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## Entity Choice in the Construction Industry: C Corp versus S Corp

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- Offices coast to coast
- We serve over 5,000 privately held construction contractors



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# Speaker Introductions

Dana Houston, CPA

Tax Director, Walnut Creek, CA

Dana has nearly 10 years of experience providing tax consulting and compliance services to contractors ranging from \$1M to \$3B in annual revenues. She specializes in corporate and partnership taxation for construction companies with extension knowledge of the tax laws that impact them.



# Speaker Introductions

Tanya P. Valle, CPA, MST, CGMA

Signing Director, Ontario, CA

Tanya has been providing taxation and business advisory services for nearly 20 years. She specializes in construction, real estate, high net worth individuals and multi-state tax compliance and planning. Tanya also has extensive experience in tax minimization strategies and IRS audit representation.



# Q&A Moderator Introduction

## Perry McGowan, JD, CPA

Technical Director, Minneapolis, MN

Perry McGowan is a professional tax advisor in CLA's Construction and Real Estate group in Minneapolis. He provides advisory services focused on the tax planning issues of construction contractors, real estate owners, and project designers.

Perry applies his 35 years of experience to family-owned businesses and their CPAs, and provides thoughtful tax strategies, transaction design, and tax risk analysis. He serves as a national resource to the industry practice and a tax liaison to industry associations.





# Learning Objectives

At the end of this session you will be able to:

- Identify advantages and disadvantages of both S and C corporation entity structures
- Outline plausible scenarios where C to S / S to C conversion makes sense
- Review impacts of tax reform on entity choice



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## Prior to Tax Reform: C Corporations

- C corporations in the U.S. paid some of the highest marginal tax rates in the world with a top rate of 35%
- Corporate Alternative Minimum Tax (AMT) was computed at the rate of 20% on AMT taxable income in excess of a \$40,000 exemption



## Prior to Tax Reform: C Corporations

- Net Operating Losses were permitted to be carried back for two years and carried over for 20 years to offset taxable income
- Double tax on payment of dividends or exit with a sale of assets with individual shareholder rates at almost 40% steered many privately-held companies away from C corporation status



## S Corporations – An Overview

- Pass-through entity avoided double taxation found in C corps.
- Certain income and deductions retained favorable character for owner tax calculations, i.e., capital gains
- Cash payments to shareholders were generally not taxable to the extent of basis in stock and debt loaned to the S corp.



## Pros and Cons of C and S corporations

- Both S and C corps have limited liability
- Both S and C corps have perpetual existence -
  - If the owner/shareholder passes away, the corporation continues to exist
- C corps have no shareholder limit, while S corps have limited ownership options



## Pros and Cons of C and S corporations

- C corps can be owned by other C corps
- C corps can deduct fringe benefits, like disability and health insurance
- C corp owners can't write off losses on their personal tax return, while S corp owners can
- It may be easier to grow as a C corp





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**Impact of Tax Reform**





# Tax Reform Benefits for C and S corporations

- C corporation tax rates were slashed from 35% to 21%
- S corporation owners may benefit from a 20% deduction of pass-through income, reducing their effective tax rates from 37% to 29.6% (subject to certain income, wage, and property limitations)



# Reconsidering the C corp

- Flat 21% rate effective for years beginning after 2017
- Alternative Minimum Tax is repealed
- Corporations eligible to deduct state income taxes



# New Tax Rates – Reconsidering the C corp

Flat 21% tax rate  
replaces graduated  
tax rates

- Effective for tax years beginning after 12/31/17
- No separate PSC rate

Blended rate  
applies to fiscal  
year corporations

- Compute tax for year using old rates
- Compute tax for year using new rates
- Prorate two amounts based on relative days before and after the change

## Reconsidering the C corp

- Highest individual income tax rate decreased from 39.6% to 37.0%
- Even with new deduction for Qualified Business Income (Sec. 199A), pass-through income, individual marginal rates exceed 21% for higher income taxpayers



