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Will Kamala Harris Proposed 28%Tax Rate Change Choice For Business?

In 2018, when former President Trump was in office, the corporate tax rate dropped precipitously from 35% to 21%, and companies celebrated. President Biden had promised early on to raise it back up, but that has proven to be a tough sell, and it still has not occurred. In the administration's most recent budget, it was slated to be 28%. And in a recent statement, the Harris campaign has proposed raising the corporate tax rate to 28%, restating President Biden's proposal.

The dollars are big. Some at the Committee for a Responsible Federal Budget say Harris' proposed rate hike could reduce the U.S. deficit by over $1 trillion in a decade. The Congressional Budget Office projected that 1 percentage point increases in the corporate rate corresponds to about $100 billion over a decade.

In addition to a 28% corporate tax rate, Vice President Harris has proposed ending foreign tax shelters by taxing offshore corporate income at the same rate as domestic income. These plans would likely find resistance in Congress, but they indicate a stark difference between the parties. But how would it impact small business, and the choices that new businesses need to make?

For many years, when an individual outgrew a proprietorship, a corporation used to be the norm. But in more recent decades, the single level of tax you get with limited liability companies (LLCs) became popular for small business. But since 2018, the 21% rate for corporation triggered a second look at these issues. A 21% vs. 28% rate is likely to invite closer questions. And if you have a corporation—one you formed or inherited—should it be S or C?

All corporations are C corporations (under subchapter "C" of the tax code) unless they file for S corporation status. If you take no action, your corporation is a C corporation. Whether S or C, a corporation is entitled to limited liability. It's traditionally one reason businesses incorporate. It is also a structure people understand. A separate legal entity, it is owned by shareholders, ruled by a board of directors who elect officers to do day to day management.

But C vs. S status is all about taxes. File a one page S election with the IRS and it is taxed almost like a partnership or LLC. A corporation may be taxed as a C corporation for many years and then change to S status. Alternatively, by filing the S election upon initial formation, it will *never* be a C corporation. That way, it does not need to worry about the built in gain tax on conversion from C to S.

Income from a C corporation is taxed twice. The corporation pays tax on its net income—currently at 21%. Then, shareholders also pay tax on distributions. Income from an S corporation is taxed once at the shareholder level, mostly like an LLC or partnership. An S corporation can have no more than 100 shareholders, only U.S. citizens and resident aliens, generally individual shareholders, and a calendar fiscal year. If there are multiple classes of stock, only differences in voting rights are allowed. For most small businesses, these criteria are easy to meet.

If the owners are more comfortable with the corporate form than an LLC, an S corporation can be a good choice. However, the accounting rules for S corporations are complicated, and it is hard for existing C corporations to convert. An S corporation can face corporate tax if it was previously a C corporation and elected S status within the last 5 years (this is the built-in gain tax noted above). Many of these rules can be avoided if you start out with an S corporation. To do this, file your S election within 75 days of forming your corporation.

How do you weigh the pluses and minuses on your facts? Often, C corporations are not the best choice for small businesses. The main reason is the double tax on income and on proceeds of sale. Besides, if you incur losses, you want to claim them personally, favoring an LLC or S corporation. But a big reason for many small businesses like C corporations is the $10M qualified small business stock break some can get. In 2021, it looked like it might be repealed or changed significantly. But it's still on the books, and can be a good reason to form a C corporation, even at a 28% rate.

Besides, with the wisdom of Silicon Valley, some startups are LLCs at the start so founders can get tax losses, and then flip to C corporation status if they have a shot at the QSBS exclusion. Big and small business will be watching the rate discussions, no matter what.

Check out my website.