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BY RICH SHAVELL

Tax Cuts & Jobs Act: Reevaluating S vs. C Corporations

The passage of the *Tax Cuts and Jobs Act* (TCJA)[1] at the end of 2017 has prompted business leaders to understand the new law and strategically position themselves for tax purposes.

One major issue is whether a C corporation should replace the S corporation as the new, ideal entity type for closely-held businesses. The correct answer is not straightforward and, as always, depends on the taxpayer's specific circumstances.

This article will present a few basic situations to help you consider whether an entity change makes sense for your business.

S vs. C Corporations

S and C corporations face very different levels of taxation. C corporations face double taxation – at both the entity level and later, at the stockholder level when the corporation pays dividends.[2] S corporations face a single level of tax such that when the accumulated earnings are later distributed, the tax is already paid. Therefore, no double taxation applies. This double taxation effect can be significant later when a company is sold.

While these tax differences remain unaffected by the TCJA, the rate at which each will be taxed has changed. C corporations are taxed at 21% regardless of net income,[3] while S corporation pass-through income is taxed at the shareholder level at the new individual income rates with the highest marginal rate bracket at 37%.[4] At a glance, the reduction to a single marginal corporate tax appears to allow C corporations to compete with S corporations.

TCJA also repealed the corporate Alternative Minimum Tax (AMT).[5] Prior AMT carryover credits can be used to offset current and future regular corporate tax.[6] However, AMT remains in place for S corporation shareholders with an enhanced AMT exemption.[7]

New 20% Deduction for Pass-Through Entities

Effective in 2018, construction entities including S corporations now have the Qualified Business Income Deduction (QBID)[8] in place of the repealed Domestic Production Activities Deduction (DPAD).[9] Compared to DPAD, the QBID deduction applies to more taxpayers and offers a potentially higher deduction to owners of pass-through entities.

However, there are limitations. The deduction applies to all pass-through entities except certain "large" service businesses such as law, health care, accounting, consulting, etc. These service businesses are subject to a phase-out of the QBID if the shareholder at the individual level has income over a statutory threshold.

Important to the construction industry is that architectural and engineering-related businesses are exempt from this specific definition of service businesses.

The new QBID permits certain shareholders (and LLC members) to deduct 20% of their pass-through income if they meet certain requirements. Similar to the DPAD, the main hurdle is meeting a 50% wage threshold. Fortunately, for more than 10 years, most contractors, architects, and engineers have secured a deduction under the previous DPAD rules with the expectation that they will also be able to obtain a full QBID.

When determining whether to conduct a business as an S or C corporation, it is important to consider whether the business qualifies for the new QBID and under which tax bracket potential pass-through income would fall.

Let's walk through two general scenarios (with three cases) to evaluate the effective tax rates for S and C corporations.

Scenario 1

Scenario 1 assumes $1 million net income using the highest federal tax rates and a reasonable salary (10% of net income) to the sole shareholder, with three cases for S corporations as shown in Exhibit 1A at right:

- **Case 1:** S corporation with 20% QBID; total business W-2 wages of $500,000
- **Case 2:** S corporation with 20% QBID is limited by the 50% wage threshold requirement; total business W-2 wages of $250,000

- **Case 3:** S corporation with zero 20% QBID; it is assumed that this service business' shareholder has exceeded the phase-out income threshold

Case 1 depicts the effective tax rate for a business owner who qualifies for the new 20% QBID, where 50% of W-2 wages is above the deduction amount.

The net income of $1 million is reduced for owner compensation of $100,000, leaving $900,000 of pass-through income before the new QBID. The 20% QBID is compared to 50% of the total W-2 wages (this includes the shareholder's W-2 wages) and this hurdle is easily passed in Case 1 (50% times $500,000 is $250,000, which is greater than the tentative QBID of $180,000). Thus, the QBID is $180,000, and the "net" pass-through income is $720,000.

Assuming the taxpayer is in the highest bracket (and the other QBID hurdles at the shareholder level are met), the "net" pass-through income is taxed at 37%, which is $266,400. Solely for analysis purposes, add $37,000 of tax on the W-2 wages to the shareholder (37% times $100,000) for a total tax of $303,400 ($266,400 tax on pass-through income plus $37,000 tax on the W-2 income).

For comparison purposes, compute two effective tax rates. First, based on the total income before shareholder compensation, there was $1 million in income for which an estimated total tax of $303,400 is computed. The effective rate is 30.34% ($303,400 divided by $1 million). Secondly, based on the pass-through income of $900,000 the effective rate is 29.6% ($266,400 divided by $900,000).

The first effective rate is useful in comparing to prior year effective rates because generally, all pass-through income and Form W-2 income was taxed at the same marginal rates. The latter effective rate is more useful in comparing C vs. S corporations, as this is a function of the entity's net pass-through income.

