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Entity Structure for Contractors Under the New Tax Law

What's Best for Today (and Tomorrow)

By Ashley McDougle, James Lundy and Ashlie Forum | Thursday, May 30, 2019

Prior to the Tax Cuts and Jobs Act (TCJA), which was signed into law on Dec. 22, 2017, there had not been any significant changes to the tax code in more than three decades. The changes brought about by the new law have prompted contractors to reexamine the entity structure that is best for their businesses. The considerations are complex and cannot be viewed only from a tax standpoint. Future business goals will need to be considered alongside other considerations. This article examines how the TCJA affects contractors who are trying to determine the best ownership structure for their businesses, whether as a C corporation or a pass-through entity (partnership, S corporation or LLC).

TAX RATES

Here's a look at the different entity types and how the tax rates compare.

- **C corporations:** For 2018, C corporations are subject to a 21% flat tax. Previously, C corporations were taxed at the highest tax rate of 35%.
- **Pass-throughs:** TCJA allows for pass-throughs to qualify for a 20% deduction, referred to as Qualified Business Income deduction (QBI). When contractors maximize the QBI deduction, it will result in an overall tax rate reduction from 37% (highest overall individual tax rate) to 29.6%.

PROFIT DISTRIBUTIONS

At first glance, it appears that C corporation structure would result in lower taxes; however, profit distributions to the owners need to be considered.

- **C corporations:** When profits are distributed out to the owners, there is a double tax since the income, taxed at 21%, is taxed again as a dividend to the owner at the dividend tax rate of 23.8%.
- **Pass-throughs:** Assuming there is a sufficient amount of basis, there is no additional tax on the distributions.

In summary, the total maximum tax rate for the C corporation is 21% plus an additional 23.8% at the individual level. The pass-through entity tax rate to the individual owners is only 29.6%. Despite the significant reduction in the rate for C corporations, however, due to the double taxation of income for C-corps, in many cases, pass-throughs will be more tax efficient. (Please note this only addresses the federal tax rates; state income tax rates need to be considered as well).

There are many other factors to consider besides the tax rate, including the following.

- **State income tax deductions:** For C corporations, there is no limitation on the state tax deduction. For pass-throughs, there is no limitation either; however, when the deduction is passed through to the individual for 2018 under the TCJA, the individual is limited to a $10,000 deduction for state taxes. Many states are addressing this, and more pass-throughs may be subjected to income taxes in the future.
- **Accumulated earnings tax:** This taxes a corporation for retaining funds beyond its "reasonable needs," at a 20% tax rate. C corporations are permitted to accumulate up to $250,000 of funds without question. The entity must be able to demonstrate that any amounts retained beyond this threshold are for the reasonable needs of the business. This is achievable since contractors need to retain earnings for working capital, banking, bonding and surety purposes. In the event of an IRS audit, a letter from the bank or bonding company can document the need for retaining equity.
- **Sale of the business:** The key factor is whether the sale is an asset sale or stock sale. Under a stock sale, when C corporation stock is sold, generally there is no disadvantage to being a C corporation versus a pass–through. The corporate stock will normally produce a capital gain subject to a preferential tax rate (23.8%) if it is held for more than one year. Additionally, a portion of the gain on the sale of stock may be exempt from federal taxes if certain conditions are satisfied related to the small business stock sale rules. Under an asset sale, the disadvantage for a C corporation occurs where the buyer insists on an asset sale. The corporation will recognize a gain subject to 21% tax rate and a second tax on the profit distribution to the owners at the 23.8% dividend tax rate. This double tax, explained above, will generally produce higher overall taxes compared to the same sale of assets if held in a pass-through entity.

There is no clear and concise answer as to which entity structure is best suited for a construction contractor. It is important to analyze the unique characteristics of each business while considering the federal and state tax implications and the business' long-term intentions to pick the right entity structure.

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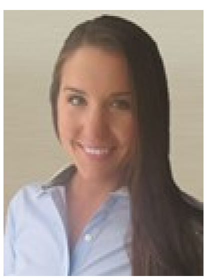

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