

Strategic Planning for Business Entities after 2017 Tax Reform

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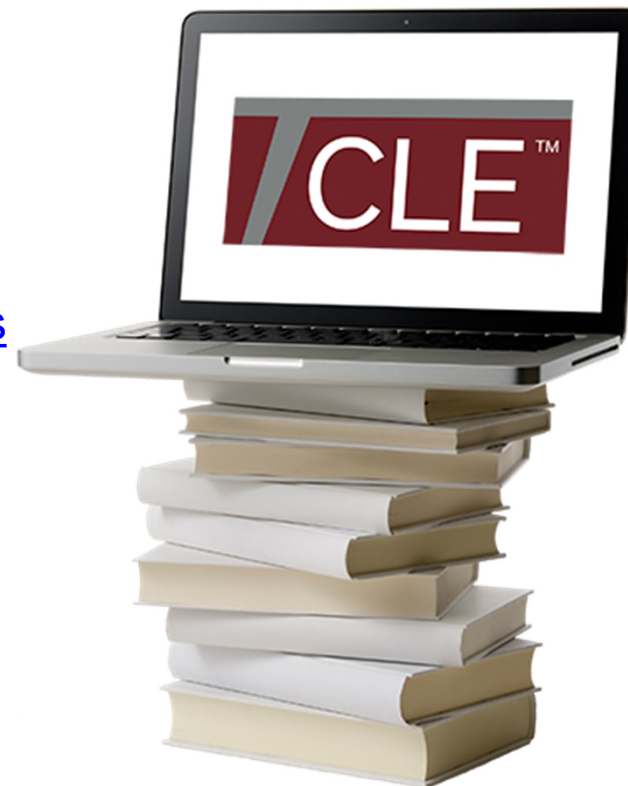
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WELCOME

Overview

- How the impact of the new tax rates for C corporations and the 20% deduction for pass-through entities may motivate C corporation taxation
- How these rules change the paradigm for transferring a business and how this informs a decision to change to a C corporation
- Strategies for changing a business entity's status when the rules change again

Overview – Effect of Tax Reform on Business Structuring

- Type of Entity
- Corporate Level Tax Savings Combined with Level of Dividends Distributed to Shareholders
- 20% Deduction of Qualified Business Income under Code § 199A
- S Corporation Compared to Partnership
- Whether Real Estate is Qualified Business

Overview – Effect of Tax Reform on Business Structuring

- Application of Code § 199A to Trusts (and other issues re trusts under tax reform)
- Whether Use C Corporation for Long-Term Investments
- Conversion Strategies

Type of Entity

- Corporation
 - C Corporation
 - S Corporation
- Partnership
 - Limited Liability Company
 - Limited Partnership
- Limited Liability Company
 - Partnership or Disregarded Entity
 - S or C Corporation

Distributing 100% of Corporate Net Income After Income Tax (II.E.1.a.)

Income after Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	\$100,000	\$100,00
Federal and State Income Tax	<u>-26,000</u>	<u>-26,000</u>
Net Income after Income Tax	\$74,000	\$74,000
Income Taxes at 28.8% or 20%	<u>-21,312</u>	<u>-14,800</u>
Net Cash to Owner	<u><u>\$52,688</u></u>	<u><u>\$59,200</u></u>

Distributing 50% of Corporate Net Income After Income Tax (II.E.1.a.)

Income after Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	\$100,000	\$100,00
Federal and State Income Tax	<u>-26,000</u>	<u>-26,000</u>
Net Income after Income Tax	\$74,000	\$74,000
Distribution to Owner	\$37,000	\$37,000
Income Taxes at 28.8% or 20%	<u>-10,656</u>	<u>-7,400</u>
Net Cash to Owner	<u>\$26,344</u>	<u>\$29,600</u>
Corporate Cash Plus Shareholder Cash	<u>\$63,344</u>	<u>\$66,600</u>

Distributing None of Corporate Net Income After Income Tax (II.E.1.a.)

Distributing None of Corporate Net Income After Income Tax	\$100,000
Federal and State Income Tax	<u>-26,000</u>
Net Income after Income Tax	<u>\$74,000</u>

Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities (II.E.1.)

	Individual in Top Bracket	Individual in Modest Bracket
Distributing 100% of Corporate Net Income After Income Tax	47.3%	40.8%
Distributing 50% of Corporate Net Income After Income Tax	36.7%	33.4%
Distributing None of Corporate Net Income After Income Tax	26.0%	26.0%
S Corporation, Partnership, or Sole Proprietorship	34.6%-45.8%	27.4%-46.2%

Declaring Dividends

- Professional firms tend to distribute all profits
- Sale to irrevocable grantor trust requires much cash
- Personal holding company tax (II.A.1.e.)
- Accumulated earnings tax (if not a personal holding company) (II.Q.7.a.vi.)

