Chapter 4: C Corporations

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Please note. Corrections for all of the chapters are available at **www.TaxSchool.illinois.edu.** For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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The Tax Cuts and Jobs Act (TCJA), enacted in December 2017, cuts the corporate tax rate to 21%, which is 16 percentage points lower than the highest individual tax rate of 37%. On the surface, that seems to be a rather significant incentive to form a C corporation for conducting a business rather than a pass-through entity in which the business income flows through to the owners and is taxed at the individual income tax rates. In addition, a C corporation can deduct state and local taxes without the limitations that apply to owners of pass-through entities or sole proprietors.

Are these two features enough to clearly say that a C corporation is the entity of choice under the TCJA? In most client situations, the answer is likely "no."

TAX COMPARISONS

The fact that corporations are now subject to a flat tax rate of 21% is one of many factors that should be considered in determining whether a C corporation structure is appropriate. For instance, the TCJA continues the multiple tax bracket system for individual income taxation and also creates a new 20% deduction for pass-through income for the 2018 through 2025 tax years: the qualified business income deduction (QBID). In addition, for many smaller businesses, the flat 21% rate could actually result in an increase in tax liability. Many of these businesses purposely kept taxable income at or near $50,000 to take advantage of the former 15% rate.

The TCJA does not change or otherwise eliminate taxation on income distributed (or funds withdrawn) from a C corporation — the double-tax effect of C corporation distributions. These factors somewhat mute the apparent advantage of the lower corporate rate.

Note. For more details about the new tax rates for individuals, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation — Individual Concerns. For more information about the QBID, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues.

As shown in the following table, under the new individual income tax rate structure, the top bracket is reached at $600,000 for a married taxpayer filing jointly (MFJ) for the 2018 tax year. For those filing as single taxpayers or as head of household (HoH), the top bracket is reached at $500,000.[1] Of course, not every business structured as a sole proprietorship or a pass-through entity generates taxable income in an amount that triggers the top rate. As shown in the following table, up to $77,400 of taxable income for MFJ taxpayers is taxed at rates lower than the 21% corporate rate. Therefore, businesses with relatively lower levels of income will likely be taxed at a lower rate if they are not structured as C corporations.

Taxable Income Brackets for Individuals — 2018

Tax Rate	Married Filing Jointly and Surviving Spouses	Head of Household	Single	Married Filing Separately
10%	$ 0–19,050	$ 0–13,600	$ 0–9,525	$ 0–9,525
12%	19,051–77,400	13,601–51,800	9,526–38,700	9,526–38,700
22%	77,401–165,000	51,801–82,500	38,701–82,500	38,701–82,500
24%	165,001–315,000	82,501–157,500	82,501–157,500	82,501–157,500
32%	315,001–400,000	157,501–200,000	157,501–200,000	157,501–200,000
35%	400,001–600,000	200,001–500,000	200,001–500,000	200,001–300,000
37%	Over 600,000	Over 500,000	Over 500,000	Over 300,000

1. IRC §1(j).

RATE COMPUTATION — FISCAL-YEAR CORPORATIONS

Under the TCJA, the tax computation for a calendar-year corporate tax return is fairly simple. For 2018 and future years, a flat rate of 21% is applied. However, for fiscal-year corporations with a fiscal year that begins in 2017 and ends in 2018, the tax computation is more complicated. The tax is calculated by determining the proportionate number of days in 2017 and applying the 2017 rate to that share of taxable income, then taking the proportionate number of days in 2018 and applying the 2018 rate to that share of taxable income.[2]

Example 1. Widget Corporation has a March 31, 2018 yearend. It earned exactly $50,000 of income. The number of days in its tax year before January 1, 2018, is 275, which is 75.34% of the total number of days in the tax year. The number of days after January 1, 2018, is 90, which is 24.66% of the total number of days in the tax year.

Tax on $50,000 in 2017 is $7,500 ($50,000 × 15%); therefore, the tax for 275 days is $5,651 ($7,500 × 75.34%). The tax on $50,000 in 2018 at 21% is $10,500. Therefore, the tax for 90 days is $2,589 ($10,500 × 24.66%). Thus, Widget Corporation will pay tax of $8,240 ($5,651 + $2,589) for the year ended March 31, 2018.

Planning Tip. The blended rate drops by 1.17% per month ((35% – 21%) ÷ 12 months). Consequently, many fiscal-year corporations are in a higher tax bracket in 2017–2018 than they will be in future years. Thus, corporate-level deductions may be worth more in fiscal year 2017–2018 than they will be in future years. Corporations can realize a tax benefit by utilizing tax strategies that accelerate deductions when the applicable tax rate is higher and defer income to tax years when the applicable rate is lower.

