Tax Cuts and Jobs Act

The Significance of Choice of Entity

With the changes brought about by the recently-enacted Tax Cuts and Jobs Act (TCJA), many businesses are questioning whether it might be better to restructure as a C corporation instead of a pass-through, given the lower corporate rate. When one business type changes tax rates, it is important to consider the ramification on the business type, but also to consider the relative difference between the various entity choices. Also, with the introduction of the pass-through deduction of up to 20% of qualified trade or business income, some individuals that operate in any of the specified service businesses are questioning whether they should operate differently in order to maximize this opportunity.

Huge uncertainties still exist, and there is a lack of formal guidance from the Internal Revenue Service (IRS) necessary to make informed decisions regarding entity structures. Remember also that any changes to an entity's structure must have a substantial non-tax motive under the economic substance doctrine (IRC 7701(o)).

This white paper will discuss the business entity choice considerations raised by the passing of the new tax law.

Corporate changes

The earnings of C corporations are subject to double taxation. First, there is a corporate-level tax on earnings, and second, earnings are subject to another level of taxation at the individual level once distributed. For corporations that pay out qualified dividends, this is usually taxed at 15% or 20% and potentially subject to the additional investment income tax of 3.8%. There is potential to defer the second level of tax because the tax is not incurred until dividends are actually distributed by the corporation. However, there are potential reductions in the value of the tax deferral for undistributed corporate earnings such as the personal holding company tax, accumulated earnings rules and reasonable compensation rules.

Key Takeaways

When one business type changes tax rates, it is important to consider the ramifications on the business type and the relative differences between the various entity choices.

The new pass-through entity deduction has added a new layer of complexity for business owners considering choice of entity. Business owners should note that this deduction sunsets in 2025.

Every business owner should consult their advisor and be thoughtful and deliberate in evaluating their individual situation prior to converting any existing entities.

Key Corporate Tax Changes

There is a permanent reduction in the corporate tax rate from 35% to 21%.

There is no special rate for personal service corporations (21% rate will apply).

The corporate alternative minimum tax (AMT) has been repealed.

There is now expanded availability of the cash basis method of accounting.

Dividend received deduction percentages have been reduced. The 80% deduction is reduced to 65% for 20%+ owned corporations and 70% deduction is reduced to 50% for < 20% owned corporations.

Net Operating Losses (NOLs) are limited to 80% of taxable income. The two-year carryback rule was repealed, and now it can be carried forward indefinitely.

State and local taxes (SALT) continue to be fully deductible (unlike the personal income tax reduction in the SALT area).

With the TCJA, the top corporate tax rate was reduced to 21% as noted. Now, income that is distributed as dividends to individuals, for example, is taxed at a combined rate of 44.8% (21% + 20% + 3.8% - corporate tax paid, individual rate on qualified dividends and the Medicare surtax), which is relatively close to the new top individual rate of 40.8% (including the Medicare surtax again). If corporate earnings are distributed, it appears the gap between the two rates has decreased substantially under the new law. However, rapidly-growing businesses that are raising capital and/or heavily reinvesting their cash may prefer C corporation status to "only" pay 21% now rather than pay higher personal rates that result from pass-through status of other entities. Although they will eventually have to pay taxes on future capital gains or qualified dividends, if the business is growing enough, the tax deferral (21% now, and capital gains or qualified dividends not taxed until years or decades in the future) may still be compelling.

To aid in the evaluation of choice of entity status, the table provided below outlines some tax advantages and disadvantages of C corporations:

Advantages	Disadvantages
• (New) Lower rate on undistributed earnings leaves more after-tax dollars for reinvestment	• Double tax on distributed profits
• There is a potential elimination of the 2nd level of tax if the stock qualifies as §1202 "qualified small business stock"	• Tax traps such as the accumulated earnings tax and the tax on Personal Holding Companies
• Ability to engage in tax-free reorganizations	• The audit risk for "reasonable compensation" issues
	• Ease of becoming a C corporation but difficulty to get out

Here are some considerations mentioned recently about whether C corporation status could be the right entity choice:

- C corporations have a clear advantage over pass-through entities in their ability to deduct state and local income taxes. C corporations can deduct all state and local income and property taxes paid or accrued in carrying on a trade or business vs. flow-through entities which are limited to $10,000.
- C Corporations may be considered for businesses that hold investment assets. That income is taxed at a lower rate. However, be careful of the personal company holding tax and accumulated earning tax issues. These rules will likely take on greater significance with the changes in tax rates.
- Small businesses that operate as C corporations may be able to offer “qualified small business stock.” If this stock is held for at least five years, all gain upon its sale is completely tax-free (Section 1202 gain exclusion). S corporation (S Corp) shares and LLC membership interests cannot qualify for this tax-free gain.
- There is a new excess business loss limitation that applies to non-corporate owners (e.g., pass-through businesses). Under the new law, pass-through owners can only deduct up to $250,000 ($500,000 married filing jointly) against other ordinary income. Any excess business losses that are disallowed are treated as a net operation loss (NOL) carryover to the following tax year.

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- C corporations can take advantage of 100% dividends received deduction against dividends from foreign subsidiaries that conduct active business in the US (Individuals and pass-through entities cannot take advantage of this).
- Consider the 70/30 split for reasonable compensation. 70% of income distributed as salary to the owner and 30% is retained within the corporation and distributed as a dividend. The 70/30 split is the number that dominated the conversation during the tax reform debate over the last year as the correct amount of “reasonable compensation.” But, it really is a facts-and-circumstances approach to reasonable compensation.
- Are some professionals limited in choice of entity because of state professional board rules?

