Entity Choice Considerations Under Tax Reform

By Julia Dengel

The tax legislation informally known as the *Tax Cuts and Jobs Act* (TCJA) generally went into effect on January 1, 2018, and includes some of the largest modifications to the Internal Revenue Code (the Code) in 31 years. This significant tax law reduced tax rates for most businesses and individuals, expanded and enhanced capital expensing, created new limits on deductions for business interest expense and net operating losses and fundamentally changed the U.S. tax system for taxing foreign income. The combined effect of these and the various other elements of the TCJA has transformed the landscape for choice of entity, prompting many taxpayers to re-evaluate the form in which they conduct business. Important factors to consider for this purpose include effective tax rate, future tax rate, fringe benefits and compensation, accounting methods and ownership and succession. With this paper, we explore several of these factors to help you evaluate the need for a possible change.

Choice of Entity in General

Both before and after the TCJA's enactment, there are two primary ways businesses are taxed under the Code: as a corporation and as a pass-through. The following compares these two tax structures **before** the TCJA:

	Corporation	Pass-Through
Form of business	• C corporation	• S corporation, an entity taxed as a partnership[1], a disregarded entity or sole proprietorship
Level of taxation	• Taxable entity, separate & distinct from its owners • Earnings distributed to owners generally taxable, *i.e.*, double taxation	• Income generally only taxable at owner level • Distributions to owners generally nontaxable, *i.e.*, only taxed once
Income tax rates	• Eight graduated income tax brackets with top rate of 35 percent • Qualified dividends taxed at top rate of 20 percent plus net investment income tax (NIIT) of 3.8 percent, if applicable • Accumulated earnings tax (20 percent) • Tax on undistributed personal holding company income (20 percent) • Full/partial gain exclusion on qualified small business stock	• Seven graduated individual income tax brackets with top rate of 39.6 percent plus NIIT of 3.8 percent, if applicable • Self-employment income of individual owners taxed at top rate of 15.3 percent, if applicable • Built-in gains tax

[1] General partnership, limited partnership, limited liability partnership and limited liability company

Pass-through structures have mostly been the entity of choice for closely held businesses since the last major overhaul of the Code in 1986, as the pass-through avoids double taxation and can create simplicity.

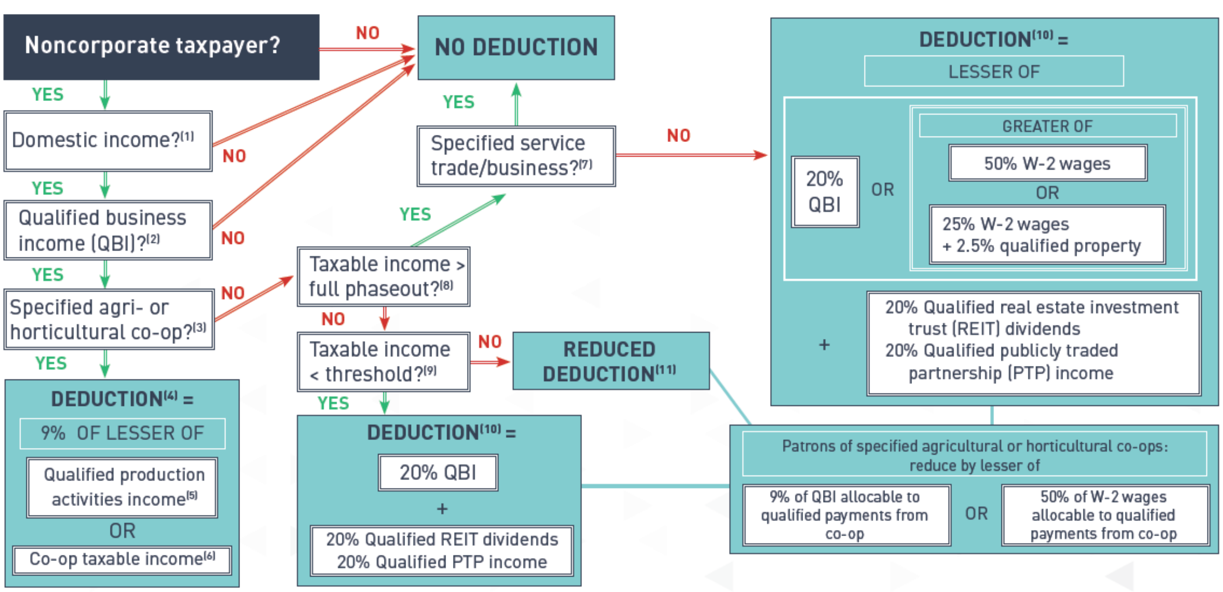
Changes for C Corps

The corporate tax rate was reduced from a maximum rate of 35 percent to 21 percent. Although the rate reduction is permanent, the potential for double taxation still exists, with dividends to individual taxpayers from domestic C corps subject to a maximum tax rate of 23.8 percent, considering the effect of the NIIT. The dividends received deduction—allowed for dividends from one corporation to another—is reduced in situations where the company owns less than 80 percent of another corporation. Instead of an 80 or 70 percent deduction for the dividends received, the deductible amount is reduced to 65 and 50 percent, respectively, depending on the level of ownership. In addition, the corporate alternative minimum tax (AMT) was permanently repealed, while the individual AMT remains in effect.

