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Choosing the Right Business Entity

C Corporations and Pass-Through Entities Yield Different Tax Consequences

From a tax perspective, pass-through structures — such as limited liability companies (LLCs), S corporations and partnerships — have historically been a good choice when selecting a business entity. However, increases in individual income tax rates have made the decision whether to convert to a C corporation a closer call. And if lawmakers reduce the federal corporate tax rate, C corporations may become more attractive.

Making the right entity choice in today's tax environment

Is it time to convert your business into a C corporation? For most companies, the answer probably is "no" or "not yet." However, it it's a good idea to evaluate the impact of higher individual rates on your tax-planning strategies. And if lawmakers reduce the federal corporate tax rate, C corporations may become more attractive.

Higher taxes on individuals

This year, several tax law changes take effect that increase tax rates for individuals — and thus for owners of pass-through entities:

- The top marginal income tax rate increased from 35% to 39.6% for single filers with taxable income exceeding $400,000 ($450,000 for joint filers).
- The top tax rate for long-term capital gains and qualified dividends increased from 15% to 20% for taxpayers in the 39.6% bracket.
- An additional 0.9% Medicare tax now applies to FICA wages and self-employment income in excess of $200,000 ($250,000 for joint filers).
- A new 3.8% Medicare tax applies to net investment income — including dividends, net capital gains and passive business investments — to the extent a taxpayer's modified adjusted gross income exceeds $200,000 ($250,000 for joint filers).

There are also several "stealth taxes," such as itemized deduction reductions and personal exemption phaseouts for higher-income taxpayers, that may increase your effective income tax rate.

C corporation vs. pass-through

Owners of pass-through entities are taxed at individual income tax rates on their share of the company's current income, whether it's distributed or not. Now, for the first time in many years, the top individual tax rate is higher than the top corporate rate of 35%. At first blush, this may seem to give C corporations an advantage. But keep in mind that C corporations that distribute their earnings to shareholders or sell their assets are subject to double taxation.

Corporate income or sale proceeds are taxed twice: once when they're received by the corporation, potentially at a top marginal rate of 35%, and again when they're distributed to shareholders in the form of dividends, at a rate potentially as high as 23.8% (the 20% capital gains rate plus the aforementioned 3.8% net investment income tax (NIIT), which applies to C corporation dividends). This means that the maximum combined corporate and individual tax rate on corporate earnings is 50.47%.

For instance, on $100,000 of income taxed at the highest rate, the C corporation would pay $35,000, leaving $65,000 to be distributed as dividends to the individual. Presuming that this $65,000 is taxed at the highest rate of 23.8%, the tax would be $15,470, for a total combined tax of $50,470 or 50.47%. This example excludes the impact of state income tax.

So, for now, double taxation continues to place most C corporations at a disadvantage — at least in terms of tax efficiency — in comparison to pass-through entities. This may change, however, if Congress reduces the corporate tax rate.

For example, if the top corporate rate drops to 25%, as some members of Congress have proposed, the maximum combined corporate and individual tax rate would be 42.85%. This rate compares more favorably to the top individual rate, particularly when you take into account a C corporation's ability to defer taxes by retaining earnings rather than distributing them as dividends. (However, keep in mind that, if a corporation's retained earnings reach a certain level, they may be subject to the accumulated earnings tax.)

The S corporation advantage

In the current tax climate, S corporations may have some unique advantages, particularly for shareholders who are active in their businesses. Shareholder-employees of S corporations are subject to payroll taxes on their wages, but so long as their compensation is reasonable, they're not subject to self-employment taxes (Social Security and Medicare) on their share of the corporation's income or on any distributions they receive.

At the same time, S corporation shareholders who "materially participate" in the business avoid the 3.8% Medicare tax on net investment income on their nonwage income (subject to certain limitations discussed below). This means that S corporations that minimize wages paid to shareholder-employees and maximize nonwage income (while ensuring that salaries aren't unreasonably low) can minimize payroll taxes while avoiding *both* this net investment income tax (NIIT) and self-employment taxes on nonwage income.

Caution — even if you're actively involved in the business, the NIIT would — absent special circumstances — apply to S corporation earnings in the form of investment income such as interest, dividends and capital gains.

While active LLC members — and, in some cases, limited partners — may be able to avoid NIIT on their shares of the entity's income, their material participation in the business will likely trigger self-employment taxes.

Review your entity choice

Choosing the right entity type requires a multilayer analysis involving a variety of business, financial, liability and tax considerations. We recommend conducting a review of your entity choice periodically to assure that it is still a good fit in light of changing business circumstances and evolving tax laws.

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If you have any questions, please feel free to contact your Seiler professional at (650) 365-4646 or email info@seiler.com. We would be happy to discuss appropriate courses of action for your particular circumstance.

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