51. [LO 3] Sandra would like to organize LAB as either an LLC (taxed as a sole proprietorship) or a C corporation. In either form, the entity is expected to generate an 8 percent annual before-tax return on a $500,000 investment. Sandra’s marginal income tax rate is 37 percent and her tax rate on dividends and capital gains is 23.8 percent (including the 3.8 percent net investment income tax). If Sandra organizes LAB as an LLC, she will be required to pay an additional 2.9 percent for self-employment tax and an additional .9 percent for the additional Medicare tax. LAB’s income is not qualified business income (QBI) so Sandra is not allowed to claim the QBI deduction. Assume that LAB will distribute all of its after-tax earnings every year as a dividend if it is formed as a C corporation.

a. How much cash after taxes would Sandra receive from her investment in the first year if LAB is organized as either an LLC or a C corporation?

b. What is the overall tax rate on LAB’s income in first year if LAB is organized as an LLC or it is organized as a C corporation?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | *LLC* | *Description* | *C Corp.* | *Description* |
| *(1) Pretax earnings* | *$40,000* | *8% × $500,000* | *$40,000* | *8% × $500,000* |
| *(2) Entity level tax rate* | *0%* |  | *21%* |  |
| *(3) Entity level tax* | *-0-* |  | *8,400* | *(1) × (2)* |
| *(4) Earnings after-entity-level tax* | *$40,000* | *(1) – (3)* | *$31,600* | *(1) – (3)* |
| *(5) Deduction for 50 percent of SE tax* | *(536)* | *(1) × .9235 × .029 × .5* | *NA* |  |
| *(6) QBI deduction* | *0* | *Does not qualify* | *NA* |  |
| *(7) Net income taxable to owner* | *39,464* | *(4) + (5) + (6)* | *31,600* | *(4) × 100% distributed as dividend* |
| *(8) Income tax paid by owner* | *14,602* | *(7) × .37* | *6,320* | *(7) × .20* |
| *(9) Self-employment tax* | *1,071* | *(1) × .9235 × .029* | *NA* |  |
| *(10) Additional Medicare tax/Net investment income tax* | *332* | *(1) × .9235 × .009 additional Medicare tax* | *1,201* | *(7) × .038 net investment income tax* |
| *(11) Owner-level tax* | *$16,005* | *(8) + (9) + (10)* | *$7,521* | *(8) + (10)* |
| ***After-tax cash flow*** | ***$23,995*** | *(1) – (11)* | ***$24,079*** | *(7) – (11)* |
|  |  |  |  |  |
|  |  |  |  |  |
| *b.* | *LLC* |  | *C Corp.* |  |
| ***Overall tax rate*** | ***40.01%*** | *(11)/(1)* | ***39.8%*** | *[(3) + (11)]/(1)* |