Code § 199A Deduction for Qualified Business Income (II.E.1.c.)

- Repealed Code § 199 deduction for domestic production activities
- Taxable years beginning after December 31, 2017 but not beginning after December 31, 2025
- Applies to an individual or trust that owns a partnership interest, S corporation stock, or a sole proprietorship (passthrough entity)
- Deduction up to 20% of qualified business income (QBI)
- Each trade or business separately tested (not defined)
- Causes underpayment penalty to apply at 5% instead of 10% understatement

Types of Income and Activities Eligible for Deduction (II.E.1.c.ii.)

- Must be a qualified trade or business
- Each is tested separately; no guidance how to delineate
- Does not include:
 - Compensation for services rendered (salary to S corporation owner-employee)
 - Code § 707(c) guaranteed payment (but preferred profits interest should qualify)
 - Code § 707(a) payment for services rendered

Types of Income and Activities Eligible for Deduction (II.E.1.c.ii.)

Specified service business

- Disfavored businesses include any trade or business involving the performance of services in the fields of health, law, ~~engineering, architecture,~~ accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.
- Taxable income (before QBI deduction) below threshold means that these businesses are not blacklisted (II.E.1.c.v.)

Types of Income and Activities Eligible for Deduction (II.E.1.c.ii.)

Specified service business (continued)

- Disfavored business involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in Code § 475(c)(2)), partnership interests, or commodities (as defined in Code § 475(e)(2)).
- No relief for taxable income under thresholds

Calculation of Deduction Generally

(II.E.1.c.iii.)

- (A) the sum of certain QBI-related amounts for each qualified trade or business the taxpayer carries on, plus
- (B) 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.
- Focus on (A)
- Losses from a qualified trade or business carry to the following year to reduce the deduction

QBI amount (II.E.1.c.iii.)

- QBI-amount is the lesser of the taxpayer's combined QBI amount or 20% of the excess (if any) of (i) the taxpayer's taxable income over (ii) the sum of the taxpayer's net capital gain and aggregate qualified cooperative dividends
- Add 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income (not discussed later)

QBI-related amount (II.E.1.c.iii.)

For each separate trade or business, the lesser of:

- 20% of the taxpayer's QBI with respect to the qualified trade or business, or
- the wage limitation

The wage limitation does not apply when taxable income (before the Code § 199A deduction) is below certain thresholds (II.E.1.c.v.).

Wage Limitation (II.E.1.c.iii.)

For each separate trade or business, the greater of:

- 50% of the W-2 wages with respect to the qualified trade or business, or
- the sum of:
 - 25% of the W-2 wages with respect to the qualified trade or business, plus
 - 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property

Wage Limitation (II.E.1.c.iii.)

W-2 wages:

- Wages subject to withholding and include elective deferral, such as Code § 401(k) and similar plans
- Must relate to qualified business income
- Must be properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return

Qualified Property (II.E.1.c.iii.)

Depreciable property:

- held by, and available for use in, the qualified trade or business at the close of the taxable year
- used at any point during the taxable year in the production of qualified business income
- the depreciable period for which has not ended before the close of the taxable year

Depreciable period is greater of 10 years or class life.

Qualified Property (II.E.1.c.iii.)

- Unadjusted basis
- Appears to require capitalization and therefore disqualify assets expensed under Code § 179
- Bonus depreciation capitalizes and depreciates part immediately (II.G.4.b.)
- Using bonus depreciation, most property placed in service after September 27, 2017, and before January 1, 2023 receives an immediate deduction for the entire purchase price. This is simpler and more favorable than Code § 179.

Taxable Income Thresholds (II.E.1.c.v.)

- \$315,000-\$415,000 for married filing jointly
- \$157,500-\$207,500 for all other taxpayers, including trusts
- Below threshold, most ineligible service businesses become eligible and the wage limitations do not apply
- Benefits phase out over that range
- Phase-outs apply cumulatively

Partnerships Compared to S Corporations (II.E.1.d.)

Example

- \$300K QBI before owner's compensation
- Reasonable comp would be \$200K
- Distribute \$200K or more

Results:

- S corporation deduction based on \$100K QBI after deducting wages
- Partnership deduction based on \$300K QBI

Real Estate as QBI (II.E.1.e.)

- Code § 199A deduction is only for a “trade or business”
- From preamble to NII regulations: “Within the scope of a section 162 determination regarding a rental activity, key factual elements that may be relevant include, but are not limited to, the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease).”

Trusts and QBI (II.E.1.f.)

- Grantor trusts are disregarded and their items attributed to their deemed owners.
- The trust and beneficiaries are allocated the various items in proportion to their respective portions of distributable net income (“DNI”), determined after applying the separate share rules, if relevant.
- The Code § 199A deduction is not included in calculating DNI. Considering that both deductions are artificial deductions rather than deductions of actual expenditures, there is some logic to this.
- Taxable income thresholds are applied separately at the trust and beneficiary levels.