In Case 2, the same business has its QBID limited because 50% of W-2 wages ($125,000) is lower than 20% of net income ($180,000). Notice the slight increments to the effective rates.

Case 3 is a non-architectural/engineering service business with an owner above the income threshold. As a result, Case 3 has the highest effective tax rate because the new QBID is completely eliminated.

"Net" Pass-Through

It is important to note that the previously mentioned "net" pass-through taxable income refers to the shareholder's pass-through income on his personal return. The QBID is taken at the individual S corp shareholder level, not the entity level, and does not affect the individual taxpayer's adjusted gross income (AGI).[10]

EXHIBIT 1A: **Scenario 1 – S Corporation**

	CASE 1	CASE 2	CASE 3
Net Income Before Salary	1,000,000	1,000,000	1,000,000
Shareholder Salary	(100,000)	(100,000)	(100,000)
Net Income	900,000	900,000	900,000
20% Deduction	(180,000)	(125,000)	-
"Net" Pass-through Taxable Income	720,000	775,000	900,000
Highest Federal Individual Tax Rate	37%	37%	37%
Federal Tax on "Net" Pass-Through Income	266,400	286,750	333,000
Plus – Federal Tax on Salary ($100,000 x .37)	37,000	37,000	37,000
Total Federal Tax	303,400	323,750	370,000
Divide by Total Income	1,000,000	1,000,000	1,000,000
Effective Tax Rate	30.34%	32.38%	37.00%
Divide by Income After Owner's Comp	900,000	900,000	900,000
Effective Tax Rate	29.60%	31.86%	37.00%

This process is similar to the previous DPAD in that the resulting deduction is quantified and reported on the taxpayer's individual return. While the DPAD lowered AGI, the QBID will not. This is noteworthy because there are several other deductions and credits affected and measured by the AGI.

So, the effect is to keep the AGI elevated rather than diminished by the QBID. As noted previously, there are several hurdles for which the QBID may be limited. Next, consider three cases for C corporations as shown in Exhibit 1B below:

- **Case 1:** C corporation with all cash distributed via dividend
- **Case 2:** C corporation with half cash distributed via dividend
- **Case 3:** C corporation with no cash distributed via dividend

In Case 1, the $900,000 net income (after shareholder W-2) is taxed at a flat 21% for $189,000 in federal corporate income tax. The residual after-tax earnings of the entity can be distributed via dividend with a 20% assumed dividend rate (depending on total income at the shareholder-individual level, it could be lower or even higher). There is $142,200 of tax at the individual shareholder level. The total tax is $368,000 when considering the tax on the W-2 ($189,000 plus $142,200 plus $37,000).

This total tax is compared to the $1 million in total income for an effective tax rate of 36.82%, which is higher than the S corporation's 30.34% as previously computed.

Next, we compute the effective tax rate without the W-2. Here, the total tax of $331,200 ($189,000 corporate tax plus $142,200 tax on dividends) is divided by 900,000 for an effective rate of 36.8%. This is compared to the 29.6% effective tax rate for the S corporation.

Case 2 reflects the same results but the entity decides to distribute as taxable dividends only 50% of the after-tax earnings thereby delaying a portion of the tax in Case 1. Accordingly, the effective rates drop.

EXHIBIT 1B: **Scenario 1– C Corporation**

	CASE 1	CASE 2	CASE 3
Net Income Before Salary	1,000,000	1,000,000	1,000,000
Salary	(100,000)	(100,000)	(100,000)
Net Income	900,000	900,000	900,000
Corporate Flat Tax Rate	21%	21%	21%
Corporate Tax	189,000	189,000	189,000
Net Income	900,000	900,000	900,000
Minus – Corporate Taxes Owed	(189,000)	(189,000)	(189,000)
Cash Available to Distribute	711,000	711,000	711,000
Cash Distributed	711,000	355,500	-
Maximum Dividend Tax Rate	20%	20%	20%
Tax on Dividends	142,200	71,100	-
Plus – Federal Tax on Salary ($1000,000 x .37)	37,000	37,000	37,000
Plus – Corporate Tax	189,000	189,000	189,000
Total Federal Tax	368,200	297,100	226,000
Divide by Total Income	1,000,000	1,000,000	1,000,000
Effective Tax Rate	**36.82%**	**29.71%**	**22.60%**
Divide by Income After Owner's Comp	900,000	900,000	900,000
Effective Tax Rate	**36.80%**	**28.90%**	**21.00%**

Case 3 reflects zero dividends and again, the effective rate drops. The tax at the individual level is deferred until the dividends are paid. The result here is the flat tax rate of 21%.

