



Tax reform and entity conversion
Moving beyond basic math

June 2018



Executive summary

The 2017 Tax Act¹ posed a pivotal dilemma to private business owners about the way their businesses are structured for tax purposes. While the Act offered a combination of tax-rate reductions and various tax breaks for C corporations and certain owners of certain pass-through entities, lack of clarity in the new law leaves many pass-through owners struggling to understand whether they will qualify for such tax-rate reductions and also whether it makes sense to retain pass-through status. Some pass-through entities have performed modeling to help decide between staying as currently structured or converting to a C corporation. This is a much bigger decision, one that should consider the strategy and the future of the business, with ripple effects that can reach far and wide. Given the complexity of tax law, the devil is in the details. There are few businesses that can afford not to see how they would fare under such a conversion, and those who are looking out for the best interests of a pass-through entity, its owners, and its future owners have a fiduciary responsibility to properly vet the matter.

No easy answers

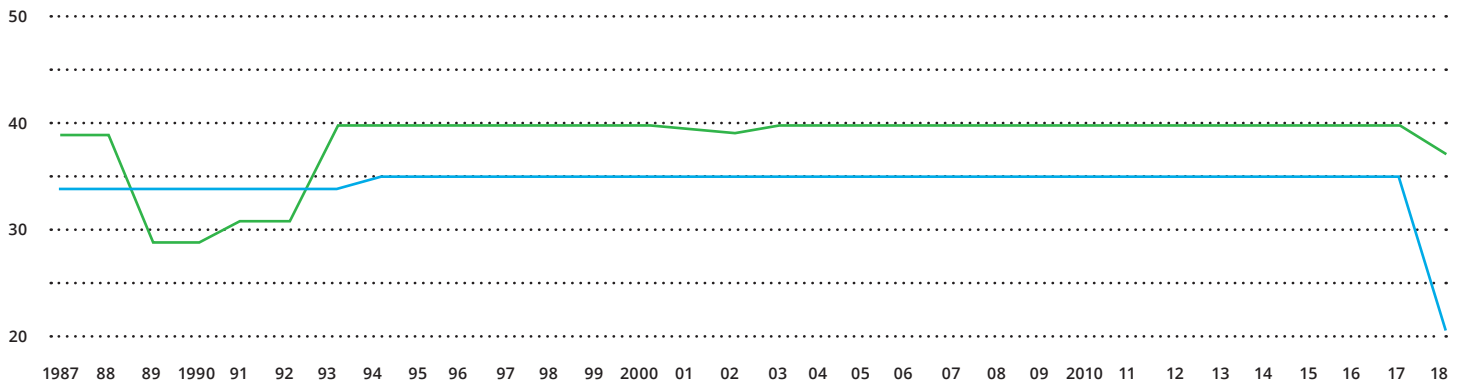
When the Act was passed last December, it was the first major change in the tax code since 1986. In addition to lowering the C corporation federal tax rate to 21 percent, it also introduced advantages to certain individual and trust owners of pass-through entities through a special 20 percent pass-through deduction. However, many business owners will not qualify for the full 20 percent deduction. In addition, a new cap on state income tax deductions at the individual level (\$10,000) may cause state income taxes generated from ownership in a pass-through entity to become 37 percent more expensive because of the limited or lost deductions. In concert, these changes left many pass-through entities wondering whether now is the time to convert to a C corporation given the reduced corporate income tax rate.

This might seem like a problem solved with basic math. Understanding the rate differential and the detrimental impact of limited state income tax deductions by individual shareholders may be easily quantifiable. The corporate tax rate is 21 percent. If the owner qualifies for a full 20 percent pass-through deduction, his effective rate is 29.6 percent. With no deduction, his rate is 37 percent. The new \$10,000 cap on deductions for state income, sales, and property taxes means that many individuals will no longer receive a federal benefit for state taxes paid as a result of their allocable share of pass-through income. State taxes remain deductible by C corporations. Thus, the analysis would appear to be straightforward—claiming the C corporation saves at least 8.6 percent annually, plus any amounts saved by having deductible state income taxes.

The impact of the 20 percent pass-through deduction is a critical component in the comparison to corporate form. Determining whether a business qualifies for the pass-through deduction may not be a simple task, in large part due to uncertainties created by the new law. For example, the pass-through deduction is limited to income that is effectively connected to a US trade or business. It also expressly excludes a number of businesses including those in the fields of health, law, accounting, investment management, and consulting. And it doesn't stop there—the list of businesses that do not qualify is expanded to include any company whose “principal asset” is the “reputation or skill” of one or more of its employees or owners. To date, there has been limited guidance about what defines these terms. Even for businesses whose activity qualifies, the deduction is limited to various wage and asset basis hurdles. Once a pass-through is comfortable with the amount of qualifying business income available for the deduction, it must then determine whether each state conforms or decouples from the deduction. This may not be a quick analysis.

US Federal tax rates²

- Top individual rate
- Top corporate rate



The 2017 Tax Act created a wide gap between corporate and individual tax rates. Many private business owners are now questioning whether it makes sense to retain pass-through status.



