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The hot question since the passage of the Tax Cuts & Jobs Act of 2017 and Section 199A is, "Should I revoke S Corp status and go to C Corp?" The answer is No. What is interesting is that Wharton School at University of Pennsylvania in a June article estimated that approximately 235,000 business owners will convert from a pass-thru entity to a C corporation in 2018. Yuck! The C Corp vs S Corp conundrum if viewed purely from an income tax perspective is not a conundrum at all; it is quite simple.

The primary motivation is the seemingly attractive 21% tax rate for C corporations and while this might be lower than some taxpayer's marginal rate, this is a sucker hole for business owners for two painfully obvious reasons. First, your marginal rate might be 24% or 26%, but your effective tax rate (or blended tax rate) is much lower. We'll show you… not to worry.

Second, there is a little thing called double taxation where the C corporation pays a tax and then the shareholders pay a dividend tax on the money that is distributed. And… if you think you're a smarty pants and say, "Yeah, but, I'll just keep all my money in the C corporation for a rainy day and lower tax rates," there is another little thing called accumulated earnings tax (AET).

Let's illustrate this with some good old fashioned devils buried deep into the details. Assumptions include-

- Section 199A deduction for the S corporation's shareholder
- $24,000 in standard deduction (yeah, 2018 numbers, but whatever)
- 3.8% surtax on top of the 15% capital gains tax rate for the $300,000 column

Buckle up buttercup 'cause here we go-

S Corp Income	**100,000**	**200,000**	**300,000**
Salary	40,000	80,000	120,000
Payroll Tax	6,120	12,240	18,360
Income Tax	6,980	24,150	44,266
Total Tax S Corp	13,100	36,390	62,626
C Corp Income	**100,000**	**200,000**	**300,000**
C Corp Tax	21,000	42,000	63,000
Dividends	79,000	158,000	237,000
Dividend Tax	0	23,700	44,556
Total C Corp Tax	21,000	65,700	107,556

Effective S Tax Rate	13.1%	18.2%	20.9%
Effective C Tax Rate	21.0%	32.9%	35.9%
Delta **(extra tax because of C Corp)**	**7.9%**	**14.7%**	**15.0%**

As you can see, a **C Corp does not make sense after you add in capital gains tax on the dividends** and the C Corp vs S Corp argument is put to rest. This in turn makes sense- the lawmakers didn't set out to kill S corporations. They set out to give every business owner a tax break. Geez… half of Congress (535 doesn't divide evenly, we get it) probably run S corporations on the side for their consulting and speaking gigs.

Also note the effective tax rate (or labeled as tax "pain") for the S corporation owner. At $100,000 in net business income, the total tax pain including payroll taxes is 13.1%, and at $200,000 it is only 18.2%. This is still well below the C corporation tax rate of 21%.

And! There's more! C corporations do not enjoy the 20% Section 199A deduction either. Pile that onto the numbers above for even more reasons.

So, please pump the brakes on the "I wanna dump my S Corp for the magical tax arbitrage offered by a C Corp" nonsense. Wow, that was harsh. We did tell you to buckle up but then we offended you by calling you buttercup. Safety with an insult.

C Corp Accumulated Earnings Tax

If you think you are clever and attempt to accumulate your C corporation's earnings and not pay out dividends, you could trigger the accumulate earnings tax (AET). This tax is specifically aimed to prevent tax avoidance by not paying out dividends.

Businesses can accumulate earnings, no biggie, just ask Apple**.** But Apple has to justify why it is holding back so much of its earnings… and they do that by saying, "Well, we need it for this and we're accustomed to that, and we have this thing coming up, baby needs new shoes, and blah blah blah." Here is a list the IRS utilizes in addition to shoes-

1. Providing for bona fide business expansion or plant replacement.
2. Acquiring a business enterprise through purchasing stock or assets.
3. Facilitating the retirement of company debt created in connection with its trade or business.
4. Providing necessary working capital for the business.
5. Providing for investments in or loans to customers or suppliers if necessary to maintain the business of the corporation.
6. Providing for contingencies such as the payment of reasonably anticipated product liability losses, actual or potential lawsuit, loss of a major customer, or self-insurance.