In Notice 2018-38,[3] the IRS confirmed that in determining the tax on corporate income under IRC §11(a), IRC §15 applies to fiscal-year corporations when the corporation's tax year began before January 1, 2018, and ends after December 31, 2017, resulting in a blended tax rate as explained above. The IRS also noted that certain fiscal-year corporations (e.g., life insurance companies and regulated investment companies) that compute tax liability under IRC §11(b) must also compute tax liability for a tax year straddling January 1, 2018, in accordance with the IRC §15 formula. The IRS also pointed out that the repeal of the corporate alternative minimum tax (AMT) under the TCJA is a change in the tentative minimum tax rate from 20% to zero under IRC §§15(a) and (b), with a January 1, 2018, effective date.[4]

PASS-THROUGH DEDUCTION

As mentioned earlier, under the TCJA, for tax years beginning after 2017 and before 2026, an individual business owner as well as an owner of an interest in a pass-through entity is generally entitled to a QBID of 20% of the individual's share of business taxable income.[5] However, for taxpayers who exceed a taxable income threshold ($315,000 for MFJ taxpayers and $157,500 for all other taxpayers), the deduction is limited to the lesser of:

- 20% of QBI, or
- The **greater** of:
  - 50% of the W-2 wages paid with respect to the qualified trade or business, or
  - 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property (QP).[6]

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2. IRC §15.
3. IRS Notice 2018-38, 2018-18 IRB 522.
4. Under IRC §15(a), a fiscal-year corporation's tentative minimum tax is computed by applying the corporate AMT rate for 2017 through December 31, 2017, with a tentative minimum tax computed by applying the 0% rate through the balance of the fiscal year. The corporation's tentative minimum tax for the tax year that includes January 1, 2018, is the sum of that proportion of each tentative minimum tax which the number of days in each period bears to the number of days in the entire tax year.
5. IRC §199A.
6. IRC §199A(b)(2).

This limitation is phased in for MFJ taxpayers with taxable income between $315,000 and $415,000. For all other taxpayers, the limitation is phased in for taxable income between $157,500 and $207,500.

Architects and engineers can claim the QBID, but other service business are limited in their ability to claim it.[7] For them, the QBID is phased out when taxable income exceeds $315,000 for MFJ taxpayers and $157,500 for all others.

The QBID results in tax savings on qualifying income, but the extent of the savings depends on the percentage of income that a business generates that qualifies for the deduction and the taxpayer's marginal tax bracket. If pass-through income is taxed at the highest rate of 37%, the QBID reduces the 37% rate to effectively 29.6%. However, as the normal rate applicable to the income of a pass-through (or sole proprietor) business decreases, the benefit of the QBID also decreases. Only when individual marginal income tax rates are 24% or less does the QBID reduce the effective rate beneath the 21% corporate rate (assuming all pass-through income is qualifying income). The more nonqualifying income a sole proprietor (or pass-through business) has, the less the effect the QBID has in lowering the effective average marginal income tax rate.

The TCJA provides a windfall for personal service corporations (PSCs). They were taxed, under prior law, at a flat 35%.[8] Under the TCJA, they are subject to the same 21% flat rate applicable to other C corporations.

Observation. Clearly, the amount of income a business generates and the type of business impacts the choice of entity. For further elaboration of this point, see the discussion of the QBID and the impact of W-2 wages and QP basis in the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues. For more information on comparison of entities, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Entity Comparison.

ADDITIONAL TAX ON DISTRIBUTED INCOME

Another factor influencing the choice between a C corporation or a flow-through entity is whether the C corporation distributes income, either as a dividend or when shares of stock are sold. The TCJA, in general, does not change the tax rules concerning qualified dividends and long-term capital gains. Preferential tax rates apply at either a 15% or 20% rate, with an additional 3.8% net investment income tax that applies in certain situations.[9] If the corporate "double tax" applies, the pass-through effective rate is always lower than the combined rates applied to the corporation and its shareholders. This is true even without factoring in the 20% QBID for pass-through entities.

However, for certain pass-through service businesses that have higher levels of income that are subject to the QBID limits, the effective tax rate is almost the same as the rate that applies to a corporation that distributes income to its shareholders. This is particularly true because a corporation can deduct state taxes for any of the 44 states[10] that impose a corporate tax and because PSCs are now taxed at the same 21% rate as all C corporations (rather than the flat 35% that previously applied).[11]

Observation. The 21% corporate tax applies to nondeductible dividend distributions. An individual taxpayer's tax on the dividend can range from 15% to 23.8%. The combined result almost always exceeds the individual rate applicable to income from a pass-through entity.

7. IRC §199A(d)(2).

8. A personal service corporation is one in which the employee-owners perform at least 20% of the personal services and own at least 10% of the outstanding stock of the corporation on the last day of an initial 1-year testing period. See IRS Pub. 542, *Corporations.*

9. IRC §1411.

10. See, e.g., *State Corporate Income Tax Rates and Brackets for 2018.* Scarboro, Morgan. Feb. 7, 2018. Tax Foundation. [taxfoundation.org/state-corporate-income-tax-rates-brackets-2018/] Accessed on Jun. 20, 2018.

11. IRC §11(b).