Effect of 2017 Tax Reform on Choice of Business Entity

By Steven B. Gorin

- What is the superior choice of business entity under the 2017 tax reform legislation?
- A C corporation produces superior annual income tax results, but only if it reinvests the lion's share of its income; and it generally has less favorable exit strategies, giving one significant pause before considering converting to a C corporation.
- For those businesses that stay put as a pass-through, how does the new section 199A deduction work?

Tax reform enacted at the end of 2017 made C corporations much more attractive from the standpoint of annual income taxes than S corporations, partnerships, or sole proprietorships (collectively, pass-throughs). Or did it? And how about the consequences of transferring one's business by sale to third parties or through estate planning tools?

C corporations now have a flat, 21-percent federal income tax rate. Even personal service corporations use the new low rate. This contrasts with the top federal income-tax bracket of 37 percent for pass-through income, which may be reduced to 29.6 percent by way of a 20-percent deduction for qualified business income—if and to the extent that one's pass-through qualifies for the deduction. Partners and sole proprietors in lower income-tax brackets face 15.3-percent self-employment tax, and those in the highest brackets may pay 3.8-percent self-employment tax or net investment income tax. S corporation owners who work in the business must report compensation income to the extent of the lesser of cash they receive or "reasonable compensation," and in 2017 the IRS explained to its agents how to keep taxpayers out of tax court when the IRS reclassifies distributions as compensation. Any amounts classified as wages are not eligible for the 20-percent deduction.

However, lower C corporation tax rates must be tempered by the taxation of distributions as dividends. A shareholder in the top bracket pays 23.8-percent federal income tax on qualified dividends, considering net investment income tax. Add state income tax, and the double taxation involved in declaring dividends each year can make C corporations unattractive.

If one lives in a state imposing five-percent income tax, here is a comparison of effective annual tax burdens, considering all of the above factors:

	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%

Although one can quibble over the assumptions used to generate the rates this chart uses, it demonstrates that a C corporation really produces superior annual income tax results only if it reinvests the lion's share of its income.

Suppose, seeing this, one says, "I don't care about taking annual distributions from the business. My goal is to build up the business by reinvesting earnings and selling it at some point." Reinvested earnings add to the basis of one's partnership interest or S corporation stock, but they do not add to the basis of one's C corporation stock. Although one will not incur the annual tax pain of taking distributions, one will feel it on the back end when selling. However, some C corporation owners will be able to avoid the gain either by dying and getting a basis step-up, or by the IRC section 1202 exclusion. Generally, the IRC section 1202 exclusion applies to stock that the corporation issued to the taxpayer (or was issued to the donor or decedent who transferred the stock to the taxpayer) if the corporation was never an S corporation, and the corporations' activities were always among those approved by IRC section 1202 (which does not include professionals).

Suppose a pass-through converts to a C corporation. If the entity used the cash method of accounting for tax purposes and averages over $25 million in gross receipts, it may be required to convert to the accrual method and pick up income on its accounts receivable, unless it qualifies for an exception. Furthermore, if an S corporation converts to a C corporation, it must wait five years before making an S election.

An S corporation that converts might consider taking steps to preserve the ability to distribute its accumulated adjustment account (AAA) (its reinvested earnings taxed to its shareholders that can be distributed tax-free):

- Cash distributions made in the first C corporation taxable year after revoking the S election can use AAA instead of counting as dividends.

- After that first year, some AAA may be able to be used if the shareholders are the same as when the S election was revoked.

- If an S corporation converts to a C corporation, its AAA is wiped out and must start over if it later makes an S election. Before revoking the S election, consider undergoing a IRC section 368(a)(1)(F) tax-free reorganization in which a new parent takes on the existing corporation's S status and AAA; then the existing corporation becomes a C corporation. If the old entity wants to revert to S corporation taxation, it can elect to be a qualified subchapter S subsidiary—an entity that is disregarding from its parent.

Suppose the political climate changes in Washington, D.C. again and corporate tax rates increase. After five years, the C corporation could make an S election. However, the conversion may be taxable:

- Any assets with value in excess of basis that are sold within five years after making the S election are taxed at not only the shareholder level, but also the corporate level. If the C corporation uses the cash method, any accounts receivable would get hit with this double tax, so it might want to change to accrual before making the S election. The corporation might consider selling other assets before the conversion.

- If the corporation uses LIFO inventory, recapture would be taxed.

Suppose the taxpayer decides to stay put as a pass-through. How does the new IRC section 199A deduction for qualified business income (QBI) work? It applies only to qualified income from a qualified trade or business. This has several components.

First, the business cannot be a specified service trade or business (SSB). An SSB is any trade or business other than certain businesses that (a) do not qualify for the IRC section 1202 exclusion from capital gain on the sale of C corporation stock, or (b) involve the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. The businesses mentioned in (a) are 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 (except that engineering and architecture are not blacklisted like the others are). The businesses mentioned in (a) are not blacklisted if the taxpayer's taxable income is below certain limits.

Second, income as an employee of the qualified business, guaranteed payments that a partner receives for services rendered to the partnership, and similar payments do not qualify. A partner who receives only a distributive share of profits benefits more than an employee-shareholder of an S corporation. Suppose, before considering the owner's compensation, a business has $300,000 of QBI, reasonable compensation is $200,000, and distributions to the owner are at least $200,000. If the business is an S corporation, then the $200,000 wages the S corporation pays its owner will reduce the QBI from $300,000 down to $100,000. If the owner were a sole proprietor or a partner paid only though his or her share of profits, QBI would be $300,000.

Third, the deduction is the lesser of (a) 20 percent of QBI, or (b) the greater of (i) 50 percent of wages paid or (ii) the sum of 25 percent of wages paid and 2.5 percent of the unadjusted basis of qualified property. The limitation in (ii) does not apply if the taxpayer's taxable income is below certain limits. In addition, although adding the qualified property was intended to benefit real estate, note that real activity must qualify as a trade or business. Taxpayers receiving rent through triple-net leases should consider whether their rental activity qualifies as a trade or business.

As mentioned above, having taxable income below certain levels helps one avoid certain limitations to the QBI deduction. For a married person filing jointly, taxable income (ignoring the QBI deduction) no more than $315,000 obtains the full benefits, which phase out over that level until fully phased out at $415,000. For other taxpayers, the amounts are $157,500 and $207,500, respectively.

Moving beyond the QBI deduction, any type of business can benefit from bonus depreciation, which allows most tangible personal property (equipment, etc.) to be 100 percent written off in the year of purchase if placed in service after September 27, 2017, and before January 1, 2023.

Businesses should also consider their debt equity structure. Suppose an owner loans to his or her business (other than a sole proprietorship). A taxpayer in the top bracket would pay 40-percent federal tax (37 percent plus 3.8 percent net investment income tax) on interest income, whereas the business' federal benefit would be only 21 percent if a C corporation or 29.6 percent for a pass-through with a full 20-percent QBI deduction. IRC section 163(j) also may limit deductions for business interest and applies to more businesses due to 2017 tax reforms.

This article attempts to highlight some of the many issues raised by 2017 tax reform. Feel free to e-mail the author for details supporting the statements made.