Pass-through entity types

Pass-through entities like S corporations, partnerships, or LLCs (Limited Liability Corporations) are taxed once, income is “passed through” and each owner reports their respective share of income. There is no tax on profits at the entity level. Sole proprietorships and pass-through (“disregarded”) entities that do not elect corporate status report income and expenses on the individual owner’s tax return (e.g., Form 1040). Income from pass-throughs is taxable to owners whether or not it is actually distributed from the entity. Under prior tax law the single tier taxation of pass-through entities versus the two tiers of corporate taxation had a significant impact on the choice of business entity type. Pass-through entities have generally been taxed at lower rates than corporations due to lower rate structures for the individuals and the double taxation of the corporation earnings. Now, as mentioned previously, with the maximum individual rate at 40.38% and the highest potential combined rate on corporate earnings that are distributed at 44.8%, the gap has appeared to have lessened. This appears true, until we add in the effects of the new pass-through business deduction.

Now, under TCJA, owners of pass-through businesses are offered a 20% deduction for their “qualified trade or business income.” “Qualified trade or business” means any trade or business other than a specified service business. This reduces the top marginal tax rate for owners of pass-through business entities from 37% to 29.6% (37% x (1-20%)), making the real difference between tax treatment larger or offsetting some of the nominal reduction in the difference between pass-through and corporate taxation discussed above.

How does this new consideration affect the choice of entity? In general, it seems that businesses looking to sell soon, and/or that are taking out substantial ongoing profits as cash flows will tend towards opting for the pass-through business structure since the net or aggregate rate is still lower for the individual taxpayer.

Those that operate in a specified service business and who have income above the phase-out threshold may not benefit from the deduction, and may consider restructuring.

Unfortunately, advice regarding this area of the new tax law should be given with a big dose of caution. Huge uncertainties exist, and there is a lack of formal guidance necessary to make informed decisions regarding entity structures. For example, one of the main areas of concern with regard to the new qualified trade or business income deduction relates to the definition of "specified" service trade or business. Is it possible to spin off parts of a specified service trade or business so that it might qualify for the 20% deduction for the non-specified service activities? We don't know the answer.

As a result of the new lower corporate rate, should taxpayers reconsider their choice of entity?

	C Corporation	Pass-Through
Income tax rate	21%	29.6% (effective)*
Dividend/Exit tax rate	20% + 3.8% = 23.8%	0%
Aggregate tax rate	44.8%	29.6%
State/Local tax deduction	100%	Property taxes deductible, SALT income taxes not deductible

*Assumes no 3.8% tax applicable and full use of 20% pass-through deduction

To aid in the evaluation of choice of entity status, here are some tax advantages and disadvantages of pass-through status:

Advantages	Disadvantages
• **(New)** Lower overall tax burden vs. the distribution of C corporation profits (unless the entity qualifies as §1202 qualified small business stock)	• No possibility of deferral of tax (currently taxed even if not distributed to owners)
• Pass-through of losses	• State and local taxes (SALT) on pass-through income subject to $10,000 cap
• Partnerships have certain advantages: – Flexibility in allocating tax benefits/burdens – Possibility of asset basis step-upon transfer of interest or upon death (§754) – Greater distribution flexibility	• S corporations: – Restricted ownership – Restricted distributions – Must pay a "reasonable" salary
• S Corp owners can minimize self-employment taxes. Salaries are subject to self-employment taxes, but distributions are not.	

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In addition to the income tax considerations in evaluating pass-through entity status versus C corporation status, there are potential estate planning considerations as well. Some of the more popular estate planning techniques can be far more "gift-efficient," and sometimes, income tax-efficient if the entity is a pass-through rather than a C corporation. For example, consider the common estate planning technique of gifting an interest in a business entity to an Intentionally Defective Grantor Trust. One of the reasons for using this technique is to remove any subsequent appreciation in the value of the business entity from the grantor's taxable estate. Another benefit is that when the grantor pays the income tax on the trust's net income and net capital gains, the payment is not considered a gift for transfer tax purposes. The trust is able to grow much faster because it doesn't have to pay its own income taxes. If the business is a pass-through entity, distributions to cover the income taxes are paid to the trust and retained by the trust since the grantor pays the income tax. If the business was a C corporation, dividends would have to be paid to the trust to replicate the distributions that a pass-through entity would make. This would defeat the principal benefit of C corporation status (use of the lower tax rate) if earnings were distributed and subject to the two levels of taxation instead of being subject to only the new lower corporate tax rate. This is only one example of the intersection of choice of entity and estate planning. Any conversion analysis shouldn't ignore the estate and transfer tax possibilities and ramifications.

Conclusion

The passage of the TCJA has planted the seed for many business owners to reconsider their optimal choice of entity. Remember that the reduced corporate rate is permanent but the pass-through entity treatment is not as it is part of the personal income tax law. The new pass-through entity deduction has added a new interesting layer of complexity and analysis, but it does sunset in 2025. The results surrounding the pass-through entity deduction are highly dependent on the type of business, the definition of qualified business income and application of the wage and qualified property limit rules under that section of the TCJA as well as the disparity in the way in which compensation is treated depending on type of business.

There is no easy, quick answer to "which entity is better under the new rules?" Entity choice is specific to circumstances including, importantly, non-tax issues. What may be a good choice of entity today may be different in the future as the economy changes, and as new factors impact an individual's situation. Estate planning and future tax considerations should be evaluated. If you are considering a potential change, you should work with an advisor who is able to perform lots of modeling and a tax advisor knowledgeable about the complex tax rules. There should be thoughtful, deliberate consideration before converting any existing entities.

To learn more, please consult with your Key Private Bank Advisor.