®But if you don't have a good argument, then IRS could whack you with the AET. Here is a quick list of activities that do not bode well for accumulating earnings in your C corporation-

1. Loans to shareholders or related parties.

2. Payments by the corporation that personally benefit the shareholders.
3. Investments in assets having no reasonable relationship to the corporation's business.
4. A weak dividend history.
5. Retention of earnings to provide against unrealistic hazards.
6. Working capital levels that appear high in relation to need.
7. Salaries paid to shareholder/employees that are either extremely high (avoiding corporate tax) or extremely low (avoiding shareholder tax).

We bet that before you read this list, you already had some of these ideas incubating in your brain. Again, you're not the first wizard to run a business. The funny thing about this list is that there was a wizard or two, way back when, who did this… and got caught… and ruined it for all of us. Remember that pigs get fed, hogs get slaughtered.

The accumulated earnings tax is 20%, which shockingly matches the highest dividend tax rate for individuals.

Spending Your Money

Who wants to keep all their money in their business? Don't you want to spend your money? If you say to yourself that you'll keep your taxes lower by not paying out dividends and you also say to yourself that you can avoid the accumulated earnings tax because you have a good excuse for your piles of money, you are now tying up your money and you can't spend it.

So if you listen to some people talk about keeping money in the C corporation to enjoy the 21% corporate tax rate… and paying out dividends at a later date when you might have a lower capital gains and dividends tax rate, your money is not your money. In other words, why the heck do you want to work your butt off and not be able to enjoy the fruits of your labor?

Lastly, your objective in life is to build wealth… and if you can save some taxes along the way, then great. But don't stunt your wealth building for the sake of saving some taxes. By needing to leverage your money into wealth building and to save overall taxes, the C corporation is a bad idea.

We leave room for the person who does not need the money and if they do, they are okay with a higher tax rate. But if we look at practically… and in the eyes of most business owners the C Corp vs S Corp discussion is moot.

C Corp vs S Corp Intangibles

At WCG, we tend to keep things simple. Yes, we'll complicate the heck out of stuff if it makes sense to do so and if it will meet certain objectives. As such, in the interest of simplicity, here we go-

1. LLC is your first choice. Simple. Easy. Tax efficient.
2. Corporation is your next choice. Unpopular and tax inefficient, but there might be reasons why you need one (keep income off 1040, California, venture capitalist).
3. Professional LLC (PLLC) or Professional Corporation (PC) if you are an accountant, attorney, medical doctor or engineer.

See! Simple. Let's look at a fun table of intangibles, shall we?

	LLC	**Corporation**	**S Corporation**
Formation	Articles of Formation	Articles of Incorporation	NA
Internal Governance	Operating Agreement	Bylaws, Shareholder Agreement	Depends
Owners Called	Members	Shareholders	Depends (Shareholders)
Owners Own	Interest	Shares	Depends
Owners Take	Owner Draws	Dividends	Shareholder Distributions
Federal Tax Rate	15.3% + Individual Tax Rate	21% + Dividend Tax Rate	Payroll Tax + Individual Tax Rate

Some notables-

Under S corporation, the "depends" is double-talk that we accountants love to use for everything. However, in this case it is quite simple. Since an S corporation is only a tax election, nothing changes from an internal governance and ownership perspective. If you have an LLC taxed as an S Corp, then you will have an Operating Agreement and you will own an interest. If you have a corporation taxed as an S Corp, then you will have Bylaws (and perhaps a Shareholder Agreement) and you will own shares. However, in accounting parlance, we will commonly refer to owners of an LLC taxed as an S corporation as shareholders from a tax return perspective but they are truly members.

The 15.3% under LLC represents self-employment taxes which are the same as Social Security and Medicare taxes.

C corporations remain tax inefficient and S corporations remain a good tool for overall tax efficiency. This table does not necessarily shoot down C Corps in the C Corp vs S Corp UFC match-up, but sheds some light on the overall conversation.

