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Considerations for Converting Your Business from a Partnership, LLC or S Corporation to a C Corporation for Government Contractors

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There are a number of business, financial, income, and estate tax reasons that warrant your consideration regarding converting your existing business from operating as a Partnership, LLC or S corporation (collectively "Flow-Through Entities" and in the singular "Flow-Through Entity") to a C corporation for income tax purposes. If, after reading this memorandum, you desire to take advantage of the planning alternatives described herein, you must notify the IRS no later **March 15, 2022**, to make this election for the 2022 calendar year. It is important to note that the election to become a C corporation is *irrevocable* and a business cannot change its status again for five years after the election; therefore, you should only consider this election if you have consulted with us, your own attorney and/or CPA since every business has different circumstances.

The 2017 Tax Cut and Jobs Act (the "Act") reduced the corporate income tax rate to a flat 21% while continuing to allow the full deduction of state and local income taxes. In order to provide similar tax relief for Flow-Through Entities for which no income tax is imposed and their income flows through and is taxed to the individual owners, the Act included a 20% reduction in the taxable portion of Qualified Business Income ("QBI"). This 20% reduction in the amount of the QBI will produce an effective overall tax rate of 29.6% for taxpayers in the 37% income tax bracket. Under the Act, there are several limitations on which income qualifies as QBI. The QBI tax benefit is phased-out for joint filers with taxable income starting at $340,100 and completely eliminated at $440,100 of taxable income. For single individuals and heads of households, the phase-out begins at $170,050 and is completely eliminated at $220,050. This taxable income limitation will prevent most successful business owners with a working spouse from claiming any benefit from the QBI deduction. Furthermore, since not all states utilize the QBI deduction in their income tax, and therefore, the QBI deduction may have no effect on the amount on non-deductible state income taxes imposed on the owner of a Flow-Through Entity. The effects on after-tax income if the owner's taxable income is just below the $340,100 limitation for full utilization of the QBI deduction is shown in **Table 1**. **Table 2** shows the effects on after-tax income if the QBI deduction is disallowed because of the taxable income limitation. **Table 2** also shows the effective income tax rate for C corporations at 24.5% and 32.65% for Flow-Through Entities assuming a state income tax rate at 5%.

Since the election of President Biden, many tax planners were hesitant to make an election to become a C corporation because of the fear of an increase in corporate tax rates. However, given the current situation, it is becoming more unlikely that there will be an increase in the corporate income tax rate until after the next Presidential election, if then. Furthermore, if the corporate income tax rate increases, it is likely that the individual tax rates will increase as well.

A. <u>Advantages of Becoming a C Corporation</u>.

1. If your business has one of the following reasons to retain a portion of net after-tax profits, then you could reduce your effective tax rate by 8% or more by becoming a C corporation:

a. Your business is required for banking, insurance or bonding to maintain a significant amount of liquidity.

b. Your business needs to start building a cash reserve for potential future acquisitions or to buy out a departing owner.

c. Your business has previously incurred significant debt that will need to be repaid.

Since none of these uses of after-tax profit will generate any current income tax deductions, therefore, would the owner rather accumulate these funds with an effective tax rate of 24.95% as a C corporation or 32.65% as a Flow-Through Entity?

2. A C corporation allows you more flexibility in creating multiple classes of stock for investors and employees compared to an S corporation, with its limit of one class of stock.

a. An investor class of stock can include preferential rights to income and/or return of their investment and with these preferences investors are less likely to demand significant control of management or voting from the business. In addition, many investors are more resistant to investing in a Flow-Through Entity because of the potential for phantom income (i.e., an allocation of income from the Flow-Through Entity in excess of cash distributions to the investors from the Flow-Through Entity).

b. Awarding of actual equity to key employees to increase retention can have the following benefits with proper planning: (i) increasing the value the owner will receive upon sale by delivering an intact management team; (ii) increasing the likelihood you will get from LOI to closing by limiting a key employee's ability to obstruct the acquisition without first receiving additional compensation; (iii) creating an asset that will allow the key employees to receive favorable capital gains treatment on this type compensation rather ordinary income; and (iv) a stronger and more enforceable restricted covenant for post-employment because the employees are also stockholders. While this type of structure could be used with an LLC, under the Internal revenue Code members are not allowed to receive a salary for services rendered to the LLC. This significantly increases the complexity of the employee's income tax filing since they are now owners of the LLC who will be required to file and pay estimated income taxes rather than have their taxes withheld by their employer, and, therefore, it can negatively affect the employees' view of the overall benefits of this plan.