Trusts and 2017 Law (II.J.3.d.)

- Trust administrative expenses – Code § 67(e) makes deductions not be itemized
- State tax deduction under Code § 164(b)(6) – separate \$10,000 limitations; consider that property taxes but not income taxes are unlimited for trade or business or rental real estate
- ESBT may now have nonresident alien as permissible current beneficiary (II.A.2.g.)
- ESBT deduction for charitable contributions on K-1 from S corporation now applies Code § 170 instead of Code § 642(c) (III.A.3.e.ii.(b).)

Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation (II.E.1.g.)

- Dividends a C corporation receives from another domestic C corporation have up to 10.5% federal income tax rate
- Taxable interest and capital gains have 21% federal income tax
- Top individual – 23.8% on qualified dividends and long-term capital gain
- Top individual – 40.8% on taxable interest income, nonqualified dividends, and net short-term capital gains

Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation (II.E.1.g.)

Investment management fees deductible to C corporation but not to individual

But a C corporation needs to pay dividends to avoid:

- Personal holding company tax, or
- Accumulated earnings tax (\$125,000 accumulated earnings & profits if merely holds investments and is not a personal holding company)

Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation (II.E.1.g.)

How distribute earnings?

- Convert to S corporation to distribute current taxable (not tax-exempt) but not accumulated earnings and profits
- Passive investment income test easy to plan around

Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation (II.E.1.g.)

How divide assets on death of taxpayer or primary beneficiary?

- Code § 355 N/A
- Create partnership of C corporations now – one for each share of bequest or remaindermen
- Post-mortem, partnership divides assets among corporations according to each beneficiary's desired allocation

Convert from S Corporation to C Corporation (II.E.2.b.)

- Might need to convert from cash to accrual method if more than \$25M gross receipts and not a qualified farmer or personal service corporation
- Consider distributing note before yearend
- Consider distributing money in first C corporation year

Convert from S Corporation to C Corporation (II.E.2.b.)

Preserving AAA in case later convert back to S corporation (II.P.3.c.)

- Form new parent S corporation
- Old corporation becomes a QSub, and its tax attributes now belong to parent
- QSub converts to C corporation
- When convert back to QSub later (Code § 332 liquidation), the old AAA remain

Convert C Corporation to S Corporation (II.E.2.c.)

- Code § 1374 built-in gain tax (II.P.3.c.ii.). Consider pre-conversion (a) converting from cash to accrual if material accounts receivable, and (b) selling assets that might be sold within 5 years.
- Excess passive investment income (II.P.3.c.iii.); tax-free investments do not generate AAA (II.P.3.c.iv.)
- If inventory, beware LIFO recapture (II.P.3.c.i.)

Hybrid (II.E.4.)

- Consider a limited partnership with a C corporation general partner.
- C corporation is allocated the profits intended to be reinvested.
- Limited partners are allocated the profits intended to be distributed.
- As with any structure, it is easier to get into this structure if one starts with a partnership than if one starts with a corporation (whether S or C).

Business Interest Deductions Limited (II.G.19.a.)

- Added by 2017 tax reform.
- Applies to businesses with gross receipts over \$25 million
- Does not apply to electing real property business, electing farming business, and certain other businesses
- Deduct interest only to extent of interest income, floor plan financing for auto dealers, and 30% of adjusted taxable income (ATI)
- Depreciation N/A to ATI until 2022

How 2018 Partnership Audit Rules Affect Ownership (II.G.18.c.)

- If subject to new audit rules, allocation of tax liability may be different than expected and burdensome to amend partnership tax returns
- Opt out allowed annually if no more than 100 direct or indirect owners and each partner is an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner
- Revocable or other grantor trusts and disregarded LLCs are not eligible partners
- Consider nonprobate transfers or using an S corporation (latter has many pros and cons)
- Will discuss more next quarter

Profits Interest

- Revaluation required
- Code § 2701 if controlled by one Family
- Under 2017 tax reform, certain sales of compensatory partnership interests recharacterized from long-term to short-term gains (II.M.4.f.ii.(b).)
 - More than 3-year holding period
 - Taxpayer may net the gains and losses unless sale to a related party.

Life Insurance (II.Q.4.b.)

2017 Tax Reform

- Retroactively invalidated Rev. Rul. 2009-13
- Reportable policy sale
 - Code § 103(a)(3) changes tax consequence to stranger-owned policies
 - Code § 6050Y reporting requirements

Conclusion

- February 14 webinar [Fiduciary Income Tax Refresher and Update 2018](#)
- April 24 webinar for First Quarter Newsletter
- Blog: [Business Succession Solutions](#)
- Reports on Heckerling:
<http://www.thompsoncoburn.com/forms/gorin-heckerling>
- [Gorin's Business Succession Solutions](#)