C Corporation Benefits

As business entity types go, C corporations are not all bad. It is easy for S Corps to throw rocks at C Corps given everything we've said so far. Here are some benefits in the C Corp vs S Corp cocktail party fodder-

Keep Income Off 1040
One of the benefits is you keep income off your individual tax return (Form 1040). For example, if you had an LLC whose business transactions were typically reported on Schedule C of Form 1040, if you converted this LLC to a corporation, the income is contained in the corporate tax return (Form 1120). If you pay a salary or pay out dividends, that changes things. Why would you want to keep income off your individual tax return? Perhaps you have Social Security or disability benefits that might disappear or become taxable. Perhaps you are running away from some bad guys who are collecting on a debt. Perhaps you use the C Corp to pay for your mistress of her expensive tastes. All kinds of reasons!

Venture Capital
As mentioned elsewhere, the golden rule is: the person with the gold makes the rules. So, if you are looking for an investor to kickstart your heart like Nikki Sixx, and the only way it happens is if you create a C corporation, then that is what you do. All kidding aside, venture capitalists, angel investors, and all the other silly things people call themselves, like corporations as opposed to LLCs.

Employee Ownership
Having your employees own member interest in an LLC can be tricky since each one would get a K-1 regardless if their interest was economic only (profits) or equity (ownership). You could get around this by having your employees own the right to a portion of the business which triggers into equity upon a certain event such as transfer of ownership or control. In other words, Employee A has the right to 2% ownership upon sale, partial or wholesale. This works! But… it can also be messy and hard to explain. WCG converted to a C corporation for this reason; we are selling bits and pieces of our business to partners and employees, and shares in a corporation makes more sense. Each partner is paid a fee for service directly from the corporation.

This is akin to a barrel of oil… you can either own the right to the barrel of oil, or the barrel of oil itself.

California (and others)

If you are a professional such as attorney, accountant, medical doctor or engineer, you typically have to register as a professional entity, either a Professional LLC (PLLC) or a Professional Corporation (PC). However, some states, such as California, does not recognize PLLC and as such you must create a corporate that is deemed to be a PC. And in those cases, we typically recommend an immediate S corporation election to have your PC taxed as an S Corp (see crummy C Corp tax rates above).

Colorado and Texas, among several other states, allow for a PLLC or a PC… up to you. WCG is a PC.

Who wants to pick on California some more? We do.

State Disability Insurance

California allows corporate officers to opt-out of State Disability Insurance (SDI). SDI is California's version of FMLA, and some business owners want to go on leave for new babies, etc. However, if your baby-making days are clearly in the rearview mirror, then perhaps you want to opt-out of SDI. This is easily done, but only for corporate officers… and No, members of an LLC are not considered corporate officers since LLCs are companies not corporations. All in all, WCG creates far more corporations in California for this reason and for the PC designation reason.

Attorney Stuff

If your estate plan attorney or another attorney recommends a corporation, ask the hard questions so you understand why. There might be good reasons to do so… and we leave room for attorneys to be right some of the time.

In summary, like a nauseating college paper that you know for darn well your professor will only skim in between martini sips, unless you fit the buckets above, then you should be an LLC, or an entity taxed as an S corporation.

C Corp Business Consultation

Do you have more questions? Need to debate the C Corp vs S Corp? Still think a C Corp is the way to go? It might be the perfect solution to a perfect problem. Let's chat!

Name (required)

Email (required)

Business Name

Message

Phone Number (nice to have)

State

Submit

Our fee is $150 for 40 minutes (or $250 for advanced consultation with a Partner or Senior Manager). If we decide to press forward with an engagement, we will **credit the consultation fee towards future services**. If you don't need convincing and already want our services such as tax return preparation, Business Advisory Services or Tax Patrol, and you simply have some housekeeping questions, we answer those at no charge. Charging a consult fee to tell you how great we are is not cool.

Consultations are scheduled on weekdays during the work day. Yes, we can accommodate other days and after-hours, but those are reluctantly agreed to after some eye-rolling and complaining. Additionally, our schedules are more compressed during January through April. We will answer your questions to determine three things-

- Do you need our help?
- Can WCG and its support staff help you?
- Can we work together as a collaborative partnership?

From there we can determine the best plan which might be a simple "keep on keeping on"; otherwise we will construct a malleable plan together and provide a quote for those services.

Shockingly we actually return all consultation requests via email or perhaps a phone call (if the moment strikes us). No black holes here!

Jason Watson, CPA is the Managing Partner of WCG, a business consultation and tax preparation firm, and is the author of Taxpayer's Comprehensive Guide on LLC's and S Corps which is available online.