PEASE & ASSOCIATES, CPAs

TAX TALK

TO C OR NOT TO C – SHOULD YOU BE A C-CORPORATION?

PROFIT MAKING BUSINESS?

NO → Form as LLC and pass losses to owner. When business becomes profitable, reassess C-corporation

YES ↓

Can the owners leave significant amounts of profit in the corporation every year for at least 5 years?

NO → Use an LLC or S-corporation for single level tax and possible 20% business deduction.

If you were a C-corporation, then Corp would pay 21% and you would pay a second tax when taking out the money. After paying this double tax, your total tax bill over all the years will be roughly 38%.

If Congress restores the corporate tax rate to its historic rate of 34%, your total tax bill will be 49%.

YES ↓

Business will have < $50 million of assets, not perform prohibited services[1], no ownership changes anticipated?

NO → (see above)

YES ↓

CORPORATION IS A 1202 CORP
You should be a C-corporation

THEN ↓

Form new C-corporation and drop business into new C-corporation → THEN → C-corporation pays 21% Federal Income Tax → THEN → After 5 years, liquidate corporation and take out all the money with no added tax imposed on liquidation → THEN → **Your Total Tax Bill over all the years is 21%**

Individual Federal income tax rate can be as high as 37%.

The 20% Qualified Business Income Deduction MIGHT reduce the individual income tax rate on your business income to 29.6%.

For C-corporations, currently the income tax rate is 21%.

In general, when the C-corporation distributes profit to its owners, the owners must pay a second income tax on the money received. Avoiding the second tax is critical.

If a C-corporation qualifies as a 1202 Corp, then the owner does NOT pay the second tax when the corporation is liquidated.

If your business is an existing S-corporation or is an LLC with appreciated assets (including goodwill), some additional steps are necessary.

[1]Prohibited Services are professional services including legal, accounting, medical, architectural, financial services, athletes, consulting, and others.

Important: See notes on 2nd page.

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There are many caveats and many additional considerations. This is a simplified version of the analysis which should be correct in most cases.

Being a C-Corporation only works if the current law is not changed. The tax rate for C-corporations was decreased from 34% to 21% at the end of 2017. This is the lowest tax rate ever on C-corporations. Political uncertainty should make one cautious about having a C-corporation as a long term plan. A change in approach in Washington D.C. could lead to the corporate tax rate being increased back to its historic levels. The 5-year holding period till liquidation for 1202 stock could well be the sweet spot as the liquidation would occur shortly after the next presidential election. If rates are increased, the higher rates would not apply for long before the 5-year liquidation opportunity arises.

The analysis needs to be done on a case-by-case basis and is very fact specific. A few examples:

1. If someone dies owning an LLC, the LLC is allowed to increase its income tax basis in its assets to what they are worth at the time of death. This eliminates the income tax. However, if the business is owned in a C-corporation, there is no step up of asset basis and there is no escaping the tax. An older or sick taxpayer needs to consider this.

2. If you are contributing appreciated assets to a 1202 corporation, to the extent of the appreciation at the time of contribution, the individual must pay tax on that much of the gain at liquidation. This includes goodwill as a potentially appreciated asset. You could actually increase your tax bill if this is done incorrectly.

3. If noncash assets appreciate in the 1202 corporation prior to liquidation, the corporation has to pay income tax on that appreciation at the time of liquidation.

Items 2 and 3 are manageable with appropriate foresight and planning.

The examples only deal with Federal taxes. Each state and even some cities have their own rules in regards to taxing a corporation as well as whether they tax the liquidation of a 1202 corporation. This state and local tax issue must be considered as well.

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