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2018 Federal Tax Reform: Rethinking Business Structure

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The recently signed Federal tax bill contains big changes to the taxation of business entities.

2017 Tax Law:
$1,000 of corporate income taxed at 35 percent, leaving $650. Dividend of $650 to shareholder taxed at 20 percent, leaving $520.

2018 Tax Law:
$1,000 of corporate income taxed at 21 percent, leaving $790. Dividend of $790 to shareholder taxed at 20 percent, leaving $632.

The new tax law reduces the tax rates of most C-corporations. However, there will be a rate increase from 15 to 21 percent for a large number of corporations that were used to paying only 15 percent on income up to $50,000 of earnings each year.

The new law also provides a twenty-percent business income deduction for pass-through entities (sole proprietorships, partnerships, limited liability companies, and S-corporations) that meet certain criteria.

Individual tax rates are also reduced by 2.96 percent, with the top rate now being 37 percent.

Notes :

A: 0% capital gains applies to income of less than $38,600 (single) or $77,200 (married-jointly)
B: 15% capital gains applies to income between $38,600 to $239,500 (single) and $77,200 to $479,000 (married-jointly)
C: 3.8% net investment income tax applies to investment income (including capital gains) above $200,000 (single) or $250,000 (married-joint)

C-Corporations

Under the new law, C-corporations are taxed at a flat 21 percent. This will be a significant reduction for corporations with significant taxable income each year; as they currently pay a rate of 35 percent. However, there will be a rate increase from 15 to 21 percent for a large number of corporations that were used to paying only 15 percent on income up to $50,000 of earnings each year. That is an extra $3,000 of tax each year that these corporations will have to pay. It does not stop there. C-corporations are subject to double taxation which occurs when the corporation dividends its income out to shareholders who must include those dividends in their income. The rates on dividends vary from 0 percent (total taxable income of less than $9,325) to 20 percent (total taxable income of more than $418,400).

Thus, the combined tax rate applicable to a C-corporation shareholder prior to 2018 assuming a 35 percent corporate tax rate and 20 percent dividend tax rate was 48 percent. Under the new tax bill starting in 2018, the combined tax rate, assuming a 21 percent tax rate and 20 percent dividend tax rate, will be 36.8 percent.

Pass-Through Entities

Pass-through entities are not subject to double taxation. As the name suggests, income is passed through to the business owner. Thus, for example, if the business owner were in the 33 percent income tax bracket, the business owner's share of the business income would be taxed at 33 percent.

2017 & 2018 Federal Individual Tax Rate Comparison

2017 Single	2017 Married-Joint	2017 Ordinary Rate	2017 Capital Gains Rate	Notes
0 - $9,325	$0 - 18,650	10%	0%	
$9,325 - $37,950	$18,650 - $75,900	15%	0%	
$37,950 - $91,900	$75,900 - $153,100	25%	15%	
$91,900 - $191,650	$153,100 - $233,350	28%	15%	
$191,650 - $416,700	$233,350 - $416,700	33%	15%	C
$416,700 - $418,400	$416,700 - $470,700	35%	15%	C
$418,400+	$470,700+	39.6%	20%	C

2018 Single	2018 Married-Joint	2018 Ordinary Rate	2018 Capital Gains Rate	Notes
$0 - 9,525	$0 - 19,050	10%	0%	
$9,525 - $38,700	$19,050 - $77,400	12%	0%/15%	A
$38,700 - $82,500	$77,400 - $165,000	22%	15%	
$82,500 - $157,500	$165,000 - $315,000	24%	15%	C
$157,500 - $200,000	$315,000 - $400,000	32%	15%	C
$200,000 - $500,000	$400,000 - $600,000	35%	15%/20%	B&C
$500,000+	$600,000+	37%	20%	C

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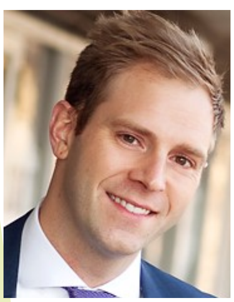
Now, the maximum combined C-corporation rate of 36.8 percent could be less than the top individual and pass-through rate of 37 percent.

These changes are significant enough that it is wise to rethink your business structure and consider whether a change to a pass-through entity or a C-corporation, as the case may be, may result in tax benefits.

The State and Local Tax attorneys at Dickinson Law can help you make sense of these changes and make sure your business is set up to for success under the new Federal Tax Law.

Contact the authors with additional questions.



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Under the new Federal tax law, individual tax rates are reduced by 2.96 percent, with the top rate now being 37 percent; therefore, the tax rates for pass-through entities are also reduced. In addition to the reduction in individual rates, **the new tax law provides for a 20-percent business income tax deduction for pass-through entities meeting certain criteria.** This deduction applies to all pass-through entities where the business owner(s) each earn less than $157,500 individually, or $315,000 filing jointly. Certain professional service business owners, such as lawyers, doctors, and accountants see a phase out of this deduction as their income reaches $207,500 individually or $415,000 filing jointly. Other types of businesses exceeding the $157,500 or $315,000 threshold are subject to different limitations on the deduction.

Business Structure Considerations:

Historically, the maximum 48 percent combined C-corporation rate exceeded the top individual rate, 39.6 percent, and was the reason many businesses organized as pass-through entities, such as S-corporations, limited liability companies, or partnerships. However, starting in 2018, the maximum combined C-corporation rate is 36.8 percent which could be less than the top individual and pass-through rate of 37 percent. Complicating this analysis is the business income deduction available to certain pass-through entities which allows pass-through entities to deduct 20 percent of their pass-through business income. Thus, the decision to organize as a C-corporation or pass-through is less clear.

If a business is in a high-growth stage generating significant income that is reinvested in the business rather than distributed to shareholders, it is likely more beneficial in the short term to be a C-corporation since the income will be taxed at a maximum 21 percent rate, keeping in mind that the retained earnings may later be taxed when distributed to shareholders.

However, if the business is mature and makes distributions to business owners, rather than reinvesting in the business, it is likely beneficial to be treated as a pass-through entity, such as an S-corporation, especially if the business owners can take advantage of the 20 percent business income deduction.

There are many other issues that arise when restructuring a business, such as S-corporation election or revocation issues and employment tax, to name a few. Before restructuring your business, you should consider all aspects of the restructuring and such consideration should not be limited to the issues analyzed herein.

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The above analysis is based on the statutes as of this date of this paper. As of the date of this paper, the IRS has not promulgated regulations or provided informal guidance interpreting the laws discussed herein. Accordingly, these matters are not free from doubt and our analysis is not binding on the IRS. We do, however, expect the IRS to provide guidance in the future. Therefore, due to the evolving nature of the Federal tax law changes, we suggest you regularly contact your tax advisor to discuss the effects of such changes on your business.