With the same assumed economic results, these computations appear to reflect that the effective rate is significantly different depending on how much in dividends are paid from the C corporation's after-tax earnings.

Scenario 2

Scenario 2 assumptions are intended to measure a lower level of total income. Here we construe $600,000 net income using the highest federal tax rate and a reasonable salary to sole shareholder of $100,000. All income is again assumed to qualify for the new 20% QBID. The issue is whether smaller net income affects the computed effective tax rates.

Exhibit 2A below considers three cases for S corporations:

- **Case 1:** S corporation with 20% QBID; total business W-2 wages of $500,000
- **Case 2:** S corporation with 20% QBID is limited by the 50% wage threshold requirement; total business W-2 wages of $250,000
- **Case 3:** S corporation with zero 20% QBID; this is assumed to be a service business past phase-out threshold of $415,000

If we compare the effective tax rates, we can see that having a lower amount of net income does not change the effective rates very much. As long as the "QBID" is not limited, the effective rate remains similar at 29.6% for both income levels of $1 million and $600,000. This of course assumes the highest marginal individual tax rates apply.

Consider three cases for C corporations as shown in Exhibit 2B on the next page:

- **Case 1:** C corporation with 100% of after-tax earnings distributed via dividend
- **Case 2:** C corporation with 50% of after-tax earnings distributed via dividend
- **Case 3:** C corporation with zero after-tax earnings distributed via dividend

As we initially consider the new tax rates, it appears that C corporations have lower effective tax rates on average than S corporations. This is especially the case as C corporation effective rates do not change based on C corporation net income because of the new flat rate.

However, when analyzed further, S corporations are still predominantly taxed less than C corporations in most situations. This can be seen in Exhibits 1B and 2B, where Cases 2 and 3 for C corporations assume a half or no dividend distribution to the owner. These cases do not avoid tax.

EXHIBIT 2A: **Scenario 2 – S Corporation**

	CASE 1	CASE 2	CASE 3
Net Income Before Salary	600,000	600,000	600,000
Shareholder Salary	(100,000)	(100,000)	(100,000)
Net Income	500,000	500,000	500,000
20% Deduction	(100,000)	(75,000)	-
"Net" Pass-through Taxable Income	400,000	425,000	500,000
Highest Federal Individual Tax Rate	37%	37%	37%
Federal Tax on "Net" Pass-Through Income	148,000	157,250	185,000
Plus – Federal Tax on Salary ($1000,000 x .37)	37,000	37,000	37,000
Total Federal Tax	185,000	194,250	222,000
Divide by Total Income	600,000	600,000	600,000
Effective Tax Rate	**30.83%**	**32.38%**	**37.00%**
Divide by Income After Owner's Comp	500,000	500,000	500,000
Effective Tax Rate	**29.60%**	**31.45%**	**37.00%**

Instead, tax is deferred to future years in which those undistributed dividends are paid and taxed at the shareholder level. The result is an effective tax rate that is higher in later years, reversing the lower effective tax rates. But, this deferral comes with a certain level of audit risk and does not necessarily force the conclusion that switching an S corporation to a C corporation is the best course of action.

Ancillary Issues

These scenarios are not all-encompassing and do not factor in additional variables that CFMs will need to consider. For example, the benefits of the Dividends Received Deduction[11] and the potential impact of the AMT for small businesses may need further scrutiny.

In addition, not all taxpayers will always fall into the highest marginal tax brackets in all years. Likewise, in certain years, the tax rate at which dividends are taxed could be less than 20% depending on the situation of the respective individual taxpayer.[12]

Or, if the dividends represent investment rather than business income, the dividends may be subject to the investment income surtax of 3.8%[13] further elevating the computed effective tax rate of doing business as a C corporation.

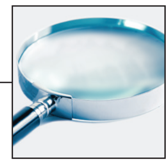
State Taxes

A significant assumption is that these scenarios do not address state and local income taxes, which will certainly have an impact on the computed effective tax rates. The scenarios previously mentioned would need to be modified to address businesses operating in states that impose state corporate and/or individual taxes.

For example, there is no personal income tax in Florida, but a corporate income tax does apply. The state corporate income tax would elevate the effective tax rate for many Florida C corporations thereby increasing the disparity of the effective tax rates between C and S corporations under various circumstances (i.e., Case 1, where 100% of the after-tax earnings is distributed via taxable dividends).

