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Federal Tax ADVISORY

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Tax Change Planning

You don't need inside information from Congress to suspect that a reduction in the maximum tax rate for C corporations is likely. That could put the individual-to-corporate rate brackets back into the relationship they occupied for decades up to 1986. Tax planners would need to adopt a very different way of thinking about C corporations.

The Tax Reform Act of 1986 turned C corporations into public corporations, almost exclusively. The exceptions have been the unfortunate private corporations that failed to take advantage of the favorable conversion transition option after the 1986 Act. When individual rates exceeded corporate rates, even by 5%, a substantial current tax savings could result from earning income within a C corporation, as contrasted with a pass-through business entity, viewed without regard to any future additional tax on realization by individual shareholders of that value retained in the C corporation.

Higher interest rates sometimes reduced the disadvantages of any later shareholder-level tax because the discounted present value of future taxes is lower when interest rates are higher. In the current economy, however, interest rates are at record lows. Therefore, deferral is not as valuable.

Depending on the size of the corporate rate cut, taxpayers might consider using C corporations in situations not previously desired. For example, it might make sense to consider establishing a C corporation for a new business involving professional services that can enjoy a run up the lower-rate brackets. That was the tax shelter of choice in the 1960s and 1970s when states began to allow doctors to incorporate. In addition to the corporate tax rate, corporations offered better pension plans.

Corporate rate reduction might have an impact on the payment of dividends, and more importantly stock buybacks. The reduced dividend rate did not necessarily accelerate corporate dividends because public companies have long been shifting their dividend into stock buybacks. But a corporate tax rate of 20% could make stock buybacks taxed at 15% look less logical, particularly if the corporation can find productive investments for its cash.

Corporate rate reduction also might make the use of S corporations, RICs, and REITs somewhat less advantageous. The same could be true of the increasingly common Up-C transaction that allows a corporation to make a partnership investment while retaining the option to swap its partnership interest for traded stock.

In general, any time rates diverge based on differences in types of taxpayers, a lot of tax planning is spurred. High rates have been fingered as the cause of much individual tax planning. Low rates can spur planning to get into the low-rate structure.

For more information, please contact Jack Cummings at 919.862.2302.

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