3. Owners of Flow-Through Entities are subject to limitations on the following types of employee or executive benefits, whereas these same limitations do not apply to employee stockholders of C corporations:

a. C corporations can establish defined benefit and medical reimbursement plans for its employees, as well as stockholders, on a *non-discriminatory basis*. A medical reimbursement plan, also known as a medical expense reimbursement plan ("MERP"), is substantially similar to a health reimbursement arrangement ("HRA"). In fact, they are basically synonymous, with an HRA just being the more common phrase used. However, unlike HRAs, there is no physical account linked to a MERP. Rather, the business will reimburse the employee for any health expenses after the medical services have been completed. With various new benefit plans now available through health care providers, many businesses are quite interested in MERPs. MERPs are merely a way for employers to give their employees tax-free money that can only be used to pay for medical expenses. MERPs often operate as follows:

- Employees pay for their own doctor visits and medicine and then the employer reimburses them.

- Employers can contribute exactly the amount they want so the cost of a MERP does not increase from year to year.
- MERPs are incredibly flexible so it is difficult to say exactly how they should be used.

A MERP allows businesses to pay for part of their employees' deductibles, copays or co-insurance and any other qualified medical expense tax-free. Again, these plans are incredibly flexible and allow the business a number of suitable alternative arrangements. As a result, MERPs are often associated with health care plans with higher deductibles. This will save the business and its employees on the amount of premiums while also continuing to offer a good quality health plan to its employees. When deciding whether to opt for a MERP, consider that the business will usually save a lot during the first year with the goal of stabilizing that amount in future years.

b. Unlike Flow-Through Entities, employee stockholders of a C corporation do not have to report health insurance premiums as an adjustment on their individual income tax return.

c. If the employee stockholder is already maximizing his or her contributions to a qualified retirement plan, then the employee stockholder can supplement their retirement with a non-qualified deferred compensation plan. A nonqualified deferred compensation plan (a "NDCP") is a contractual agreement in which a participant agrees to be paid in a future year for services rendered this year. Deferred compensation payments generally commence upon termination of employment (e.g., retirement), death or disability. NDCPs are often geared towards anticipated retirement in order to provide cash payments to the retiree and to defer taxation to a year when the recipient is in a lower tax bracket. *These types of plans are not subject to the non-discrimination rules imposed on qualified plans*. Therefore, if desired, benefits can be offered only to a select group of employees. Consequently, the cost of this benefit is lower since it accrues to fewer people. Please note that failure to comply with specific IRS rules, including that the funds of an NDCP cannot be permanently set aside for the participant, will cause an immediate tax on the balance of the NDCP. Accordingly, the owner must understand the risk that the funding for NDCPs will not be protected from creditors if the company that created them files for bankruptcy.

d. If the business may need additional bank financing for operations or growth, both traditional and SBA loans to a C corporation are generally easier to get bank approval than Flow-Through Entities because the owner's personal tax returns and finances will become more relevant in the approval process. Additionally, the typical year-end tax planning by Flow-Through Entities of accelerating or decelerating income or expenses because of the tax liability that is imposed on the owner can affect banking ratios during the loan approval process. Finally, if the borrower is a C corporation and the C corporation is financially viable, then the owner may be able to limit or eliminate any personal guarantees, which most banks tend to require for loans to Flow-Through Entities.

e. A C corporation provides more flexibility for estate and gift tax planning for the owner compared to Flow-Through Entities where the family or a trust for the family will have an annual ordinary income tax filing and liability because they are owners of the Flow-Through Entity. Furthermore, irrevocable trusts which hold S corporation stock must meet certain requirements to maintain its S corporation status, which makes the trust a type of flow-through entity as well. On the other hand, an irrevocable trust receives the same favorable capital gains treatment as an individual. Therefore, having an irrevocable trust holding C corporation stock will allow the accumulation of profit in the trust for the use of the owner's family with a lower income tax rate for when the owner decides that he/she wants to pass funds to the next generation. Note that operating LLCs generally should not be gifted to irrevocable trusts because the income will typically be ordinary and an irrevocable trust reaches the maximum income tax rate of 37% at $13,451 of taxable income.