EXHIBIT 2B: **Scenario 2 – C Corporation**

	CASE 1	CASE 2	CASE 3
Net Income Before Salary	600,000	600,000	600,000
Salary	(100,000)	(100,000)	(100,000)
Net Income	500,000	500,000	500,000
Corporate Flat Tax Rate	21%	21%	21%
Corporate Tax	105,000	105,000	105,000
Net Income	500,000	500,000	500,000
Minus – Corporate Taxes Owed	(105,000)	(105,000)	(105,000)
Cash Available to Distribute	395,000	395,000	395,000
Cash Distributed	395,000	197,500	-
Maximum Dividend Tax Rate	20%	20%	20%
Tax on Dividends	79,000	39,500	-
Plus – Federal Tax on Salary ($1000,000 x .37)	37,000	37,000	37,000
Plus – Corporate Tax	105,000	105,000	105,000
Total Federal Tax	221,000	181,500	142,000
Divide by Total Income	600,000	600,000	600,000
Effective Tax Rate	**36.83%**	**30.25%**	**23.67%**
Divide by Income After Owner's Comp	500,000	500,000	500,000
Effective Tax Rate	**36.80%**	**28.90%**	**21.00%**



Not Paying Dividends

While it may appear that these scenarios suggest that delaying payment of dividends by a C corporation is without tax risk, it is not.

C corporations are not permitted to accumulate unlimited amounts of after-tax earnings in the form of liquid assets and not distribute dividends to its shareholders. C corporations can face a 20% penalty tax under the "accumulated earnings tax," which is imposed on the corporation's "accumulated taxable income" for the year.[14] This is what could occur upon audit, unless the accumulation is related to a reasonable business need.[15]

Contractors have argued in previous court cases[16] that a reasonable business need for the accumulated earnings is the requisite capital requirements to maintain their respective surety program. While not always successful, many contractors have successfully established business needs to accumulate liquid assets for surety and other purposes during audits, appeals, and in Tax Court.

A Second Entity

In certain situations, it may be advisable to establish a new C corporation (a second operating entity) to take advantage of the new lower flat corporate tax rate. For example, the new C corporation entity could perform a certain type of work and then pay fees (lowering taxable income) to the existing S corporation operating entity (or vice versa). The idea is that the taxpayer will manage the net income levels and after-tax earnings maintained in the new C corporation.

With planning and management of the net income levels and accumulation of equity, a portion of the total federal (and possibly state) income taxes may be properly deferred until the C corporation dividends are distributed. IRS upon audit could argue whether there is any economic substance for the intercompany transfers.

Summary

Depending on the specific fact pattern, the TCJA adjusts the gap in effective tax rates between S and C corporations and re-opens the debate of choice of entity. As we explore the various scenarios and cases included here, we find that S corporations that can take advantage of the new 20% QBID are taxed at a lower overall effective tax rate, notwithstanding the ability of C corporations to delay dividend payments.

Accordingly, a rush to convert from S corporation to C corporation status solely for tax reduction purposes is not anticipated. Depending on the taxpayer's specific situation, it may be beneficial to add a new operating C corporation to the contractor's group of operating entities to defer a portion of the requisite income taxes. In consultation with their tax advisors, CFMs should carefully analyze their situation and consider all applicable scenarios. ■

Endnotes

1. P.L. 115-97 *Tax Cuts and Jobs Act* signed into law on December 22, 2017; *www.congress.gov/bill/115th-congress/house-bill/1/text.*
2. IRC §11; Reg §1.61-9; *The Tax Reform Act of 1986* repealed the General Utilities Doctrine (General Utilities Co. v. Helvering, 296 U.S. 200 (1935)), which enabled corporations to distribute appreciated assets tax-free. After this repeal, S corporations with their single-level tax became ubiquitous in order for shareholders to face only one level of tax.
3. IRC §1l(b), as amended by *Tax Cuts and Jobs Act* §13001(a).
4. IRC §1(j), as amended by *Tax Cuts and Jobs Act* §11001(a).
5. RC §55, as amended by *Tax Cuts and Jobs Act* §12001(b)(6).
6. IRC §53.
7. IRC §55(d)(4)(A) Individual exemption for AMT temporarily increased for tax years beginning after December 31, 2017.
8. IRC §199A.
9. *Tax Cuts and Jobs Act* §13305(a) repealed DPAD (§199) for tax years beginning after December 31, 2017.
10. IRC §199A(e)(2) Phase-out of "QBID" for service businesses begins at $315,000 (MFJ) and under 199A(d)(3)(B) completely phases out for income above $415,000.
11. IRC §243 a percentage of certain domestic dividends received by a corporation are excluded to mitigate dividend income being taxed at multiple levels of taxation.
12. IRC §l(h)(1), capital gains rates brackets of 0%, 15%, and 20% are set as statutory dollar thresholds that are adjusted for inflation.
13. IRC §1411(a)(1).
14. IRC §531.
15. IRC §535(c)(1).
16. For example, see: Peterson Brothers Steel Erection Co., TC Memo 1988-381.

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