To C-corp or not to C-corp? That is the question.

The new U.S. tax legislation sweetens the deal for C-corps. But is it time to give up your passthrough status? In this edition of Privately Speaking, we take a business view of the new tax legislation to help you decide whether you should be reconsidering your current business structure.

What’s changed?
The headline news for C corporations is that if an individual conducts business through such an entity, then there is a permanent reduction in the general corporate rate to 21 percent. However, there is still a second level of tax applicable on dividend distributions from the corporation.

Now, if that business is alternatively conducted directly or through a partnership or S corporation (a passthrough entity), there is generally only one level of tax. Furthermore, for tax years after 2017, taxpayers must consider if they are eligible for any benefit from new section 199A. Put in very simple terms, section 199A offers a potential deduction for sole proprietors or owners of a passthrough business. The benefit of section 199A is that for certain trades or businesses (generally those generating qualified business income from a qualified trade or business) the individual owner may be entitled to a 20% deduction so as to reduce their overall effective tax rate.

It is important to note that, absent legislation, the 199A benefit is temporary and will not be available after 2025. If your trade or business is eligible, section 199A could provide a significant benefit. But, not every business is eligible, and the window for taking advantage is closing.

You have big decisions to make
Given the raft of changes that were included in the new 2017 tax law, many private company owners and investors may be asking themselves if it makes more sense for their business to be structured as a C corporation rather than a passthrough for federal tax purposes.

Figuring out the answer won’t be easy. It will require company leaders to consider more than just financial models and base rates. Indeed, any change to the company structure may have significant impacts on the future strategy of your business. Furthermore, the ripple effects of the new and interrelated provisions may not be immediately obvious.

So how do you proceed? The answer is very fact specific and requires an understanding of both present and expected future business activity. It also may require thinking about how stable you think the current tax provisions might be. Keep in mind that future legislation could be enacted to change the current tax rules.

The decision must be made carefully. C-corps can be a bit of a mouse trap—once you get in, you may never get back out—at least not without paying a significant toll charge.

—Deborah Fields, Partner in Charge, Passthroughs Group, Washington National Tax, KPMG LLP
Tick-tock: The benefits are temporary
While the benefits of the new tax code are largely available beginning in 2018, many of them—particularly those under section 199A—are scheduled to expire after 2025 (unless Congress extends it). The timeframe for taking advantage is shortening. That means decisions need to be made soon.

Even if you ultimately decide not to convert into a C-corp, the analysis and discussion between top management, the board of directors, and shareholders gives tax and finance leaders the vision necessary to engage in other important tax and financial planning.

—Brian Hughes, National Private Markets Group Leader and National Venture Capital Coleader, KPMG LLP

Are you even eligible?
Understanding whether your business income is eligible for the 20 percent deduction can be tricky. For example, the deduction is not available for taxpayers who operate within a specified list of “bad” service businesses. So if your business is primarily involved in one of the service areas listed below, there’s a good chance that your income may not be eligible:

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Athletics
- Financial services
- Brokerage services
- Investing and investment management
- Certain trading and dealing
- Any other business where the principal asset is the skill or reputation of one or more employee/owner

Before you can decide what is best for your organization, you need to start by considering how the business and its owners are currently being taxed, how the business accrues value, and how it plans to grow in the future. The pros and cons of conversion will be different for every company.

—Brad Sprong, National Private Markets Group Tax Leader, KPMG LLP

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Questions to consider

Now is the perfect time to sit down with your executive team and your tax professionals to discuss the impact of tax reform on your business. The following questions should be part of the discussion—but other factors may ultimately weigh into your decision as to whether to be a C corporation or not to be a C corporation:

1. Is the trade or business expected to generate income or loss in the foreseeable future?
2. Is any of your trade or business able to benefit from the 20 percent deduction?
3. Is there a tax cost of getting into a C corporation?
4. What is the anticipated exit strategy for the business?
5. Will cash be retained or distributed by the business?
6. Is there a state tax deduction that would be available for a C corporation but not for an individual?
7. Is there a state tax difference between being classified as a passthrough and a C corporation?
8. Are there any international considerations?
9. How sensitive is the decision to tax law changes in the future, such as an increase in the corporate tax rate?
10. Are there any "nontax" drivers to the decision, such as complexity of reporting, or investor attractiveness, or other drivers?

Want to learn more about the impact of Section 199A?

Check out this series of video “shorts” where Deborah Fields, one of KPMG’s passthrough tax leaders, introduces the key issues and what they may mean for your business.

Looking for the details?

Check out our recent report where we offer our in-depth analysis and observations on the final Section 199A regulations.

Deciding to change the tax status of your company triggers a number of additional tax and business planning considerations that need to be addressed both before and after conversion. Private company owners and executives need to understand what is at stake.

—Conor Moore, National Venture Capital Coleader, KPMG LLP
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