f. If the owner determines that the best exit strategy is an Employee Stock Ownership Plan ("ESOP"), then the owner will be able to defer a significant portion of the tax liability upon the sale if the company is a C corporation. Unfortunately, this deferral is generally not available to Flow-Through Entities. However, once an ESOP transaction is completed, it is best for the entity to convert back to a Flow-Through Entity as soon as possible since a Flow-Through Entity that is owned by an ESOP will pay reduced or no income taxes.

g. Typically, only a C corporation can have an income tax year end on a date other than December 31. Since the government's year end is September 30, it makes sense to have either a September 30 or October 31 year end. Having different year ends from the owners allows for some shifting of income between different tax years.

h. By becoming a C corporation, you can avoid having to make big cash distributions to the owners to fund their individual income tax liability from the Flow-Through Entities. Unfortunately, I have seen many situations where the entity or the owner(s) need to borrow significant funds to pay an unexpected tax liability.

i. A C corporation is *less likely to get audited* compared to S corporations and LLCs under the current IRS guidelines. In addition, the owner can separate their business and individual income tax reporting and reduce the amount of time and effort spent in December decelerating income and prepaying expenses because of the pass-through entity rules.

B. <u>Disadvantages of Becoming a C Corporation</u>. The following are some of the significant concerns that deter companies from electing to become a C corporation. However, as described below, these concerns can be minimized or eliminated for government contractors, in particular, because of their ability to control the timing of their revenue stream through billing and the typical approach to a third-party sale:

1. **Double Taxation**. To the extent that a C corporation retains any after-tax profit, it will eventually be distributed to the stockholder as a dividend, which is taxed at 15% or 20% (this is referred to "Double Taxation"). The effect of Double Taxation was significantly reduced by the Act since 21% + 15% = 36% or at worst 41% (21% + 20%) verses 37% for the individual. Again, the deductibility of state taxes by the C corporation further reduces the potential negative effect of Double Taxation. As further described below, there are several tax-efficient ways of spending this increased after-tax income for the benefit of the owners.

From my experience, most government contractors are very knowledgeable about the consistency and timing for the payment cycle from their governmental agency customers, in particular, the amount of time that will generally elapse between sending the invoice to the client and when the client will make payment. With proper planning, the government contractor has the ability to look at its projected revenue for the entire year in October and November, then it can determine the amount of income it would like to report for the year. Then, they can determine to either accelerate or decelerate their billing in November and December to somewhat control their income recognition. Accordingly, with a well financially managed government contractor, the business should be able to reasonably predict its taxable profit and then determine how much profit can be utilized by the business in the subsequent year (as described below). Then it can compute the income taxes on the amount of retained profit and the remainder, if any, can be paid as a profit-sharing bonus to owners with the only additional tax (assuming the owner is already in the maximum income tax brackets) being the Medicare taxes. This type of tax planning can significantly increase the financial benefits of the owners over many years. However, some government contracts contain limits on what benefits can be paid to the owners. That said, if an entity converts to a C corporation, then the owners' benefits and compensation need to be reviewed in light of the benefits that can be offered to the owners of a C corporation and not Flow-Through Entities to comply with any governmental regulations regarding compensation.

2. **Sale of the Business**. The two most prevalent methods of selling a business are either an *asset sale or a stock sale*. Generally, the acquirer prefers an asset sale in order to be able to expense substantially all of the purchase price through depreciation and amortization. In addition, under an asset sale, the acquirer can select the assets it will acquire and the liabilities it is willing to assume or pay for a seller. Sellers are required to pay ordinary income taxes on a portion of the purchase price and capital gains on the other portion based upon the allocation of the purchase price among the assets. If a C corporation sells its assets, the entire gain is subject to Double Taxation. This would in all likelihood increase the tax burden on sale depending on the allocation of the purchase price among the acquired assets. For example, if there will be significant ordinary income compared to capital gains on an asset sale because a significant portion of the purchase price is allocated to the value of the fixed assets, which are taxed at ordinary rates then an asset sale by a C corporation may produce an overall reduction in taxes because of the 16% difference in ordinary income rates and deductible state income taxes. On the other hand, sellers generally prefer stock sales because they get capital gains treatment on the entire purchase price. However, acquirers do not like limited ability to write-off the purchase price and becoming liable for the seller's pre-closing liabilities.

