Choice of Business Entity Considerations Under The New Tax Act

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I. BACKGROUND

- Income tax considerations play a major role in choice of U.S. business entity decisions
  - Pass-Through Entity (S corporation, LLC, LP, LLPs & partnerships); or
  - C corporation (including non-corporate entities electing C corporation status)
- The Tax Cuts and Jobs Act of 2017 (the "**Act**") changed the Internal Revenue Code of 1986 (the "**IRC**") in a manner that effects choice of entity analysis

- Prior to the Act, the IRC generally favored the use of Pass-Through Entities versus C corporations for domestic businesses owned by individuals for several reasons, including:
  - Income of C corp. is taxed twice, once at entity level and again upon distribution
  - Relative tax rates on various types of income of C corporations and individuals, (e.g., no reduced rate for corporate level long-term capital gain)
  - Normally not possible to extract appreciated assets from a corporation without tax
  - Tax considerations to both buyer and seller in later capital rounds and on sale

- The Act reduces the federal income tax cost of owning and operating a business through a C corporation and made certain other tax changes benefiting C corporation structures
- Whether those changes justify shifting from Pass-Through Entity status to C corporation tax status in a given case depends on a host of factors applicable to the business in question
- Political risk of further change

II. CHANGES MATERIALLY AFFECTING CHOICE OF ENTITY DECISION

A. Reductions in Federal Income Tax Rates (C Corp ↑)

- C corporation U.S. tax rate reduced from 35% to 21% flat rate
- Top individual U.S. tax rate reduced from 39.6% to 37%
- Individual U.S. tax rate on long-term capital gain and qualified dividends still 20%
- IRC § 1411 surtax on net investment income of individuals still 3.8%
- IRC §531 surtax on C corp. accumulated earnings in excess of reasonable business needs (“AE Tax”) still 20%

- IRC §541 surtax on C corp. undistributed personal holding company income (“PHC Tax”) still 20%
- For businesses retaining most income for growth, 21% fixed U.S. tax rate on C corp. income increases relative attractiveness of C corporation status assuming no significant AE Tax or PHC Tax issues
- For businesses distributing most annual income to owners, C corp. still less attractive

- Illustration 1 (Figures in $1,000):

	C Corp (0% Div)	C Corp (100% Div)	C Corp (50% Div)	LLC (Active)	LLC (Passive)
Taxable Income	1,000	1,000	1,000	1,000	1,000
U.S. Tax on Entity	210	210	210	0	0
State Tax on Entity	50	50	50	0	0
Distribution to Owner	0	740	370	1,000	1,000
U.S. Tax on Owner	0	176	88	370	408
State Tax on Owner	0	37	19	50	50
Total Tax	260	473	367	420	458
Tax%	26.0%	47.3%	36.7%	42.0%	45.8%

Assumptions: Effective state tax is 5%, no AE Tax or PHC Tax on corporation, no IRC §199A deduction to LLC owners (see below), individual owners in highest tax bracket, and self-employment tax implications to LLC owners disregarded.

B. 20% Deductions for Pass-Through Qualified Business Income (LLC/S Corp ↑)

- Subject to complex limits described below, new IRC §199A allows certain individual taxpayers to deduct up to 20% of their combined, allocable share of net "qualified business income" ("**QBI**") from their "qualified trades or businesses" ("**QTBs**") conducted through pass-through business entities (S Corp, LLC or partnership)
  - Not applicable to C corporation income
  - At best, lowers the U.S. individual tax rate on QBI from 37% to 29.6%
- QTB is any trade or business other than (i) the business of rendering services as an employee and (ii) certain specified trades or businesses ("**SSBs**")

