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Tax Law Changes May Impact a Business Owner's Decision on Choice of Entity

Business owners who are trying to decide which legal entity is appropriate for their companies must factor in several tax considerations in light of the 2017 Tax Cuts and Jobs Act (TCJA), the 2020 Coronavirus Aid, Relief and Economic Securities (CARES) Act and the potential for new tax legislation in 2021.

C Corporations – Tax Considerations

TCJA

- The TCJA brought a steep decline in corporate income tax rates, from a maximum of 35% down to a flat rate of 21%. While this drop is appealing, business owners also must consider their personal tax rates when assessing the benefits of conversion.
- Shareholders must deal with the issue of double taxation for C corporations as income is taxed at the corporate level of 21% when earned by the entity and then taxed again when distributed to the shareholders, either as a taxable dividend or when the corporation is sold.
- The individual dividend rate is generally 20% but can reach 37% for certain dividends. Under current legislation, dividends and gains for individuals are subject to an additional net investment income tax of 3.8%.
- While companies that intend to retain profits may benefit from the 21% tax rate, C corporation owners should be aware of the accumulated earnings tax, which is an additional penalty on undistributed profits.

CARES Act

- **Alternative minimum tax** – The TCJA eliminated the corporate alternative minimum tax (AMT) as part of its tax reform. Its repeal allowed corporations to claim outstanding AMT credits (subject to certain limitations) as refunds for years 2018 through 2020. The CARES Act accelerates this process by permitting corporations to elect to claim a refund of any unused credits from 2018 as fully refundable.
- **Net operating losses** – The CARES Act temporarily relaxes the rules governing the use of net operating losses (NOLs) as established under the TCJA. The TCJA limited the use of NOLs after 2017 to 80% of current year taxable income. The CARES Act stipulates that NOLs will no longer be subject to the 80% limitation for tax years beginning before 2021. For years beginning after 2021, the allowed NOL deduction will revert to the 80% limitation of current year taxable income for losses arising in tax years after 2017.

- **Carryback of NOLs** – The CARES Act also temporarily modifies TCJA rules eliminating the ability for NOLs to be carried back to prior years in which a corporation had taxable income. The Act permits 100% of losses from tax years ending in 2018, 2019 and 2020 to be carried back to the five prior tax years. This creates the opportunity for C corporation taxpayers to file for possible refunds of tax liabilities paid in prior years by carrying back NOLs to reduce previous taxable income.

Pass-Through Entities – Tax Considerations

- **Double taxation** – Because pass-through entities and sole proprietorships usually are not taxed at the corporate level, they may be attractive for the reduced corporate tax rate of 21% as introduced by the TCJA. However, if a company intends to pay dividends or could be sold within a relatively short period, a conversion to C corporation status may not be ideal because of the two levels of taxation.
- **Qualified Business Income deduction** – Business owners can deduct up to 20% of income taxed at the individual level (i.e., self-employment income, income from pass-through entities) under the Qualified Business Income (QBI). For example, if an owner of a qualified trade or business is taxed at a marginal rate of 37%, they may take a 20% deduction on qualified income, resulting in an effective rate of 29.6%. Although this rate is higher than the 21% corporate rate, the double taxation issue is minimized.
- **Limitations for specified service trades or businesses** – Businesses considered as specified service trades or businesses (SSTB) are limited in the amount that can be taken under the QBI deduction. Health, professional and consulting services are some examples of the types of businesses that fall into the SSTB category. High-earning taxpayers owning a SSTB business are subject to limitations and should consider their wage levels and the level of capital needed to run their business. If they have low wages and are not capital-intensive, the taxpayer may benefit from conversion to a pass-through entity due to the limited QBI deduction.

Other Factors to Consider

With the pandemic still extending across the country, a new administration taking power in 2021 and the composition of Congress likely to remain the same, it is unclear if new tax legislation designed to provide additional relief to businesses will be proposed and passed.

If a business owner determines that it is advantageous to establish a C corporation for tax purposes, they should consider longstanding tax laws and the tax reforms and relief enacted by the TCJA and CARES Act. They also should factor in expenses for legal services, tax filing and registration fees. Your tax professional can provide additional insight into how current and future tax legislation may impact your choice of business entity.

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