The decision about how to incorporate as a business and thus pay income tax—as a pass-through on owners’ personal returns or as a C corporation with a business return—has largely gone one way since the 1980s, generally favoring a pass-through structure. All things being equal, filing taxes once has beat filing twice, and by 2012, 90% of US businesses were pass-throughs, representing a mix of S corporations, Limited Liability Companies (LLCs), partnerships and sole proprietorships. Today, the decision on the optimal structure for a business isn’t quite as clear cut. Tax reform in 2017 complicated the equation with one signature move to drop the statutory income tax rate for corporate entities to 21%. This compares to an effective rate of 29.6% for owners of pass-throughs, which assumes a full benefit of the 20% deduction for certain types of business income (Section 199A).

What’s at stake
Trade-offs. Clearly, for many business owners, the choice is not as simple as closing the 8% rate gap for pass-throughs compared with corporations. It’s too soon to say how many pass-throughs restructured to convert to a corporation or to include a corporation within their structure since tax reform. However, it’s interesting to note anecdotally that more than a few owners have opted against making a change while others are still deciding. A December 2019 poll during a PwC webcast on tax strategies found that while 43% of around 500 respondents in pass-through entities have considered converting to a corporation structure, more than half have not.

Now what
Ultimately, the deciding factor often hinges less on the tax rate and more on the corresponding consequences on how the business is run operationally. Many who’ve opted to remain as a pass-through find that the flexibility and frequency with respect to cash flow and distributions outweigh or eliminate the benefits of a lower corporate tax rate. Others who’ve made the change often uncover advantages for the business that result from different provisions in the tax code (e.g., international provisions), combined with the lower rate. Analyses begin the same way, with modelling the tax considerations for both the business and partners/shareholders, but the outcomes vary as other factors are pulled in.
Considerations

Cash distribution Businesses that are reinvesting cash for business expansion, acquisitions, capital expenditures, or the like, face a potentially easier decision with respect to choice of entity. For the rest, the desire or need to distribute cash, in a tax efficient way, will often drive the decision on structure. For shareholders of C corporations, distributing cash in a corporate structure generally triggers a tax event in the form of a taxable dividend, which in turn can increase the effective rate to approximate 41% (based on net cash available after payment of corporate tax on entire income, as well as the top capital rate and the 3.8% Net Investment Income Tax). Cash distributions used for debt repayments, such as intra-family loans or as a part of estate planning transfers to trusts, can also create taxable events when distributed within a corporate structure; these distributions would likely constitute taxable dividends. Here’s how one family with multiple holdings inside a business approached entity choice: They converted the real estate assets generating rental income into LLCs, thus separating the true operations of the business from the high cash flow-generating assets; these distributions were then available to go to shareholders in a tax efficient manner. In addition, a sale of real estate will generally give rise to capital gain income that is taxed at rates at the individual level compared with creating two layers of tax within a corporate structure.

The exit strategy should not be overlooked. If a sale of the business is on the near horizon, looking only at current year tax savings within a corporate structure is not likely to be the best approach. It may be more desirable for one layer of tax with respect to the proceeds of the sale. Other considerations may include the built-in gains tax effect, which relates to businesses that converted from a C Corporation to an S Corporation, as well as the flexibility to make certain elections as an S Corporation.

International footprints Other provisions can act differently on pass-throughs, compared with corporates when it comes to income from international operations. The international provisions are complex and certain favorable provisions (e.g., reduced rate for FDII and the 50% deduction of a corporation's GILTI amount) are only applicable to corporations.

Policy uncertainty The 21% rate for C corporations should offer the stability that businesses crave. It is permanent, while for pass-throughs, the crucial 20% Section 199A deduction for qualified business income is set to sunset after 2025. It is among certain other tax reform provisions affecting individual taxpayers, including income tax rates, that are scheduled to expire. Thus in 2026, the statutory rate rises to 39.6% in the top individual bracket vs. the effective rate of 29.6% today for a pass-through owner with the 199A deduction. It’s also possible that a future Congress may act to change corporate tax rules. This election year has seen an unusual amount of specificity in competing tax policies among presidential candidates, with many Democratic candidates favoring increasing the corporate rate. The uncertainty is one reason why an analysis of optimal structure should stretch beyond the current tax rate impact. Owners will not only decide whether to make a change, but also whether they may need to reverse the decision, which may be limited in certain situations (e.g., once revoked, an owner cannot elect corporation status again for five years).

How PwC can help

PwC’s Wealth and Tax Planning Guide is updated annually. Find information on family and business taxes, investment and insurance planning, and options and tax-savvy alternatives for giving to charity. A thorough discussion of choices and tax implications relating to estate and gift planning is also included, as well as insights on the myriad tax issues stemming from cross border activities, including residency nuances. The Guide also covers topics relating to setting up and maintaining a family office.

Contact

Frank Graziano
Personal Financial Services Leader, PwC US
frank.graziano@pwc.com