- “**SSB Rule**” SSBs are not QTBs; so no QBI deduction is allowed for pass-through income from SSBs, unless the individual taxpayer has taxable income (from Form 1040 before QBI deduction) below certain levels
  - SSBs are businesses (i) performing health, law, accounting, actuarial, performing arts, consulting, athletics, financial or brokerages services; (ii) where the principal asset is the reputation or skill of one or more of its employees or owners, or (iii) involving securities management, investment or trading functions
  - The SSB Rule does not apply to an individual taxpayer whose taxable income is less than $157,500 ($315,000 in the case of a joint return). If taxable income exceeds the threshold amount, QBI deduction is fully phased out at individual taxable income of $415,000 (filing jointly) or $207,500 (other status)

- QBI eligible for 20% deduction is the net pass-through income from all of the taxpayer’s QTBs, excluding certain types of investment and passive income (e.g., capital gains, dividends or interest)
  - QBI does not include compensation paid to the taxpayer for services
  - QBI is limited to income effectively connected to trade or business conducted in the U.S.; pass-through foreign source income is not QBI
  - QBI is computed on a combined net basis for all of the taxpayer’s pass-through entities at the taxpayer level (profit from one QTB offset by loss from another QTB)

- “**W-2 Limit**” Additionally, for individual taxpayers with taxable income above $315,00 (filing jointly) or $157,500 (other status), the QBI deduction is limited to the greater of (i) 50% of the taxpayer’s allocable share of W-2 wages paid by the QTB; or (ii) the sum of 20% of the taxpayer’s allocable share of those W-2 wages plus 2.5% of the taxpayer’s allocable of the unadjusted basis of the QTB’ s depreciable property
  - W-2 Limit fully phased-in at $415,000 (filing jointly) or $207,500 (other status)
  - W-2 favors S corporations over LLCs/LPs in case of owners with income above the thresholds

- “**Taxable Income Limit**” A taxpayer’s annual QBI deduction cannot exceed 20% of the taxpayer’s taxable income (computed excluding net capital gains and before QBI deduction)
- QBI 20% deduction only applies to tax years through 2025
- Can yield differing results for S Corp. owners versus LLC or LP owners

- Illustration 2 (figures in $1,000):

	C Corp (0% Div)	C Corp (100% Div)	C Corp (50% Div)	LLC (No 199A)	LLC (199A)
Taxable Income	1,000	1,000	1,000	1,000	1,000
U.S. Tax on Entity	210	210	210	0	0
State Tax on Entity	50	50	50	0	0
Distribution to Owner	0	740	370	1,000	1,000
U.S. Tax on Owner	0	176	88	370	296
State Tax on Owner	0	37	19	50	40
Total Tax	260	473	367	420	336
Tax%	26.0%	47.3%	36.7%	42.0%	33.6%

Assumptions: Effective state tax is 5%, no AE Tax or PHC Tax on corporation, individual owners in highest tax bracket, and self-employment tax implications to LLC owners disregarded.

C. Alternative Minimum Tax ("AMT") (C Corp ↑)

- Corporate AMT repealed, making C corporations more attractive
- Individual AMT retained, but attachment point of AMT exemption amount increased to $109,400 and exemption phase-out threshold increased to $1 million (filing jointly)

D. Limit on Deduction of Pass-Through Business Losses (S Corp/LLC/LP ↑)

- IRC §461(l) bars individuals from currently deducting their "excess business losses" from pass-through trades or business incurred after 2017 against other income for the loss year
- Excess business losses are pass-through trade or business losses exceeding $250,000 for the tax year ($500,000 if filing jointly)
- Excess business losses for a year may be carried forward to later years as net operating losses ("NOLs")
- NOLs incurred after 2017 may only be carried forward against 80% of future years' taxable income

E. Dividends Received Deduction (C Corp ↓)

- C corporation deduction for dividends received from non-tax-consolidated less-than- 20%-owned domestic corporate subsidiaries are reduced from 70% to 50%
- C corporation deduction for dividends received from a non-tax-consolidated 20% or greater domestic corporate subsidiary is reduced from 80% to 65%