# Entity Comparison

	Pass-through	C Corporation
Single level of tax?	Yes	Generally no
Graduated tax rates?	Yes – 10% to 37%; 8% to 29.6% with 199A	No – 21% flat tax; up to 23.8% s/h tax
SALT deduction?	Limited to \$10k	Yes
Limits on fiscal year?	Yes	No
Limits on cash method for large businesses?	No	Yes
Accumulated earnings tax?	No	Yes
Excess business loss limitations?	Yes	No



## Reconsidering the C corp

- C corporations are far more attractive in closely held business settings than they have been in 30 years
- While the reduction to 21% is currently written as permanent law, this can always be changed
- Changing between C and S corporations are mainly tax-free in one direction. More complicated to convert back to an S corporation than the other way around



# Example: C corporation is favorable

## Assumptions:

*Business is profitable, pays tax*

*Sec. 199A at maximum rate*

*Shareholder is in highest bracket*

*No cash dividends*

		Combined 1120	C corp taxation 1040	S corp tax 1040
Net Income		\$ 1.00		\$ 1.00
Corporate Tax Rate	21%	\$ (0.21)		
Net Cash Available for Distributions		\$ 0.79		
Cash Paid to Shareholder			\$ -	\$ 1.00
Less S/H Tax for Dividends	23.8%		\$ -	
Less highest 1040 rate,	37%			
Sec 199A rate at	20%			(\$0.296)
Net After-Tax Cash		\$ 0.79	\$ -	\$ 0.70
<b>Difference in net after-tax cash</b>		<b>\$ 0.09</b>		
Effective Tax Rate:		21%		30%



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## Questions and Considerations for Entity Conversion or Selection



# Factors to Consider

- Plans for distributions/reinvestment of earnings
- Plans for ownership transition
- Nature of corporation's assets
- Is the company profitable?
- State income tax profile of corporation and shareholders
- Cost of capital/expected return on investments
- Among others...

# Plans for Distributions

- Will the shareholder be taking dividends from the C corporation?
  - Impact of double tax minimized if all or some cash stays in the entity
  - Indefinite deferral of all dividends may lead to assessment of accumulated earnings tax on C corporation

# Plans for Distributions

- In lieu of dividend payments, consider other cash payments to owners, such as rent, guarantee fees, loans
  - Must be at arm's length rates
- Owner compensation may be adjusted upwards
  - C corporation: changes character of income to shareholder from capital gain to ordinary
    - ◇ Reasonable compensation challenge by IRS
  - S corporation: reduces amount available for Sec. 199A deduction



# Appreciating Assets

- Flat 21% tax rate applies to both capital and ordinary income in a C corp.
- Preferential capital gains rates generally available in S corp.
- Many deals are structured as asset sales
- Planning for sale to third party should look at additional tax on cost of sale of assets rather than stock



# Profitable or Loss Company?

- If company is generating operating losses, benefit may not be realized in the same subsequent periods for S or C corps.
- S Corp – “excess business losses” are not allowed in a taxable year and become part of the individual taxpayer’s Net Operating Losses in subsequent taxable years
  - Aggregate deductions for taxpayer trade or businesses over aggregate gross income or gain plus a threshold of \$500,000 (Married Filing Joint)



# Profitable or Loss Company?

- C corp. – Net Operating Losses (NOL) limited to 80% of current year business income
  - NOL Carrybacks are now disallowed
  - NOL Carryforwards do not expire

# Product or Service Revenue

- Is company selling product or services or some combination of both?
- Sec 199A deduction is not available for specified service company with revenues greater than the threshold
  - < \$315,000 joint/\$157,500 single
  - Phase-out: \$315,000 - \$415,000 (MFJ); \$157,500 - \$207,500 (Single)
- Awaiting guidance on eligible nonservice business
- May want to create separate line of business or separate legal entity for two lines of business to take deduction



## Sec. 1202 Exclusion

- Gain on the sale of qualified small business stock issued after September 27, 2010 is eligible for a 100% exclusion (earlier periods have partial exclusion)
  - You must acquire stock directly from a C corporation
    - ◇ Stock outstanding at time of an S to C conversion is not qualified
    - ◇ C Corporation must have < \$50M of assets at/before purchase
  - Stock must be held for > 5 years
  - Gain exclusion limited to greater of \$10MM or 10 times basis





