Implications of the 2017 Tax Act: Choice of Entity

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- Signed into law on December 22, 2017
- Provisions generally apply NOW – to taxable years beginning after December 31, 2017
- Corporate and International changes are "permanent;" almost all individual changes (including the new 20% deduction applicable to sole proprietors and pass-throughs) expire Dec. 31, 2025
- The volume of new rules coupled with the speed with which the Act went through the legislative process has left practitioners and taxpayers (clients) scrambling to learn, understand and PLAN
- Will likely need corrections but enacting any corrective legislation will be very difficult with the current Congress (would either need 60 votes or would have to use budget reconciliation process (again) – using budget reconciliation will come with challenges (e.g., will likely not be a budget resolution before Spring, 2018 at the earliest; provisions have to have a "revenue effect))
- No JCT Bluebook yet – only have House, Senate and Conference

Corporate Changes

- Permanent reduction in corporate tax rate of from 35% to 21%
- No special rate for personal service corporations
- Repeal of Corporate AMT
- 80% dividends received deduction reduced to 65%; 70% dividends received deduction reduced to 50%
- NOLs limited to 80% of taxable income for tax years beginning after Dec. 31, 2017; no carryback; indefinite carryforward
- Expanded availability of cash method

New Deduction for Certain Business Income

Who can claim the deduction? *Sole proprietors and owners of pass-through entities*

What is the amount of the deduction?

- 20% of qualified business income for each "qualified trade or business," subject to the W-2 wage and qualified property limitation, *plus*
- 20% of any qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income

What type of income is eligible for the deduction?

- Must be effectively connected with a qualified U.S. trade or business
- NOT short-term and long-term capital gains and losses, dividends and dividend equivalents, certain commodity gains and losses, certain foreign currency gains and losses, certain notional principal contract income, and interest income or annuity income that is not business related;
- NOT "reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business, (which essentially means wage income)," IRC § 707(c) guaranteed payments for services, and non-partner capacity payments (under regulations)

New Deduction: Limitations

If a taxpayer has less than $315,000 (married filing jointly) or $157,000 (all other filers) of taxable income before the deduction, the two main limitations on the deduction do not apply; however, the limitations are phased in over the next $100,000 (or $50,000) of taxable income

TWO MAIN LIMITATIONS:

(1) Qualified trade or business does not include:

- A specified service trade or business, or
- The trade or business of performing services as an employee
- A specified service trade or business = any trade or business:
  - Involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financials services, or brokerage services (this list specifically excludes engineering and architecture), OR
  - Where the principal asset of such trade or business is the **reputation or skill of one or more of its owners or employees**, OR
  - Which involves the performance of services that consist of investing and investment management, trading, or dealing in: Securities (as defined in IRC § 475(c)(2)), Commodities (as defined in IRC § 475(e)(2)), or partnership interests
  - There is significant ambiguity with respect to which businesses will be carved out from application of the deduction

(2) Second limitation:

For every qualified trade or business, the deductible amount is limited to:

- – 50% of W-2 wages (including shareholder/employee wages) with respect to the qualified trade or business, or
- – 25% of W-2 wages, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property

- W-2 wages = with respect to any person for any taxable year, the amounts paid by such person with respect to employment of employees during the calendar year ending during such taxable year (and reported to SSA) and allocable to the QBI
- Qualified property = tangible property that is subject to depreciation

Overall Limitation

- Once the taxpayer computes the deduction, there is an overall limitation that applies. The deduction is equal to the LESSER of:
- The combined qualified business income of the taxpayer (deductible amount for each qualified trade or business plus 20% of aggregate amount of qualified REIT dividends plus qualified PTP income) OR
- 20% of the excess of taxable income minus the sum of any net capital gain
- Why? To avoid allowing the deduction against income already taxed at 23.8% (20% capital gain rate plus NIIT)
- Example: Taxpayer has $60,000 of QBI, $150,000 of long-term capital gain, $30,000 of wages and $40,000 of itemized deductions:
  - Taxable income = $200,000 ($240,000 - $40,000)
  - Deduction is limited to $10,000 (the lesser of 20% of QBI ($12,000) or 20% of excess of taxable income over net capital gain ($10,000))

