Printable Version - Tax Reform Impact - Should S Corps switch to a C Corp?

August 1, 2018

Should S Corporations Switch to C Corporations?

The impact of the Tax Reform on entity structure

Retaining the most money after taxes is one of the top concerns of any corporation. There are different corporation types, however, and the type of corporation you choose for your business can have a very significant impact on the amount of taxes that will apply to your particular business.

As part of the tax reform, corporate and individual tax rates were reduced. This left many company leaders questioning if they were registered as the most beneficial entity type for their unique situation.

Regular corporations (C-Corps) rates dropped from a top rate of 35% to a flat rate of 21%. However, C-Corps are still burdened by double taxation. The profits from this type of entity structure is hit with the 21% corporate tax, then shareholders pay tax on dividends that are distributed to them. Individuals with incomes over $425,800 for single filers and $479,000 for joint filers will pay a 23.8% tax on qualified dividends. This includes the 3.8% Medicare surtax on net investment income. People with incomes below these thresholds pay lower rates of 0%, 15% or 18.8% on their qualified dividends, depending on their taxable incomes.

Alternately, S Corporations (S-Corps) are passthrough entities. This means that income from the business is generally not taxed at a corporate level, instead being taxed at the shareholder level at their individual tax rate. The losses from S-Corps can also pass through to shareholders, with some limitations. Distributions are generally nontaxable to the extent of the stock basis of each shareholder. The tax reform also added a 20% deduction for pass-through income.

So for those corporations considering switching from an S-Corp to a C-Corp, there may be no truly compelling reason to change. An S-Corp owner in the 37% tax bracket, who has a 20% pass-through write-off is effectively lowering their tax rate on the S-Corp profits to 29.6%. However, the break is peppered with restrictions and limitations, such as its unobtainability for high wage earners in many service fields. It is also important to note that the 20% deduction is currently slated to end after 2025.

Additionally, C-Corps face a tax disadvantage when they are sold. Many buyers desire to purchase a corporation's assets, rather than buy their stock, allowing them to take greater amortization deductions and depreciation amounts. Two layers of taxation are drawn from the sale of a C-Corp's assets. Gains are taxed at the corporate level of 21%. When the aftertax proceeds are distributed to shareholders, they are taxed again at the individual level, up to 23.8%. Compare that to the asset sales of an S-Corp, where a general single level of taxation at the individual shareholder rates occurs. Every tax situation is unique. Contact your Faw Casson team to analyze how this, or any of the many other changes caused by the tax reform, may impact you.

Want to know more?
Your Faw Casson advisor is available to answer any questions or concerns you may have. Please don't hesitate to give us a call.

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