STEWART LAW, P.A.
CORPORATE · TRUSTS · ESTATES
Create a Legacy ™

Navigating Business Tax Classifications in 2018

Here, we will analyze the federal income tax liability for a business owner in two different situations. In these examples, it is important to note that a number of assumptions are being made. The business will be a non-Specified Service Business focused on manufacturing. In other words, it is not a profession such as medicine, law or accounting and not dependent on the "reputation or skill" of its owners or employees. The owner's primary goal is to re-invest earnings back into the company to fuel growth (i.e., purchasing new machinery, hiring employees, etc.). Accordingly, the owner will not distribute dividends to herself. The business has qualified property, such as machinery, with a $200,000 unadjusted basis. Additionally, the owner is married and will be filing a joint tax return and the owner's spouse did not bring in any income during the taxable year. We're assuming the revenues and expenses are cash basis.

<u>Example 1</u>:

Gross Revenues: $1,000,000
Non-Wage Expenses: $500,000
Non-Owner Wages: $200,000
Owner Wages: $100,000

Net Income: $200,000

S-corporation Tax:

The owner's taxable income is $300,000 ($200,000 Qualified Business Income ("QBI") + $100,000 salary) and thus less than the $315,000 taxable income phase-out threshold for married filing jointly status. Therefore, the owner will be entitled to the full 20% deduction for QBI. The 20% deduction on $200,000 of QBI is $40,000 and results in $160,000 of QBI passing through to the owner's personal income tax return. In total, the owner has $260,000 in taxable income from her $100,000 salary and the $160,000 QBI passed through.

After the standard deduction of $24,000, the taxable income is reduced to $236,000. This results in a personal income tax liability of $45,219.

909 EAST BOULEVARD • CHARLOTTE • NORTH CAROLINA 28203
(704) 552-5160 • (704) 552-5230 FAX
WWW.TSTEWARTLAW.COM

C-corporation Tax:

With C-corporations now subject to a flat 21% tax rate, the business will have to pay a $42,000 tax bill on $200,000 income. Because the owner is not taking out additional dividends, the owner could re-invest $158,000 into the business without additional tax. As to the personal income tax liability, the owner's income is $100,000 from the wages. After taking the standard deduction of $24,000, the taxable income is reduced to $76,000. This results in a personal income tax liability of $8,739. The total income tax liability between the C-corporation tax and individual tax is $50,739 ($42,000 + $8,739).

Summary of Example 1:
S-corporation tax liability: Company ($0) + Personal ($45,219) = $45,219
C-corporation tax liability: Company ($42,000) + Personal ($8,739) = $50,739

Of course, an additional and significant factor is that the S-corporation owner has paid the income taxes on the $200,000 of business net income and could take out the remaining cash for personal use without additional income tax while the C-corporation owner would owe approximately an additional 20% on these dividend distributions. This could make the income taxes nearly twice as high in the C-corporation case, largely a result of the S-corporation owner getting the benefit of some rate brackets well below the 21% that applied to all of the C-corporation's taxable income.

<u>Example 2</u>:

Gross Revenues: $2,000,000
Non-Wage Expenses: $800,000
Non-Owner Wages: $200,000
Owner Wages: $100,000

Net Income: $900,000

S-corporation Tax:

The owner's taxable income is $1,000,000 ($900,000 QBI + $100,000 salary), more than the $415,000 phase-out limit for married filing jointly status. Therefore, the owner will be entitled to the lesser of: (1) the 20% deduction on QBI and (2) the greater of: (a) 50% of the allocated W-2 wages, or (b) the sum of 25% of the allocated W-2 wages and 2.5% of unadjusted basis of qualified property.

The 20% deduction on $900,000 of QBI results in $180,000 of deduction. 50% of the allocated W-2 wages to non-owners and the owner ($300,000) is $150,000. 25% of the allocated W-2 wages ($300,000) is $75,000 plus $5,000 (2.5% of $200,000 in unadjusted basis in qualified property) results in $80,000. The owner's deduction will thus be limited to 50% of the W-2 wages which is $150,000. Therefore, $750,000 ($900,000 - $150,000) of QBI will be passed through to the owner's personal income tax return.

In total, the owner has $850,000 in taxable income from her $100,000 salary and the $750,000 QBI passed through. After the standard deduction of $24,000, the taxable income is reduced to $826,000. This results in a personal tax liability of $244,999.

C-corporation Tax:

At a flat 21% tax rate, the business will have to pay a $189,000 tax bill on $900,000 of income. Because the owner is not paying herself dividends, the owner will be able to re-invest $711,000 into the business without additional tax. As to the personal income tax liability, the owner's income is $100,000. After taking the standard deduction of $24,000, the taxable income is reduced to $76,000. This results in a personal tax liability of $8,739. The total income tax liability between the C-corporation tax and individual tax is $197,739 ($189,000 + $8,739).

Summary of Example 2:
S-corporation tax liability: Company ($0) + Personal ($244,999) = $244,999
C-corporation tax liability: Company ($189,000) + Personal ($8,739) = $197,739

Here the C-corporation owner is incurring $47,260 less in income tax ($244,999 - $197,739). Again, however, an important difference is what amounts to "prepaying" income taxes. The S-corporation owner could take personally what remains of the $900,000 QBI without additional income taxes while the C-corporation owner, who had $711,000 remaining after payment of corporate income taxes, would owe approximately an additional 20% of that amount or about $140,000. If the C-corporation owner did pay herself these funds from the company, she would again have a larger income tax bill than the S-corporation owner and could have benefitted from pass- through income taxation.

*** The information contained in this communication is not intended to constitute legal, accounting or tax advice.*