- [Note: here is a separate limitation applicable to qualified cooperative dividends]

- The W-2 Wage and Qualified Property cap does not apply to the 20% deduction applicable to qualified REIT dividends or qualified publicly traded partnership income; ***if this cap would otherwise limit the deduction and the entity is eligible*****, consideration should be given to operating as a REIT or PTP**
- If the deduction is unavailable because the passthrough is operating a specified service business but the entity is also operating a second business that is not a specified service business or the entity is operating an ancillary service, it is not entirely clear how the deduction applies – how are these businesses/activities grouped? **Consideration should be given to re-structuring - separating out a business/activity to which the deduction is available;**
- Intercompany payments should be considered – to manage qualified business income

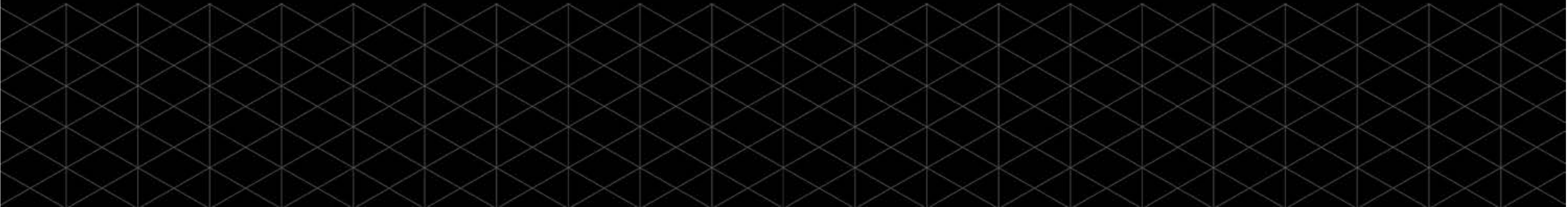
Limit on Deductibility of Excess Business Losses

- New section 461(l) – taxpayers other than C corporations are NOT allowed to deduct "excess business loss"
- "Excess business loss" = the excess of the aggregate deductions attributable to the taxpayer's trades or businesses over the sum of the taxpayer's aggregate gross income or gain from those business, to the extent that the the loss exceeds $250,000 (for single filers) or $500,000 (for joint filers) –in other words, excess business loss over $250,000 ($500,000) is NO LONGER DEDUCTIBLE, regardless of whether it is active loss
- Carried forward indefinitely as an NOL under section 172 (which, under the new rules, are limited to 80% of taxable income); no carryback
- Applies at the partner/S-corp shareholder level
- Applies after the passive loss rules are applied
- SIGNIFICANT change – can no longer use excess active losses against other non-business income (e.g., salary income, fee income, portfolio income)
- Levels the playing field with pass-through entities (partnerships and LLCs will continue to get basis for debt (unlike S corps) but this will become less important due to this limit)

Deduction of State and Local Taxes

- C corporations can deduct state and local income and property taxes paid or accrued in carrying on a trade or business.
- The 2017 tax law limits the deductibility of state and local income and property taxes for individual owners of pass-through entities, e.g., LLC members or S corporation shareholders. IRC Section 164(b)(6).
  - The standard deduction for individual taxpayers has been increased to $24,000, for joint taxpayers. To deduct state or local taxes, these taxes and any remaining itemized deductions would need to exceed $24,000.
  - In addition, for those taxpayers who can still itemize, state and local income and property taxes are limited to $10,000.
  - Compared to C corporations' generally unlimited deduction, state and local income and property taxes of pass-through entities can only be deducted on their owner's individual returns up to $10,000.
  - Note that property taxes and local sales taxes paid or accrued in carrying on a trade or business can be deducted at the pass-through entity level (not subject to the $10,000 itemized deduction limitation).
- C corporations have a clear advantage over pass-through entities in their ability to deduct state and local income taxes.