Qualitative considerations

This level of complexity is a new challenge for many business owners. Regardless of whether a conversion to a C corporation would deliver a tax benefit in the near term, does it meet the strategic and economic goals of the business and its owners—both now and into the future?

The new law can serve as a catalyst for owners to engage in a series of fundamental conversations about the structure, strategy, and future of their business. The choice owners make now about whether to convert or stay as a pass-through entity will cascade through the business and may affect its future direction.

Understanding how to proceed with considering a conversion from pass-through to a C corporation starts with knowing how the business is being taxed now, how its owners are being taxed at an individual level, understanding how the business accrues value, and projecting its ultimate exit strategy. And that means asking a series of foundational and qualitative questions, including but not limited to:

Do you plan to retain earnings for future investment in the business?

Many might find the choice of whether or not to convert to a C corporation or stay a pass-through entity to be a fairly straightforward calculation. If 100 percent of the business income is retained, the annual federal effective tax rate on the C corporation drops all the way to 21 percent, while the pass-through entity's rate is still 29.6 percent.³ Thus, the initial calculation will favor C corporation status.

However, this analysis changes as one considers an individual owner's desire for access to cash. A dollar earned and distributed by a pass-through entity that qualifies for the full pass-through deduction remains taxed at a top federal marginal rate of 29.6 percent, while a dollar earned and distributed by a C corporation will be taxed at an effective rate of 36.8 percent (first at the corporate level at 21 percent and then again as a dividend at 20 percent). Thus, the desire for access to cash will have a dramatic impact on the choice between pass-through vs. C corporation.

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What is the business's growth trajectory?

If the business is expected to grow meaningfully, the return on investment of retained earnings could be considerably greater than the value of distributions taken from the business, on an after-tax basis. Consider that the historical average return of funds invested in the S&P is 10 percent.⁴ If the company is able to grow at a rate of 15 percent from the investment of its retained earnings into the operations of the business, its overall revenue could double in approximately two-thirds the time, compared to having been distributed to the owners and invested in the S&P at the 10 percent rate.

When it is sold, the value of the business would have risen far more than the total of after-tax cash received and invested by the owners had they taken earnings out of the business. But if the business owners are only focused on capturing the pass-through deduction, without factoring the value of reinvested earnings and their long-term goal of increasing the overall value of the business, they may not be able to see that a better option is available to them.

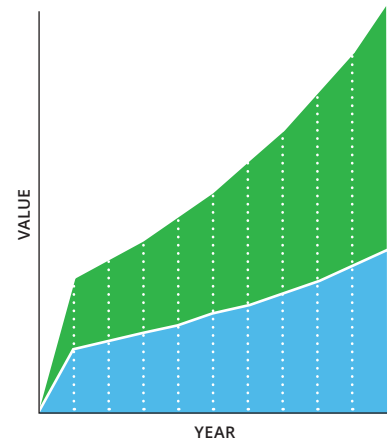
Is an exit from the business on the near-term horizon?

Even in the instance just described, a C corporation may not be the best approach if the owners plan to sell their business in the foreseeable future. Consider that buyers often seek to receive a step-up in the tax basis of the business assets they're acquiring. If assets are sold in a C corporation, the resulting gain is taxed at the corporate level and then again as the remaining proceeds are distributed to the selling shareholders. Conversely, a pass-through entity generally provides the flexibility for a buyer to purchase a business and step up the basis of the acquired assets without subjecting the seller to two layers of tax. This is also true if the seller is an S corporation that is not subject to the built-in gains tax.

Again, the key decider may be what the business owners are contemplating strategically, in the near term and the long term. The tax implications and related issues will differ greatly based on those strategic decisions.

What is the business's growth trajectory?

- 15% growth on retained earnings
- 10% return on S&P 500



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How do state and international income taxes affect the analysis?

Converting to a C corporation may impact how a business is taxed in various state jurisdictions as well as the taxability of its international operations. State taxes can have a significant impact on the analysis. The state corporate income tax rates can be significant (e.g., 12 percent in Iowa, 9.99 percent in Pennsylvania, 9.8 percent in Minnesota, 9.5 percent in Illinois, 9.4 percent in Alaska, 9 percent in New Jersey, and 8.84 percent in California). There are several states where the corporate tax rate is significantly higher than the individual tax rate (e.g., in Alaska there is a 9.4 percent difference and Pennsylvania, a 6.92 percent difference). Even with a potential federal income tax deduction for the corporate state income taxes, the state income taxes can affect the analysis. For example, consider a state with an individual state income tax rate of 5 percent and a corporate income tax rate of 8 percent. If all business activity is conducted in this state (i.e., no apportionment variables exist), the corporation would pay \$8 for every \$100 of profit. The federal income tax deduction is \$1.68 (at 21 percent federal rate) for a net cost of \$6.32. This is a significant increase over the \$5 state income tax on the individual owner of a pass-through entity.

A related consideration is the fact that most states allow resident individuals to claim a credit for taxes paid to other states on income coming from a pass-through entity. As a result, the analysis needs to address the state tax rules in the states where the business is operating and the state tax rules in the states where the owners live.

