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Why entrepreneurs should slow down before taking this tax break

- Pass-through entities, including S-corps, may be eligible for a 20 percent deduction on qualified business income.
- Those who don't qualify may consider becoming a C-corporation and taking a 21 percent tax rate.
- Though the lower rate is attractive, business owners should think beyond their tax bills before making the change.

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Lower income tax rates have made incorporation an attractive strategy to some business owners, but accountants warn that entrepreneurs ought to think twice before going corporate.

The Tax Cuts and Jobs Act sought to ease taxes on businesses in two ways.

One provision makes available to entrepreneurs a 20 percent deduction on qualified business income. This break is for pass-through entities — including sole proprietorships and S-corporations.

Business owners who wish to qualify for the full deduction must have taxable income below $157,500 if single, or $315,000 if married.

Entrepreneurs whose income exceeds those thresholds hope to take advantage of a different provision in the new tax law. This one lowers corporate tax rates to 21 percent from the top rate of 35 percent.

Here's the catch: They'd have to convert their pass-through entity to a C-corporation.

"The minute the law was passed, people said, '21 percent? Great. We're gonna convert,'" said Carolyn Mazzenga, office managing partner and CPA for Marcum LLP in Melville, N.Y.

"We basically had to slow people down and say, 'Let's talk about this,'" she said.

Here's why rushing to turn your business into a C-corp may be a costly mistake.

Know your entity

S-corps and other pass-through entities are known as such because their income "passes through" to the owner and is taxed at his or her individual rate, which is as high as 37 percent.

C-corps, however, file their own income tax returns and are subject to a corporate tax rate, which is now as high 21 percent.

Both C-corps and S-corps provide entrepreneurs with limited liability protection, meaning that the creditors of the business can't seize the personal assets of the owners — as long as the owners adhere to certain filing and reporting requirements.

Two tax tiers

"For those who don't qualify for the 20 percent break, the C-corporation has closed the gap quite a bit in the form of a lower tax rate," said Tim Steffen, CPA and director of advanced planning at Robert W. Baird & Co. in Milwaukee.

But there is more to the story than just the reduced corporate tax rate, he said. That's because owners of C-corps are dealing with two tiers of taxes related to their business.

Income generated by the business is subject to the 21 percent rate. If the owner wishes to tap any of that business income, he needs to take a dividend and pay a rate of up to 20 percent.

If this same owner decided to keep his business as an S-corp and he failed to qualify for the 20 percent business income deduction, he'd only be on the hook for a top individual income tax rate of 37 percent.

"The rates are almost the same for the pass-through at the top income tax bracket and the C-corp," Steffen said.

Taxes upon sale

Think carefully about the future of your business, particularly in the next five to 10 years, before you convert to a C-corp.

"Selling a C-corp can become very tax-expensive," said Mazzenga at Marcum.

This is because owners face a double tax once they sell the assets of the company: First, they pay the corporate rate of 21 percent, and then owners cough up a 20 percent tax for distributions they receive.

Questions to ask

Have a chat with your CPA before you move forward on changing the entity of your small business. You'll likely need a projection to see how your tax picture will change under a different business structure.

Consider these questions as you proceed:

- **Are you profitable?** If you're making money, reinvesting into your business, and not taking distributions, a C-corp may make sense. Meanwhile, if your venture is losing money and you're an S-corp, you may be able to deduct the losses against other income sources.
- **Do you plan to sell your business soon?** Don't forget about the double-tax that applies to C-corps amid a sale. If you're going to spin off your business, perhaps consider remaining an S-corp.
- **How does your growth compare to your tax liability?** Work with your CPA to crunch the numbers on whether your business is profitable enough to warrant a change to a C-corp.

"It's easy to say that you won't care what the tax is when you sell the business — until the time comes and you're like, 'Wow,'" Mazzenga said.

"This really forces the business owner to think about things they weren't necessarily honing in on," she said.