Choice of Entity – Factors to Consider



Rate Differentials

- Corporate rate = 21% plus 18.8% (79%* 23.8% (Qualified Dividend rate of 20% plus NIIT of 3.8%)) for a top marginal rate of 39.8% on dividend distributions to individuals; impact of double taxation is significantly reduced; C corps may be able to use other provisions to lower effective tax rate (e.g., full expensing)
- Top individual rate (37%) plus 3.8% on wages or NIIT, if applicable
- Passive Investor in a Partnership/S Corp (no wage/qualified property limitation) = 32.64% ((100% -20%)*40.8% (37% + 3.8% NIIT)) if you can take advantage of the 20% deduction; 40.8% if you can’t
- Active owner of a Partnership or an S corp = rate varies between 30.72% to 40.8% depending upon a number of complicating factors

Use of C Corp?

- Using C corporation as a shelter: to the extent that earnings can be re-invested instead of distributed, the second level of tax can be avoided; important to note that the Act did not eliminate the basis step-up upon death – so if assets remain in the corporation, the second level of tax could be permanently avoided
- In cases in which the owners of a business have no intent to sell (no foreseeable plan to dispose of assets), and are willing to re-invest profits into the business (in lieu of distributing profits), forming (or converting to) a C corporation should be considered
- If a corporation holds investment assets, the corporation can pay much lower rates on the investment income during the investor's lifetime and upon that investor's death, there will be a basis step-up and the second individual level of tax is completely eliminated.
  - Fixed income investments – interest is taxed at up to 40.8% to an individual but at 21% in a corporation
  - Equity investment (stock in another corporation) – dividends taxed at 23.8% to an individual but 10.5% to a corporation (because of the 50% dividends received deduction (50% x 21%))
  - Need to get around the personal holding company and accumulated earnings tax rules but there may be ways to do that – these rules will likely take on greater significance again with these changes in rates

C corps, cont.

- Possible use of section 1202 gain exclusion for certain small business stock
- Excess Business Losses limitation does not apply to C corporations – under current rules, the ability to use pass-through loss to offset other taxpayer income was a benefit to the use of a pass-through – can now only deduct up to $250,000 ($500,000)
- Changes in International tax provisions serve as an incentive for U.S. partnerships and S corporations with foreign subsidiaries to be structured as C corporations (because only a C corporation can take advantage of the 100% dividends received deduction against dividends from foreign subsidiaries that conduct active businesses outside the U.S.)
- Need to consider costs of conversion (if applicable); exit strategies – difficult to get out of a C corp

S corp vs. Partnership/LLC

- Although these are both pass-throughs, they are NOT the same – there are many differences that can create issues and there is far less flexibility in an S corp (e.g., no equivalent of "profits interest;" no ability to do special allocations)
- Sometimes beneficial under current rules to take advantage of the reasonable compensation concept with an S corporation to shield the remainder of income distributed to an active owner from self-employment taxes - not as helpful if most of the owners are passive and most of the income is being distributed to them
- With new rules, the way in which the new pass-through deduction rules apply to a particular set of facts may make an S corp or a partnership more or less attractive – dependent upon application of the limitations to the deduction and the taxpayer's income level

S corp vs. LLC – Examples of New Deduction – Example (1)

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Assumptions:

- Assume that the trade or business is NOT a specified service trade or business
- Assume that each taxpayer has over $415,000 of other taxable income on their joint returns

S corporation – two owners – one 80% active owner (A) and one 20% passive investor (20%)

Assume $1,000,000 of income, $400,000 of which is paid to A as reasonable compensation; $600,000 is distributed - $480,000 to A and $120,000 to B. Assume that the S corp pays no other W-2 wages and has $500,000 of unadjusted basis in qualified property

A:

Qualified Business Income = $480,000

W-2 wages and qualified property cap = $160,000 (50% of allocable share of W-2 wages ($320,000 – which is higher than 25% of allocable wages plus 2.5% of allocable share of unadjusted basis in qualified property)

Deduction = $96,000 –not limited by cap

A has paid the 3.8% Medicare tax on $400,000 of comp (= $15,200)

B:

Qualified Business Income = $120,000

W-2 wage and qualified property cap = $40,000

Deduction = $24,000 – not limited by cap

Example (1) cont.