# Earnings & Profits

- Presence of C corp. earnings and profits impacts taxability of cash distributions to shareholders
- Conversion to S does not eliminate E&P
  - Distributions from S corporation with E&P in excess of S corporation AAA may be treated as dividends



# Owner Compensation

- Former planning for owner compensation focused on maximizing deductible compensation for C corporation shareholder/employees while avoiding a possible re-characterization as dividend income
- Compensation for S corporation shareholder/ employees was minimized as a means of reducing employment taxes



# Business Interest Expense Limitation

- Deduction for business interest expense limited to the sum of:
  - 30% of adjusted taxable income
  - Business interest income; and
  - Floor plan financing interest
- Limitation applies at entity level
- Limitation N/A if avg. annual gross receipts  $\leq$  \$ 25M



## Other Items for Consideration

- Starting in 2018, an individual's itemized deduction for state or local taxes is limited to \$10,000
  - Includes real property taxes, personal property tax, state and local, and foreign income taxes and general sales taxes
- Limitation does not apply to taxes paid in connection with a Sec. 162 trade or business or Sec. 212 investment property
- States conformity to the Tax Cuts and Jobs Act



# Other Items for Consideration

- Rate changes in future years
- Availability of the cash method of accounting to C corporations
- Accumulated Earnings Tax
- Financial Statement Reporting as a C corp
- Built-in Gains Tax
- Excess net passive income tax
- Shareholder eligibility
- Number of shareholder restrictions
- Single class of stock required for S-corporation



# Terminating the S Election

- Terminate S status by voluntarily revoking election
- Requires consent of shareholders who hold more than 50% of the number of issued and outstanding shares
- Files statement with IRS Service Center where S election was filed
- Five-year wait period applies between date of revocation of S status and re-election

# Terminating the S Election

- Election made during the tax year and before the 15<sup>th</sup> day of the third month is generally effective for the entire year
  - Can specify future effective date in election
- After the 15<sup>th</sup> day of the third month, change is generally effective first day of the next year
  - Can specify a midyear effective date in the revocation



# Terminating the S Election

- Revocation of S status effective on other than the first day of the year requires two short year returns to be filed – one as S and second as C
- S short period ends on date before terminating event; C short period begins on the date terminating event occurs
- Items of income, loss and deduction are allocated to the S and C short periods on a pro-rata method or specific accounting method





# Mechanics of Conversion

Conversion from partnership to C corp. is treated as a tax free incorporation if Sec. 351 applies and the partnership's liabilities do not exceed the basis of its assets.

Conversion from C corp. to partnership status is treated as a liquidation which generally results in gain recognition for both the corporation and the shareholders.



# Example 1 - Low income, no state tax, liquidation in 10 years

Corporate federal tax rate 21.00%  
 Corporate state tax rate 0.00%  
 Individual federal tax rate 12.00%  
 Individual state tax rate 0.00%  
 Federal CG tax rate on liquidation 18.80%  
 Benefit of 199A 20.00%  
 Discount rate 5.00%  
 Assume no special state CG tax rate

State taxable income  
 Less state income tax  
 Federal taxable income  
 Income before tax  
 Federal tax  
 State tax  
 Distributions in lieu of Federal tax  
 Distributions in lieu of state tax  
 Retained equity  
 # years accumulation  
 Liquidation value  
 Basis to shareholders  
 Capital gain, shareholders  
 Federal and state capital gains tax  
 Shareholder capital gain tax

Present value of annual taxes  
 Present value of liquidation tax  
 Total taxes paid

C	S
50,000	50,000
-	-
<u>\$ 50,000</u>	<u>\$ 50,000</u>
\$ 50,000	\$ 50,000
(10,500)	
-	
	(4,800)
	-
39,500	45,200
10	10
395,000	452,000
-	452,000
395,000	-
18.80%	18.80%
<u>\$ 74,260</u>	<u>-</u>
81,078	37,064
45,589	-
<u>\$ 126,667</u>	<u>\$ 37,064</u>



