Time to Reconsider Your Choice of Entity?

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One of the most publicized changes made by last year's Tax Cut and Jobs Act was a reduction in income tax rates for corporations and individuals. The maximum corporate tax rate has been permanently reduced from 35% to 21%, and the maximum individual tax rate has been reduced temporarily (through 2025) from 39.6% to 37%. These changes reopen the age old question of what type of entity is best from a tax perspective. It used to be relatively simple to answer – pass-through entities such as partnerships and S corporations were the preferred structure where business realities allowed for that choice. In light of the tax rate changes, this may no longer be the case and it may be time to reconsider your choice of entity.

If a business is taxed as a corporation, the business will pay tax on its taxable income at a 21% rate, meaning $21 of federal income tax on $100 of taxable income. In contrast, if the business is organized as a partnership, the income is passed through to the partners and reported on the partners' tax return. If those partners are individuals, the partners are potentially paying $37 of federal income tax on the $100 of taxable income (if the income is ordinary such as rental income). As I have previously discussed, the Tax Cut and Jobs Act provides for a deduction on qualified business income, which would include income from partnerships. Even in the best case scenario where the partners are able to take the maximum 20% deduction on qualified business income, which will often not be the case, the maximum deduction would reduce the tax to $29.60.

One of the key benefits of a pass-through over a corporation is that there is an additional layer of tax (at a rate of up to 23.8%) when the corporation distributes its profits out to its shareholders. If the corporation distributes the $79 of after-tax dollars discussed above, there would be an additional $18.80 of tax, resulting in a total tax of $39.80. Even with the tax rate reduction, this means that a corporation will result in less after-tax dollars ($60.20) for its owners than a partnership ($70.40) if the profits are distributed out. However, many companies do not distribute profits to its owners, instead keeping the profits to grow and expand the business. For those businesses, a corporation may provide a better tax answer than a pass-through in this post-tax reform environment, especially if the owners' ultimate exit strategy involves a sale of their equity in the business.
