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A Successful Future

Stuart H. Sorkin
MEMBER DC BAR

Matthew S. Haskin
MEMBER MD BAR

James A. Kaminski
OF COUNSEL

To: Clients	**From:** Stuart H. Sorkin, Esq.
Re: Conversion from LLC or S-Corporation to a C Corporation	**Date:** 9/30/2020

Are you a partner or stockholder in an LLC, partnership, S corporation or other form of pass-through entity (collectively referred to herein as "pass-through entity") and you do not need to distribute all of the profits in your pass-through entity to support your current lifestyle and any of the following applies to you or your business:

1. Your business is required to maintain at all times a certain amount of liquidity;

2. Your business will be expending significant capital that will not generate a current income tax deduction such as acquiring another business or funding the future buy-out of another partner;

3. Your business has incurred a significant amount of business debt;

4. Your business needs to provide additional incentives to retain key employees;

5. You have maximized your personal qualified retirement contributions and you want to save more for retirement;

6. You are considering using an ESOP to exit your business;

7. You are considering applying for certain types of SBA loans; or

8. You want to separate your business and individual income tax reporting and reduce the amount of time and effort you spend in December decelerating income and prepaying expenses because of the pass-through entity rules. If one or more applies to your business, then, under the new 2017 Tax Cuts and Jobs Act ("Tax Act"), you may want to consider converting your business from a pass-through entity to a C corporation. **Please note that every circumstance is different and we strongly recommend speaking with your attorney or accountant to determine whether a conversion is right for you.**

Under the new Tax Act, C corporations are now being taxed at 21% down from 35% and C corporations receive a full deduction for state and local income taxes; however, excess after-tax income which is distributed to stockholders is then taxed as a dividend and taxed again at capital gains rates of 15% or 20% ("Double Taxation"). While pass-through entities are required to file income tax returns, no income tax is imposed on these entities, their income flows through and is taxed to the individual partners. Under the Tax Act, if the partner's taxable income is less than $315,000 (Joint or $157,000 Single), then the Qualified Business Income ("QBI") from your business would be subject to a tax rate of 20%, this produces an overall effective federal tax rate of 29.6%. This favorable tax benefit is phased out for joint taxpayers with taxable income of

$415,000 ($207,500 single) and certain types of income do not qualify as QBI, and therefore these taxpayers face a maximum tax rate of 37%. In addition, the Tax Act caps the deduction of state and local taxes at $10,000 per taxpayer ($5,000 married filing separately). Accordingly, most high income taxpayer will not be able to deduct most if not all of their state income taxes since any real property taxes also are included in this same limitation. The following table is intended to illustrate the effect of the Tax Act on all three situations:

		Individual NO QBI	Individual with QBI	Corporate Tax
Taxable Income before State Income Taxes		200,000	200,000	200,000
State Income Taxes	5.75%	11,500	11,500	11,500
Taxable Income After State Income Taxes		200,000	200,000	188,500
Federal Tax Rate		37.00%	29.60%	21.00%
Federal Income Tax		74,000	59,200	39,585
Net After Tax Income		114,500	129,300	137,415

Please note that there several assumptions in this table that may not be applicable to all taxpayers. Accordingly, you should discuss any possibility of a conversion to a C corporation with your CPA and other tax advisor to confirm the applicability to your individual tax situation.

The following are several other potential significant advantages of electing to become a C corporation:

1. C corporations can have multiple classes of equity, which allows for establishing different classes of equity for potential investors and employees that have different rights than founder's equity;

2. C corporation can establish defined benefit and medical reimbursement plans;

3. Stockholders do not have to report health insurance premiums on their individual return and Stockholders can participate in employer created non-qualified deferred compensation plans ("NQDCP") (NQDCP just for employees have a lower after-tax cost for owners when implemented in a C Corporation);

4. Can have a fiscal year other than 12/31, which can allow for more income tax planning;

5. Stockholders of C corporation stock have more alternatives and flexibility regarding estate and gift tax planning;

7811 Montrose Road, Suite 500
Potomac, Maryland 20854
Writer's Direct Dial Office: 301 320-1152
Writer's Cell 202 368-7075
Writer's Email: stuart@businessandlegaladvisors.com
www.businessandlegaladvisors.com

6. No need to make annual cash distributions to stockholders to pay income taxes; and

7. Reduces the risk of IRS audits compared to S-corporations and LLCs.

If you are in a highly competitive industry, the 1st 3 advantages listed above should significantly improve your business' ability to hire and retain key employees without the negative implications of allowing employees to become stockholders in a pass-through entity.

The following are the significant disadvantages of electing to become a Corporation:

1. The potential for Double Taxation, however, with year-end tax planning this can be significantly reduced by paying the partners bonuses at year end and the partners are still only paying taxes on the income they actually receive not on phantom income as with pass-through entities.

2. Potentially significantly higher income tax can be imposed when the entity is sold in an asset sale rather than a stock sale. Again, this higher tax can be reduced through proper tax planning.

3. The imposition of the 20% accumulated earning tax, if the accumulation is in excess of the higher of $250,000 ($150,000 Professional Corporation) or amount retained for reasonable needs of the corporation. If you have documented reasons why you are accumulating the funds, the risk of a successful IRS challenge is minimized, i.e., "you cannot get in trouble, if you tell the story right."

4. There is always a risk that these low corporate tax rate will increase but most tax experts would tell you that individual tax rates are likely to rise proportionately higher than corporate tax rates.

It is important to note, that once you make a switch between S corporation and C corporation status, you are generally prohibited from switching back for 5 years. Accordingly, as noted above, we strongly recommend speaking with your attorney or accountant to determine whether a conversion is right for your business.

I hope you will find this memorandum useful and if you have any questions, please call me.

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