F. Profits Interest Changes (LLC/LP ↓)

- IRC §1061 treats as short-term capital gain (taxed as ordinary rates) any net capital gain with respect to a profits (carried) interest in an LLC or LP issued for services if held 3 years or less and LLC or LP is engaged in applicable trade or business
  - Applies to sales of profits interest held 3 years or less
  - Also applies to allocable share of pass-through gain on entity assets held 3 years or less
  - Doesn’t apply to capital interests
- Applicable trades or businesses are raising or returning capital, or investment or development activities with respect to securities, commodities and rental or investment real estate, interests

G. Foreign Subsidiary Provisions (C Corp ↑)

- Under the Act, ownership of foreign corporations by a U.S. C corporation has several added advantages over ownership of foreign corporate subsidiary by a U.S. Pass-Through Entity
- Under new IRC §245A, a U.S. C corporation parent can now deduct 100% of foreign source portion of dividends received from a 10% or greater foreign corporate subsidiary, subject to certain limitations

- In some cases IRC §245A dividend received deduction can be used to shelter gain on sale of stock of 10% or greater foreign sub. recast as dividend under IRC §1248
- No foreign tax credit for foreign taxes on dividends eligible for IRC §245A deduction

- New IRC §951A requires 10% or greater U.S. shareholders of controlled foreign corporations (a "**CFC**") to include in their taxable income "global intangible low taxed income" ("**GILTI**")
  - GILTI generally equals the CFC's undistributed foreign source income, not otherwise subject to current U.S. tax, in excess of a base threshold amount equal to 10% of the book value of the CFC's tangible assets

- U.S. C corporations (but not other U.S. taxpayers) are entitled to a partially-offsetting deduction (50% through 2025 and 37.5% thereafter) against their GILTI
- U.S. C corporations (but not other U.S. taxpayers) may also qualify for a foreign tax credit with respect to GILTI

- Under new IRC 250, subject to various limitations, U.S. C corporations (but not other U.S. taxpayers) can now deduct a portion of their foreign-derived intangible income ("**FDII**")

- New IRC §965 transition tax on 10% of greater U.S. shareholders of specified foreign corporation’s accumulated earnings and profits, calculated as of Nov. 2, 2017 or December 31, 2017
  - Lower effective rate on C corporations, but greater tax deferral opportunity for individuals owning the foreign corporation through an S corporation

H. Withholding on Sale by Foreign Partner (LLC/LP ↓)

- Under IRC §864(c), gain or loss on sale of foreign partner's interest in U.S. tax partnership (including LLC) taxed as effectively connected with U.S. trade or business to extent underlying partnership assets are used in a U.S. trade or business
- Under new IRC §1446(f), transferee must withhold 10% of amount realized by transferor of interest in U.S. tax partnership/LLC unless seller certifies its non-foreign status
  - Analogous to FIRPTA regime
  - If transferee fails to withhold, then the partnership/LLC is required to withhold from future distributions to the transferor

III. TAX TREATMENT OF CONVERSION TO C CORPORATION

- Tax partnership (including LLC) to C corp. - generally not taxable
  - Exceptions (gain recognized) if negative capital accounts, entity liabilities exceed entity inside asset basis, or C corporation issues non-qualified preferred stock
  - Resulting shareholder tax basis in shares can differ depending on approach used: (i) “assets over” (e.g., merger, statutory conversion, check the box, etc.); (ii) assets up (liquidation of LLC followed by contribution to corporation) or (iii) interests over (contribute LLC interests to corporation)
  - Conversion may result in changes in tax accounting methods and employment tax obligations
  - Low tax cost to get into subchapter C; large tax cost to get out

- S corporation to C corporation – generally tax free
  - May result in tax accounting changes
  - Treatment of post-conversion distributions as (i) tax-free distributions of previously taxed S corporation earnings; or (ii) taxable C corporation dividends; better treatment if S to C conversion occurs within two years of the Act
  - Cannot re-elect into Sub S status for five tax years and additional five-year IRC 1374 taint after conversion back to S corporation status

- No right to tax-free return to tax-partnership status if Congress later raises the C corporation tax rates

* This communication is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice.