

Long Island Business News

Everyone wants to be a C

By: Bernadette Starzee February 16, 2018

Since tax reform was passed, accounting firms have been flooded with phone calls from business clients about whether they should change their entity type.

“Clients are calling me saying, ‘I’m converting to a C-corp so I’ll only be taxed at 21 percent,’” said Carolyn Mazzenga, managing partner of the Melville office of Marcum. “Unfortunately it’s a lot more complicated than that. Converting to a C-corp could end up costing them more than if they just stayed the way they are.”



CAROLYN MAZZENGA: Accountants have been busy fielding phone calls from clients looking to change their entity type. || Photo by Bob Giglione

Mazzenga made her remarks at a recent “Tax Cuts & Jobs Act” seminar hosted by Marcum to educate business clients and others about the most comprehensive tax change in more than 30 years. Other accounting firms are holding seminars, whether in-person or online, to try to answer some of their clients’ frequently asked questions.

Much of the Marcum seminar focused on the taxation differences between C-corps and pass-through entities, which include partnerships, S-corporations, limited liability companies and sole proprietorships. These are termed pass-through entities because the income from the business flows through to the owners’ personal income statements.

The new tax law is very friendly to corporations, dropping their tax rate from 35 percent to 21 percent. But whether a pass-through entity should convert to a C-corp is a complicated question, accountants say.

“It depends on a lot of factors,” said Jill Schneider, a tax director at EisnerAmper in Syosset, adding that whether a company should make the switch “must be determined on a case-by-case basis.”

Not only will accountants look at the company’s current financials, but “we also have to look forward,” said Timothy Speiss, partner-in-charge of the personal wealth advisors practice at EisnerAmper. “I’ll want to know what their exit strategy is. Are they planning to go public? Pass the business down to the next generation? Will they have a private equity firm come in, or will they look to sell to a strategic partner or competitor down the road?”

While the drop in the corporate tax rate garnered headlines, tax reform did not completely ignore pass-through entities. After announcing its plans for tax breaks to C-corps, the federal government was pressured to level the playing field for other types of businesses. So it passed a 20 percent deduction on qualified business income for certain pass-through entities.

However, there is confusion about which businesses qualify and how much they can deduct.

“One might think that if you own a pass-through entity and you made \$1 million, you would automatically get a \$200,000 deduction,” said Michael D’Addio, a tax and business principal at Marcum. “But the law is not that simple.”

Significantly, many types of businesses are excluded from the 20 percent deduction. Companies providing services such as law, accounting, healthcare, performing arts, healthcare, actuarial sciences and financial services – services in which the skill of the owner(s) is the main asset of the business – do not qualify for the deduction unless the taxable income of the owner(s) falls under \$315,000 for married taxpayers filing jointly or \$157,500 for single taxpayers. The deductions phase out from these thresholds up to \$415,000 for married taxpayers and \$207,500 for single taxpayers.

Notably, the exclusion list did not include engineering and architectural firms, who are entitled to the deduction.

Further, the government does not want business owners to get a 20 percent deduction if they are not creating jobs. As such, the deduction is limited to 50 percent of an eligible company’s W-2 wages. So in the scenario where an eligible company has income of \$1 million, it would have to have \$400,000 in wages to be entitled to the full \$200,000 deduction.

The wage offset limitation does not apply for business owners with taxable income of less than \$315,000 for married taxpayers filing jointly or \$157,500 for single taxpayers. (Again, deductions phase out from these thresholds up to \$415,000 and \$207,500, respectively.)

Even within the general category of pass-through entities, there may be tax advantages to switching to a different type of pass-through entity.

“You can have a sole proprietor, S-corp or partnership with similar businesses and with the same economics, but they have different tax results,” D’Addio said.

“If you are a pass-through entity, you need to look at whether you are in the right kind of pass-through,” added Robert Spielman, a partner in the tax and business services division at Marcum.

But before considering a switch to another pass-through or to a C-corp, “call your accountant,” Mazzenga said. “You could be incurring fees and it might wind up costing you more in the end.”

However, accountants acknowledge that even they are not sure how it will all shake out. There may be technical corrections as the year progresses. Before that happens, the IRS is expected to issue answers to frequently asked questions with guidance that will likely influence how nuances in the law are interpreted.

“The goal of the statute was to incentivize companies to invest in their business, but it is hard for them to invest if they are confused,” Spielman said.

When frantic clients call about converting to a C-corp, “our job is to slow them down. They have to go through it methodically,” Mazzenga said. “A lot isn’t known. If they make a decision hastily they will be possibly doing something they can’t undo.”