Numerous other state tax variables can also affect this analysis. Several states impose net worth taxes on corporations, but not on partnerships or limited liability companies. Several states also impose income taxes on pass-through entities. Consideration must also be given to differences between the corporate apportionment rules and the individual apportionment rules in various states, as well as differences in the computation of the tax base.

Moreover, the Act also had broad international tax implications. It moved the United States from a worldwide to a hybrid territorial tax system. Depending upon a company's tax structure outside of the United States, these changes may impact the US tax on non-US operations, and owners may need to consider changes to the tax and legal structure of their international operations.

What other non-income tax considerations could a conversion impact?

In addition to these issues, owners should also assess the implications of a conversion to a C corporation on any historical estate planning performed for the existing owners, as the new structure could require changes. One should assess whether the current estate planning structure requires some amount of annual distributions from the pass-through entity to execute its effectiveness. If the entity converted to a C corporation, would the additional tax burden from the annual dividends reduce the overall effectiveness of the historical planning efforts?

The technical capabilities of the existing internal tax department should also be considered, and whether it has the talent and technology to handle the new reporting requirements. Does the current tax department have the technical skills and technology necessary to prepare an annual provision for income taxes as well as to complete the corporate tax filing requirements? If not, what changes should be made and how much would this cost the organization?

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Conclusion

These are all questions that can ultimately be decided through a combination of thoughtful analysis. In isolation, the answers may argue for or against a conversion. But it would be highly unusual for one answer to one question to drive the ultimate conclusion. That is because the most important consideration is how the overall tax situation looks when you put all of these pieces together. Pass-through owners should account for the interaction between new rates, new deductions, the time-value of money and after-tax cash flow and cash available following sale, the effect of a multitude of state and international considerations, the impact to historical estate planning of the owners, and the capabilities of internal tax departments among other factors.

That's a task that high-level quantitative models can't meet in isolation. There's running the numbers and then there's running through a multitude of scenarios, all of which feed off each other and inform the way forward. With the right approach and support, analyzing a potential conversion doesn't have to be a painstaking process—but it should be a thorough one. It pays to know up front whether a conversion is right for your business, as well as what it's going to take internally to make the most of it. In most aspects of running a business, opportunity can quickly turn into regret if not approached carefully and diligently—and an entity conversion is no different.

Notes

- 1 An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.
- 2 Sources: Tax Foundation, Federal Corporate Income Tax Rates, Income Years 1909-2012; Tax Foundation, Federal Individual Income Tax Rates History, Nominal Dollars, Income Years 1913-2013; Trading Economics, United States Federal Corporate Tax Rate 1909-2018, Data.
- 3 This analysis is using federal income rates only. It does not include state tax rates nor taxes imposed for self-employment or net investment income.
- 4 Morningstar, Inc., "S&P 500 Index (SPX)," <http://quicktake.morningstar.com/index/IndexCharts.aspx?Symbol=SPX>.

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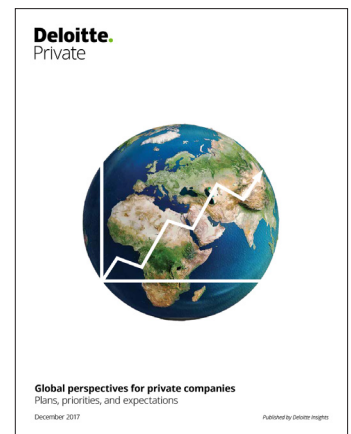
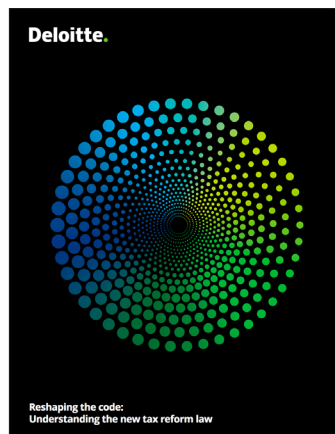
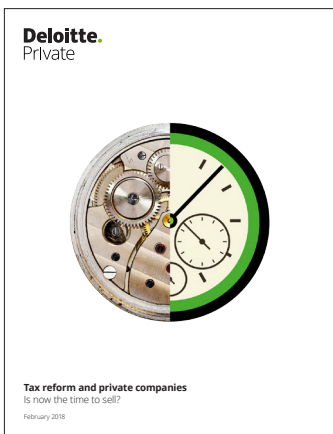
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Additional resources



Tax reform and private companies: Is now the time to sell?

<https://www2.deloitte.com/us/en/pages/deloitte-growth-enterprise-services/articles/private-company-tax-reform-implications.html>

Reshaping the code: Understanding the new tax reform law

<https://www2.deloitte.com/us/en/pages/tax/articles/understanding-the-tax-reform-law.html>

2018 essential tax and wealth planning guide

<https://www2.deloitte.com/us/en/pages/tax/articles/tax-and-wealth-planning-guide.html>

Global perspectives for private companies: Plans, priorities, and expectations

<https://www2.deloitte.com/insights/us/en/topics/strategy/global-business-survey-private-midsize-companies.html>

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