# Example 2 - High income, no state tax, liquidation in 10 years

			C	S
Corporate federal tax rate	21.00%	State taxable income	100,000	100,000
Corporate state tax rate	0.00%	Less state income tax	-	-
Individual federal tax rate	37.00%	Federal taxable income	\$ 100,000	\$ 100,000
Individual state tax rate	0.00%			
Federal CG tax rate on liquidation	23.80%	Income before tax	\$ 100,000	\$ 100,000
Benefit of 199A	20.00%	Federal tax	(21,000)	-
Discount rate	5.00%	State tax	-	-
Assume no special state CG tax rate		Distributions in lieu of Federal tax		(29,600)
		Distributions in lieu of state tax		-
		Retained equity	79,000	70,400
		# years accumulation	10	10
		Liquidation value	790,000	704,000
		Basis to shareholders	-	704,000
		Capital gain, shareholders	790,000	-
		Federal and state capital gains tax	23.80%	23.80%
		Shareholder capital gain tax	\$ 188,020	\$ -

# Example 3 - High income, state tax, liquidation in 10 years

			C	S
Corporate federal tax rate	21.00%	State taxable income	100,000	100,000
Corporate state tax rate	6.60%	Less state income tax	(6,600)	
Individual federal tax rate	37.00%	Federal taxable income	\$ 93,400	\$ 100,000
Individual state tax rate	9.00%			
Federal CG tax rate on liquidation	23.80%	Income before tax	\$ 100,000	\$ 100,000
Benefit of 199A	20.00%	Federal tax	(19,614)	
Discount rate	5.00%	State tax	(6,600)	
Assume no special state CG tax rate		Distributions in lieu of Federal tax		(29,600)
		Distributions in lieu of state tax		(9,000)
		Retained equity	73,786	61,400
		# years accumulation	10	10
		Liquidation value	737,860	614,000
		Basis to shareholders	-	614,000
		Capital gain, shareholders	737,860	-
		Federal and state capital gains tax	32.80%	32.80%
		Shareholder capital gain tax	\$ 242,018	\$ -
		Present value of annual taxes	\$ 202,418	\$ 298,059
		Present value of liquidation tax	148,578	-
		Total taxes paid	\$ 350,996	\$ 298,059

# Example 4 - High income, state tax on business income (no gain), liquid. in 10 yrs.

			C	S
Corporate federal tax rate	21.00%	State taxable income	100,000	100,000
Corporate state tax rate	6.60%	Less state income tax	(6,600)	
Individual federal tax rate	37.00%	Federal taxable income	\$ 93,400	\$ 100,000
Individual state tax rate	9.00%			
Federal CG tax rate on liquidation	23.80%	Income before tax	\$ 100,000	\$ 100,000
Benefit of 199A	20.00%	Federal tax	(19,614)	
Discount rate	5.00%	State tax	(6,600)	
Assume no special state CG tax rate		Distributions in lieu of Federal tax		(29,600)
		Distributions in lieu of state tax		(9,000)
		Retained equity	73,786	61,400
		# years accumulation	10	10
		Liquidation value	737,860	614,000
		Basis to shareholders	-	614,000
		Capital gain, shareholders	737,860	-
		Federal and state capital gains tax	23.80%	23.80%
		Shareholder capital gain tax	\$ 175,611	\$ -
		Present value of annual taxes	\$ 202,418	\$ 298,059
		Present value of liquidation tax	107,810	-
		Total taxes paid	\$ 310,227	\$ 298,059

# Example 5 - High income, add state tax, no 199A, liquidation in 10 years

			C	S
Corporate federal tax rate	21.00%	State taxable income	100,000	100,000
Corporate state tax rate	6.60%	Less state income tax	(6,600)	
Individual federal tax rate	37.00%	Federal taxable income	\$ 93,400	\$ 100,000
Individual state tax rate	9.00%			
Federal CG tax rate on liquidation	23.80%	Income before tax	\$ 100,000	\$ 100,000
Benefit of 199A	0.00%	Federal tax	(19,614)	
Discount rate	5.00%	State tax	(6,600)	
Assume no special state CG tax rate		Distributions in lieu of Federal tax		(37,000)
		Distributions in lieu of state tax		(9,000)
		Retained equity	73,786	54,000
		# years accumulation	10	10
		Liquidation value	737,860	540,000
		Basis to shareholders	-	540,000
		Capital gain, shareholders	737,860	-
		Federal and state capital gains tax	32.80%	32.80%
		Shareholder capital gain tax	\$ 242,018	\$ -
		Present value of annual taxes	\$ 202,418	\$ 355,200
		Present value of liquidation tax	148,578	-
		Total taxes paid	\$ 350,996	\$ 355,200

