- Accumulated earnings tax rules may cause some-corporations to pay tax on dividends, even if no dividends have been formally declared or paid.

Strategies for an Exit Event

A taxpayer's strategy for S or C-corporation treatment must include its plans for a future exit event, typically a sale of the company. The exit strategy could also be to "own the company for perpetuity."

The sale of a company can have different tax consequences, depending on the structure of the transaction. Two common types of sales transactions are asset sales and stock sales. A general rule is - "sellers want to sell stock; buyers want to buy assets."

If a company's stock is sold, the buyer assumes the entire-corporation and everything that comes with it. The basis of the assets inside the-corporation remains the same and the liabilities of the-corporation remain inside the entity, and are effectively assumed by the buyer. And, gain or loss on the sale is capital gain to the selling shareholder, based on proceeds received less shareholder's basis in the stock. This capital gain results in "single taxation" for both S and C-corporation shareholders, as there is no tax recognized at the entity level.

On the other hand, the sale of a company's assets will result in the original entity still being owned by the seller, with negotiations over which assets and liabilities will actually transfer to the buyer. The company's inventory, operating assets, customer relationships, goodwill, employees, etc. typically transfer to the buyer. However, the seller's accounts receivable, accounts payable, and other liabilities may or may not transfer to the buyer.

An asset sale can, once again, result in "double taxation" to the selling shareholders of a C-corporation. First, the C-corporation pays tax at the entity level, based on the proceeds received, less the basis of the assets sold by the company. The proceeds are typically used to pay off any remaining liabilities within the company, and any cash remaining is typically distributed to the shareholders as a liquidating distribution. This liquidating distribution is taxed to the shareholders at capital gain tax rates.

However, the S-corporation shareholders of an asset sale are generally subject to only one level of tax following an asset sale. No tax is generally paid by the S-corporation itself. The shareholder recognizes gain based on the proceeds received, less the basis of the assets sold. This gain typically involves some ordinary income based on depreciation recapture and inventory sold, with the remaining gain generally taxed as capital gain to the shareholders. Just as in a C-corporation, the proceeds are typically used to pay off any remaining liabilities within the company, and the cash remaining is typically distributed to the shareholders, as a liquidating distribution. Because of the increase in shareholder basis as gain is recognized inside the S-corporation, this liquidating distribution generally creates minimal additional gain.

It is also important to note the buyer receives a "step-up in basis" of assets following an asset purchase, which is different from a stock purchase. The buyer is allowed depreciation and amortization deductions for the assets acquired, based on their fair market value, which typically results in a tax benefit to the buyer, following an asset purchase. For this reason – and because liabilities transferred to the buyer can be limited in an asset purchase – a buyer may be willing to pay a higher price to purchase a company's assets as opposed to its stock.

It is possible – maybe even typical in some industries – for a company to pay a higher combined effective tax rate as an S-corporation during most years, but then pay far less in taxes following a sale of the company's assets. Understanding possible exit events for each company's industry is a necessary part of any S vs C-corporation strategy.

Management takeaway

- An exit event will impact shareholders of S and C-corporations differently.
- The sale of a company's stock may not result in a large difference in federal income tax liability between S and C-corporation shareholder sellers.
- The sale of a company's assets typically results in lower tax liability to the shareholders of S-corporations, as there is generally only one level of tax.
- Strictly for income tax purposes, buyers typically prefer to purchase a company's assets, as opposed to stock, in order to receive a "step-up in basis" and corresponding tax deductions for the newly acquired assets.

Other considerations

- The difference in purchase price paid to complete an asset sale, as opposed to a stock sale, will vary based on the type of buyer, industry and actual operating assets of the target company.
- For income tax purposes, buyers may be incentivized to pay more for the assets of a target with large amounts of depreciable operating assets, which can generally be expensed immediately following purchase, under the new tax law.
- Following an asset sale, any amount of purchase price allocable to goodwill, trademarks and brands, customer relationships, etc. is typically taxed at capital gains rates to an S-corporation seller-shareholder and amortized over 15 years by the purchaser.
- Tax law allows certain transactions to be treated as asset purchases for income tax purposes, even though the company's stock may be sold under state law. This can be beneficial when a buyer wants to retain the legal entity itself or federal employer identification number of the target, and can also be intriguing when the target company has net operating losses available to offset taxable income.

Summary

- The decision to convert to an S or C-corporation is strategic and involves many variables, likely differing by industry.
- While the difference in maximum tax rates between S and C-corporations has increased under the new tax law, S-corporations should not automatically rush to revoke S elections. Previous S elections were typically made to avoid double taxation under various scenarios, and many of the same principles still apply.
- C-corporation Strategy – Textbook Scenario
  - » Reinvest current year profits in the business, as opposed to distributing to shareholders.
  - » Shareholder holding period is long-term (10+ years).
  - » Likely exit event is stock sale.
  - » Future buyer not likely to pay premium to purchase assets, as opposed to stock.
- S-corporation Strategy – Textbook Scenario
  - » Return any available profits to shareholders as quickly as possible.
  - » Shareholder holding period is mid-term (1-5 years).
  - » Likely exit event is asset sale.
  - » Future buyer likely to pay much higher price to purchase assets, as opposed to stock.

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