Changes for Pass-Through Entities & Individuals

One of the significant provisions in the TCJA affecting pass-through entities and their noncorporate owners is the new deduction for qualified business income (QBI). This deduction represents 20 percent of a pass-through owner's QBI and is subject to various thresholds and limitations based on the business's activity type, W-2 wages and the unadjusted basis immediately after acquisition of qualified property. See Figure 1 for an overview of how the deduction is determined. This **BKD Thoughtware**® article provides a more detailed overview of the new deduction.

Figure 1



See next page for footnotes.

(1) Domestic: Effectively connected with conduct of trade/business within U.S. & Puerto Rico

(2) QBI: Net amount of items of income, gain, deduction & loss with respect to any qualified trade or business, except
- Reasonable compensation
- Guaranteed payments
- Investment income
- Short-term & long-term capital gain/loss
- Dividend income
- Interest income

Note: Overall loss treated as loss for purposes of calculation in subsequent year

(3) Specified agricultural or horticultural cooperative: An entity organized & operated on a cooperative basis that is significantly engaged in the marketing, manufacturing, production, growth or extraction of any agricultural or horticultural product, including fertilizer, diesel fuel & other supplies

(4) Deduction limited to 50 percent of W-2 wages allocable to domestic production gross receipts

(5) Qualified production activities income: Domestic production gross receipts less the cost of goods sold, losses & other expenses properly allocable to those receipts

(6) Taxable income determined before any deduction for patronage dividends, per-unit retain allocations & nonpatronage dividends

(7) Specified service business: Any trade or business involving performance of services in fields of
- Health
- Law
- Accounting
- Actuarial science
- Performance arts
- Investing & investment management, trading or dealing in securities, partnership interests or commodities
- Consulting
- Athletics
- Financial services
- Brokerage services
- Principal asset is reputation or skill of one or more of its employees or owners

(8) Full phaseout = $207,500 (single) | $415,000 (married filing jointly (MFJ)), indexed

(9) Threshold = $157,500 (single) | $315,000 (MFJ), indexed

(10) Deduction = Limited to 20 percent of excess of taxable income over the sum of any net capital gain

(11) Reduced deduction: Wage limitation phases in & the deduction for specified service businesses phases out on a pro-rata basis between the threshold & full phase-out amounts

Similar to the change for C corps, the maximum individual tax rate also has been reduced from 39.6 percent to 37 percent. In addition, a new “excess business loss” limitation applies to individuals with business-related deductions that exceed gross income by a certain amount. Any excess loss is treated as a net operating loss and carried forward.

For tax years beginning prior to 2018, both individuals and C corps were generally able to fully deduct state and local taxes in arriving at taxable income. However, following the TCJA’s enactment, the corporate state and local tax deduction remains intact, while the individual itemized deduction for those same expenses has been significantly limited to a maximum deduction of $10,000, with no carryover of disallowed deductions.

Unlike the C corp provisions, the above-mentioned provisions affecting individuals are set to expire December 31, 2025.

Factors for Consideration

Effective Tax Rate

	Corporation	Pass-Through
Previous tax law	50.47 percent (35 percent + .65 x 23.8 percent)	43.4 percent (39.6 percent + 3.8 percent NIIT)
TCJA	39.8 percent (21 percent + .79 x 23.8 percent)	40.8 percent (37 percent + 3.8 percent NIIT)

While it may be tempting to assume, based solely on the rate differential, that converting a pass-through business into a C corp is the best option, it’s important to recognize the impact of other relevant factors, such as the new QBI deduction. As can be seen in Figures 2–4, based on effective tax rates alone, there is still a potential benefit for remaining in a pass-through structure, even with the reduced corporate tax rate. Figures 2 and 3 illustrate the difference in combined effective tax rates between a C corp and S corp with identical business income but varying eligibility for the QBI deduction. Figure 4 demonstrates the effect of retaining 50 percent of the income within the business.

