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To C or not to C?

C-Corp offers tax treasures and traps as new code takes effect

By CLAUDE SOLNIK

Business people lately are eager to form or continue as C-corporations in light of lower taxes for these entities under new laws, but accountants said the devil may be in the details, potentially leading to double taxation.

The new tax code dropped taxes for C-corps from 35 percent to 21 percent, pleasing firms already with that structure and attracting attention from other companies. Pass through entities' income, on the other hand, is taxed at individual rates, which are frequently higher.

Accountants lately have been doing studies for companies, advising them whether they should switch or stay put with their corporate structure. And they say if you decide to switch, without examining things carefully, you could end up hit with additional taxes.

"The corporate tax rate is 21 percent. The individual is 37 percent. That automatically causes a business person to say, 'Maybe I should be a C-corporation,'" Timothy Speiss, partner in charge of the personal wealth advisors practice at EisnerAmper with Long Island operations in Syosset, said. "It's going to be a different decision for each person. Over the next six months, you should be consulting with your tax and business advisor."

There is no simple one-solution-fits-all answer regarding which entity is best, Speiss continued. Simply looking at that single number can lead to errors, according to many advisors.

"Each one is a different scenario and depending on the facts will merit a different approach," said Louis Vlahos, a partner who oversees the tax practice at Farrell Fritz in Uniondale.

Although the tax bill passed on Dec. 22, 2017, there are many details that need to be settled regarding its implementation. These open questions regarding conversions to C-corporations, for instance, could make switching tricky.

"People are still analyzing this. Guidance is coming out every day," Speiss said. "People will make decisions. They're business people. They take risks every day."

Jeffrey Cohen, tax partner at Grassi & Co., in Jericho, said some rules haven't been codified, although there are ways to find out how the Internal Revenue Service will handle situations.

"The IRS regulations aren't written yet. We like regulations. You can piece it together from the Internal Revenue code," Cohen said. "There's enough to make the right business decision. You have to make sure that the tax and the economics marry. You can't have one without the other."

One of the biggest questions, and risks, relates to the taxation of accumulated earnings. The Internal Revenue Service has issued guidance and memoranda. But if companies don't handle these earnings properly, they could end up paying a steep double tax in their second year as a C-corporation.

"You have to get everyone to agree they'll follow a plan of action," Cohen said. "You won't convert an S to a C unless you have a growth plan to carry you for five years."

Companies during their first year as a C-corp can distribute previously taxed income, or retained earnings, without tax consequences. If they don't distribute the money, it could be taxed.

"If you convert to a C corporation and have $30 million in income you could distribute tax free and you don't, the next time you take it out, you'll pay a [tax for a] qualified dividend," Cohen said.

Manhattan-based KKR & Co. is moving from a flow-through entity to a C-corporation, which could lead to various tax consequences for investors.

"You know what's going to happen to their shareholders?" Speiss said. "They're going to convert that to a C-corp. These shareholders are going to see 21 percent go to the government. When KKR makes a dividend distribution, they will pay tax again."

While some companies want to convert to C-corporations, C-corporations themselves can be ripe for sale – since they can retain more future profits "That impacts the sale price. The buyer is willing to pay more," Speiss said.

Vlahos said owners and buyers evaluate the value of a company, by taking into consideration things like tax laws. And C-corporations today may be worth far more than they were a year ago.

"You go through this economic analysis. They say they want this much. That's the number they want. Then they find out they'll only net this much. They won't sell," Vlahos continued of owners. "It's where that number changes."

Buyers can make back their money faster than in the past when they acquire a C-corporation, since they retain more earnings, making these deals more attractive.

"Every deal is about economics," Vlahos said. "The quicker that I as a buyer can recover my investment in a deal, the less expensive the deal is for me."

LOUIS VLAHOS: Each case has to be considered based on the situation.

Speiss advised a family-owned business that was sold a little more than a month ago, in part because the family was happy with a good business valuation.

"It was such a valuable business. They were afraid of losing the valuation," Speiss said of the sale that closed after the new tax law went into effect. "Then the law came along."

To make sure companies know what entity is best for them, and the best actions to take, companies are meeting more often with accountants.

"You create an opportunity for dialogue to learn what they're doing quarter over quarter," Speiss said. "If you don't do that, the client and advisor are at risk to miss a planning opportunity to save on income tax or risk making a mistake that could cause even more to be paid in income tax."

Cohen said more clients meet quarterly, to make sure they know what entity is best and take actions consistent with that.

"The amount of time people put in is greater than other years. You had to look at the entity structure more than in previous years," Cohen said. "My tax season this year was like two or three tax seasons, because of the law change. It was mostly positive."

All of this means more revenue for many accountants who do studies regarding what entity is best for each business. But the big savings, in the end, accrue to the company not the accountant.

"Clients were willing to pay the additional fee," Cohen said. "The joke was, 'It's good for you.' It is good for me, but it's better for them."

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