Think Twice Before Converting a Florida Business to a Corporation

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The Tax Cuts and Jobs Act taken together have many business owners considering converting their business from a pass-through entity to a C corporation in order to take advantage of the 21-percent tax rate for corporations. Although there are several reasons not to convert to a C corporation, the owner of a Florida business would likely suffer an additional detriment by doing so due to state tax laws.

A C corporation is a corporation which has not made a subchapter S election. A "C" corporation pays income taxes itself, at the new reduced 21-percent tax rate. On the other hand, the owners of businesses structured as a pass-through entity—either an S corporation, partnership, LLC or sole proprietorship—pay tax on their share of the company's income at the higher tax rate for individuals—up to a top tax bracket of 37 percent under the new tax law.

However, there are material tax disadvantages to converting to a C corporation. Significantly, there is a double tax on a business structured as a C corporation—first at the corporation level, which will pay tax at the 21-percent rate on its profit, and then a second tax when the corporation distributes the profits as dividends, which are generally taxed to the shareholders at a 23.8 percent rate. This results in a total combined corporation and shareholder tax rate (for a shareholder in the top tax bracket) of about 39.8 percent. If the business is a pass-through entity, which passes the income through to its owners, the owner's top tax rate would be 37 percent, and most small business owners would be in a tax bracket lower than that. When the double tax is taken into consideration, there is a disadvantage to converting a business to a C corporation to take advantage of the 21-percent tax rate. There are other disadvantages as well, including a potential tax cost for some businesses in cases where the amount of the company's debt exceeds the tax basis of its assets, potential transfer taxes, and accumulated earnings tax concerns.

For the owners of a pass-through business operated in Florida, there is a significant additional disadvantage to converting to a C corporation. In Florida, *only* a C corporation is subject to state income tax. There is no personal income tax on income passing through to the owners, and no separate entity level tax on the pass-through business. Converting a Florida business to a C corporation would add an additional 5 percent tax on the profits, which would otherwise not be subject to Florida tax at all if the business remains structured as a pass-through entity. This would have the effect of a combined federal and state tax rate on the earnings of the corporation of about 25 percent (because the Florida tax would be deductible by the corporation when calculating its federal income tax, the tax rate is less than the 21 percent federal tax, plus the 5 percent Florida tax rate). As a result of the increased combined federal and state tax rate due to the 5 percent Florida tax, the total double tax for an owner in the top tax rate would be nearly 43 percent, instead of the 37 percent top rate for a business structure as a pass-through entity. If the business qualifies for the new 20 percent deduction for pass-through entities, this would result in a total tax to the owner as low as 29.6 percent, further widening the gap.

This would not be a consideration for a pass-through business in a state which imposes a personal income tax, because the owner of a pass-through business would pay tax on the income earned by the business. This is not the case in Florida.

Florida is unique, even among other states which do not impose a personal income tax. Texas, Washington and Nevada do not impose a personal income tax, but they do impose a franchise or gross receipts tax at the entity level of most businesses, including pass-through entities, as well as corporations. Therefore, business owners in those states do not face the same significant disadvantage of converting to a C corporation as Florida business owners.

The decision to convert a business to a C corporation should be made after careful consultation with tax advisers and weighing the pros and cons. But for many businesses, the disadvantage to a Florida business structured as a C corporation would result in the decision to remain as a pass-through entity.

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