Figure 2: QBI Deduction

	Previous Tax Law		New Tax Law	
	Corp	S Corp	Corp	S Corp
Business income	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Pass-through business deduction	- -	- -	- -	(200,000)
State income tax (entity level)	(60,000)	- -	(60,000)	- -
Taxable income	*940,000*	*1,000,000*	*940,000*	*800,000*
State income tax (shareholder level)	- -	(60,000)	- -	(60,000)
Federal income tax on business income	(319,600)	(325,623)	(197,400)	(226,499)
Tax on distribution to owner	(184,879)	- -	(221,295)	- -
Total tax	*(564,479)*	*(385,623)*	*(478,695)*	*(286,499)*
Net cash to owner	***$435,521***	***$614,377***	***$521,305***	***$713,501***
Combined effective tax rate	***56.45%***	***38.56%***	***47.87%***	***28.65%***

Figure 3: No QBI Deduction

	Previous Tax Law		New Tax Law	
	Corp	S Corp	Corp	S Corp
Business income	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Pass-through business deduction	- -	- -	- -	- -
State income tax (entity level)	(60,000)	- -	(60,000)	- -
Taxable income	*940,000*	*1,000,000*	*940,000*	*1,000,000*
State income tax (shareholder level)	- -	(60,000)	- -	(60,000)
Federal income tax on business income	(319,600)	(325,623)	(197,400)	(300,499)
Tax on distribution to owner	(184,879)	- -	(221,295)	- -
Total tax	*(564,479)*	*(385,623)*	*(478,695)*	*(360,499)*
Net cash to owner	***$435,521***	***$614,377***	***$521,305***	***$639,501***
Combined effective tax rate	***56.45%***	***38.56%***	***47.87%***	***36.05%***

Figure 4: Retain 50% of Income

	Previous Tax Law		New Tax Law	
	Corp	S Corp	Corp	S Corp
Business income	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Pass-through business deduction	- -	- -	- -	- -
State income tax (entity level)	(60,000)	- -	(60,000)	- -
Taxable income	*940,000*	*1,000,000*	*940,000*	*1,000,000*
State income tax (shareholder level)	- -	(60,000)	- -	(60,000)
Federal income tax on business income	(319,600)	(325,623)	(197,400)	(300,499)
Tax on distribution to owner	(92,440)	- -	(110,647)	- -
Total tax	*(472,040)*	*(385,623)*	*(368,047)*	*(360,499)*
Net cash to owner	217,760	114,377	260,653	139,501
Net cash retained in business	310,200	500,000	371,300	500,000
Total net cash after taxes	***$527,960***	***$614,377***	***$631,953***	***$639,501***
Combined effective tax rate	***47.20%***	***38.56%***	***36.80%***	***36.05%***

While the examples above show the potential benefit for remaining in a pass-through structure, consideration also should be given to the state income tax deduction for corporations versus individuals, which can vary based on the state filing methodology of the pass-through entity and its owners. Depending on a taxpayer's specific tax situation, this deduction may result in an overall more favorable effective rate under a C corp structure.

As part of the effective rate analysis, taxpayers also should consider the effect of the accumulated earnings tax and the personal holding company rules as they relate to C corps. Companies affected by these provisions may be subject to additional taxes or limitations that aren't present for pass-through entities. In addition, to the extent possible, future tax rates and projected taxable income should be considered in the analysis. The ideal business structure today may not prove to be as beneficial in the future as the entity's goals and circumstances change.

Ownership & Succession

While managing the effective tax rate is a critical component of any entity choice analysis, it also is important to consider the business's overall strategy. If the sale of a business is a possibility, a pass-through entity structure will generally fare better than that of a C corp, since many sale transactions are structured as a purchase of assets versus stock. Asset sale transactions generate double taxation for C corps when the cash proceeds from the transaction are distributed to the shareholders following the sale. On the other hand, if the transaction is structured as a sale of stock, gain on the sale can be excluded from taxable income to the extent it meets the definition of "qualified small business stock." Conversely, pass-through entities tend to have a similar tax result regardless of how the transaction is structured, depending on the composition of the underlying assets.

For businesses that have no intention to sell and plan to make limited dividend distributions, a C corp may prove to be a productive vehicle for producing permanent tax savings. If the stock of a C corp is held until death, it receives a tax-free step-up in basis upon transfer. In this case, there would be limited potential gain upon a subsequent sale occurring soon after the transfer, as sales price and basis would both be approximately equal to fair market value.

Finally, for businesses that would look for an infusion of capital in the future, a C corp structure may make the most sense as there are no limitations on the type of shareholder that can participate in the entity structure or the number of shareholders the entity can have, as is the case for S corps.

For more information, see BKD's Tax Reform Resource Center or contact your trusted BKD advisor.