While asset purchase transactions represent a substantial majority of most business sales, government contractors are generally the exception to this rule. Generally, most sales of government contractors are stock sales because the acquirer does not want to risk a novation of the government contract, which is possible with an asset sale because the government contracts will need to be assigned to the acquirer. Therefore, a government contractor can elect to become a C corporation and avoid the potential negative tax consequences that would typically occur on a sale of the business.

3. **Accumulated Earning Tax**. In the event the business stock piles cash in excess of $250,000 ($150,000 Professional Corporation) for any reason not approved by the IRS (examples provided above), there is an imposition of a 20% accumulated earnings tax. Until the Act, this was not an issue of high IRS focus because the difference between corporate tax rates and individual tax rates was not significant. If you document the amount and reasons for any accumulation of profits in your annual minutes, the risk of a successful IRS challenge is minimized (i.e., "you cannot get in trouble if you tell the story right")[1].

4. **Change in the Law**. While there is always a risk that these low corporate tax rates will increase, most tax experts will tell you that individual tax rates are likely to rise proportionately higher than corporate tax rates.

5. **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 five years. If you want to make the election to become a C corporation, you must file the appropriate paperwork with the IRS by March 15, 2022.**

C. Examples of Calculations. As illustrated by **Table 1** below, if the owner's taxable income is below the phase-out of the QBI deduction, a maximized QBI deduction produces the best overall tax result and the corporate taxation still produces tax savings for the owner. However, the difference in effective tax rates is relatively small because to get the full benefit of the QBI

[1] This quote is repeated by several cast members in the movie *Basic*.

deduction, the taxable income needs to be under $340,100 and the marginal tax rate at that level is 32%. However, as illustrated by **Table 2**, if the owner's taxable income is at the maximum marginal tax rate of 37%, the owner gets no benefit from the QBI deduction and the effective rate is 24.95% under the corporate tax alternative, while the effective tax rate is 32.65% as a Flow-Through Entity. If the taxable income arises above the levels shown in **Table 2**, then the corporate income tax alternative produces more tax savings.

Table 1		**Assuming Maximum Allowable QBI**		
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		Individual NO QBI	**Individual with QBI**	**Corporate Tax**
Qualified Business Income		200,000	200,000	200,000
Other Income Taxable Income (net of deductions)		140,000	140,000	140,000
Taxable Income before State Income Taxes		340,000	340,000	340,000
State Income Taxes	5.00%	17,000	17,000	17,000
Taxable Income After State Income Taxes		340,000	340,000	323,000
Qualified Business Income Deductions			40,000	
Taxable Income After QBI Deduction			300,000	
Federal Tax Rate		32.00%	24.00%	21.00%
Federal Income Tax		70,454	59,671	67,830
Net After Tax Income		**252,546**	**263,329**	**255,170**
Effective Income Tax Rate		**26%**	**23%**	**25%**

Table 2		**Assuming Tax. Inc. over QBI Limitation**		
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		Individual NO QBI	**Individual with QBI**	**Corporate Tax**
Qualified Business Income		400,000	400,000	400,000
Other Income Taxable Income (net of deductions)		300,000	300,000	300,000
Taxable Income before State Income Taxes		700,000	700,000	700,000
State Income Taxes	5.00%	35,000	35,000	35,000
Taxable Income After State Income Taxes		700,000	700,000	665,000
Qualified Business Income Deductions			0	
Taxable Income After QBI Deduction			700,000	
Federal Tax Rate		37.00%	37.00%	21.00%
Federal Income Tax		193,550	193,550	139,650
Net After Tax Income		**471,451**	**471,451**	**525,350**
Effective Income Tax Rate		**32.65%**	**32.65%**	**24.95%**

Please note that there are several assumptions in Table's 1 and 2 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/or other tax advisor to confirm the applicability in your individual tax situation.

I hope you find this memorandum useful, and I would be happy to provide a complimentary consultation regarding conversion to a C corporation. Finally, as a reminder, please note that every circumstance is different and we strongly recommend speaking with us, your attorney and/or accountant to determine whether a conversion is right for you.

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