Now assume that the entity is a partnership (or LLC taxed as a partnership):
Same facts – assume that A is paid a guaranteed payment of $400,000

A:

Qualified Business Income = $480,000
W-2 wages and qualified property cap = $10,000 (there are no W-2 wages, so the cap is equal to 2.5% of A's allocable share (80%) of the partnership's unadjusted basis in qualified property (2.5% of $400,000 (80% x $500,000))
Deduction = $96,000 – *limited to $10,000*
Note that A will pay the 3.8% additional self-employment taxes on $880,000 ($400,000 guaranteed payment plus $480,000 allocable share of income) = $33,440

B:

Qualified Business Income = $120,000
W-2 wage and qualified property cap = $2,500
Deduction = $24,000 – *limited to $2,500*

Sometimes Being a Sole Proprietor Yields a Higher Deduction…

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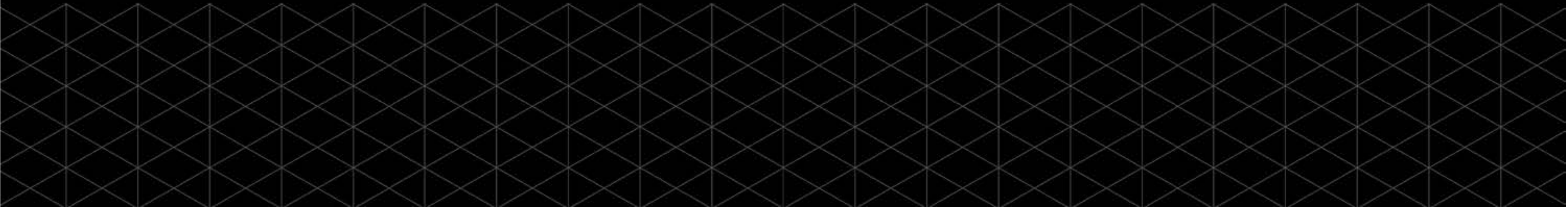
- Ignoring the downsides to conducting business as a sole proprietor (e.g., liability issues), consider the following example:

Assume a sole owner of a business with no employees (work done through outside contractors); not a specified service business (taxpayer makes widgets); no qualified property
Assume $250,000 of qualified business income; taxable income on return is under thresholds for limitation
Sole Proprietor – deduction = $50,000
S corporation (some amount will be required to be treated as reasonable comp – assume $100,000); deduction is only $30,000
Partnership – IF paid a guaranteed payment of $100,000, deduction is only $30,000; if no guaranteed payment, deduction is $50,000

- Interestingly, this situation “flips” once taxpayer income is above the thresholds

Conclusion



(1) Results are highly dependent on the interaction between the type of business, the definition of qualified business income; the application of the wage and qualified property limit *and the disparity in the way in which compensation is treated depending on type of business*.

(2) If the wage and qualified property limit is an issue and, therefore, you need the “wages” earned by the active owner to be counted toward that limit, might want to consider an S corp

(1) Choice is specific to FACTs and CIRCUMSTANCEs

Takeaways (1)

(1) There is not going to be a “mad dash” to convert to C corporations
(2) There are more “sheltering” opportunities with C corps due to rate changes
(3) The fact that the basis step-up at death was not changed, coupled with the lower corporate rate provides opportunities to leave assets in the corporation, receive step-up to market and never pay the second level of tax; in limited instances in which owners know that they will not be selling the business and will be leaving profits in the entity to re-invest and grow the company – in these instances should discuss with tax advisors and vet use conversion to a C corp
(4) Exit strategy needs to be considered
(5) The new deduction has added a new layer of analysis and complexity

Takeaways (2)

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There is no easy, quick answer to "which entity is better under the new rules?" No one size fits all.

Choice is specific to facts and circumstances…

- The decision got a little more complex with the passage of these new rules - you are now comparing a fairly complicated new deduction (without guidance) that is only applicable through 2025 with a reduced corporate rate that is known and "permanent"
- Need to consider how the new rules might affect the decision – at the very least, need to be able to discuss the application of these new rules to their business and talk through the choices
- Even if the bottom line doesn't change – the conversation is important