# Example 6 - High income, state tax, liquidation in 10 yrs., high discount rate

			C	S
Corporate federal tax rate	21.00%	State taxable income	100,000	100,000
Corporate state tax rate	6.60%	Less state income tax	(6,600)	
Individual federal tax rate	37.00%	Federal taxable income	\$ 93,400	\$ 100,000
Individual state tax rate	9.00%			
Federal CG tax rate on liquidation	23.80%	Income before tax	\$ 100,000	\$ 100,000
Benefit of 199A	20.00%	Federal tax	(19,614)	
Discount rate	20.00%	State tax	(6,600)	
Assume no special state CG tax rate		Distributions in lieu of Federal tax		(29,600)
		Distributions in lieu of state tax		(9,000)
		Retained equity	73,786	61,400
		# years accumulation	10	10
		Liquidation value	737,860	614,000
		Basis to shareholders	-	614,000
		Capital gain, shareholders	737,860	-
		Federal and state capital gains tax	32.80%	32.80%
		Shareholder capital gain tax	\$ 242,018	\$ -
		Present value of annual taxes	\$ 109,901	\$ 161,829
		Present value of liquidation tax	39,087	-
		Total taxes paid	\$ 148,989	\$ 161,829

# Example 7 - High income, no state tax, liquidation in 35 years

			C	S
Corporate federal tax rate	21.00%	State taxable income	100,000	100,000
Corporate state tax rate	0.00%	Less state income tax	-	-
Individual federal tax rate	37.00%	Federal taxable income	<u>\$ 100,000</u>	<u>\$ 100,000</u>
Individual state tax rate	0.00%			
Federal CG tax rate on liquidation	23.80%	Income before tax	\$ 100,000	\$ 100,000
Benefit of 199A	20.00%	Federal tax	(21,000)	-
Discount rate	5.00%	State tax	-	-
Assume no special state CG tax rate		Distributions in lieu of Federal tax		(29,600)
		Distributions in lieu of state tax		-
		Retained equity	79,000	70,400
		# years accumulation	35	35
		Liquidation value	2,765,000	2,464,000
		Basis to shareholders	-	2,464,000
		Capital gain, shareholders	2,765,000	-
		Federal and state capital gains tax	23.80%	23.80%
		Shareholder capital gain tax	<u>\$ 658,070</u>	<u>\$ -</u>
		Present value of annual taxes	\$ 343,858	\$ 484,676
		Present value of liquidation tax	119,302	-
		Total taxes paid	<u>\$ 463,160</u>	<u>\$ 484,676</u>



# Example 8 - High income, add state tax, liquidation in 35 years

			C	\$
Corporate federal tax rate	21.00%	State taxable income	100,000	100,000
Corporate state tax rate	6.60%	Less state income tax	(6,600)	
Individual federal tax rate	37.00%	Federal taxable income	\$ 93,400	\$ 100,000
Individual state tax rate	9.00%			
Federal CG tax rate on liquidation	23.80%	Income before tax	\$ 100,000	\$ 100,000
Benefit of 199A	20.00%	Federal tax	(19,614)	
Discount rate	5.00%	State tax	(6,600)	
Assume no special state CG tax rate		Distributions in lieu of Federal tax		(29,600)
		Distributions in lieu of state tax		(9,000)
		Retained equity	73,786	61,400
		# years accumulation	35	35
		Liquidation value	2,582,510	2,149,000
		Basis to shareholders	-	2,149,000
		Capital gain, shareholders	2,582,510	-
		Federal and state capital gains tax	32.80%	32.80%
		Shareholder capital gain tax	\$ 847,063	\$ -
		Present value of annual taxes	\$ 429,233	\$ 632,044
		Present value of liquidation tax	153,564	-
		Total taxes paid	\$ 582,797	\$ 632,044

# Entity Conversion: Look Before You Leap





# Questions?

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