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# Entity Planning in the Wake of the Tax Cuts & Jobs Act

CASE STUDY CONSIDERATIONS

IOWA STATE UNIVERSITY  
College of Agriculture and Life Sciences



# Sole Proprietorships

## Pros of a Sole Proprietorship

- Same entity as the owner (this can be beneficial when the owner has a habit of comingling personal expenses with business expenses; note that if the entity is a sole proprietor LLC, the owner may not commingle business with personal and retain liability protection.)
- No administration formalities beyond initial set up such as bylaws, minutes, etc.
- Terminates with the death of the owner
- Can offset other taxable income on Form 1040 (if non-passive) but may be limited if excess business losses; New for 2018 - Net operating losses are carried forward indefinitely and limited to 80% of taxable income
- Step up (could be down as well, however, this would be listed in the cons section) in asset basis to full fair market value at death of the sole proprietor owner
- Any salaries paid to family members (i.e. children) under the age of 18 are exempt from FICA for wages paid and the spouse and parents are exempt from FUTA
- Eligible for any retirement plan structure including SEP, SIMPLE, solo-401(k), etc.
- Tax return filing had been fairly simple in relation to preparing the Schedule C or Schedule F; however, the IRC 199A deduction has complicated calculations for some taxpayers
- 20% QBI deduction (although it's complicated and temporary, it should be beneficial)

## Cons of a Sole Proprietorship

- As the only owner, the taxpayer has unlimited liability exposure for lawsuits, business debts and liabilities
- Ability to raise capital is restrictive in that there is no real separation between the owner and the business; it can be more challenging to obtain investors and business loans
- Fringe Benefits – most are not deductible, may be able to deduct 100% of qualifying health insurance premiums; possibility exists to establish plans to benefit family such as IRC § 105 plan to assist
- Taxes owed can potentially be higher due to the lack of complexity; for example, owner is subject to FICA taxes on the entire net income balance up to the Social Security wage base limit, whereas in an S corporation, the owner is subject to FICA taxes on the taxpayer's W-2 wages only
- New for 2018 – Interest expense is limited to 30% of adjusted taxable income (unused amount carries over indefinitely); there is an exception where gross receipts are \$25 million or less

## Neutral Factor for a Sole Proprietorship

- Subject to individual graduated tax rates, starting in 2018; the highest rate is 37%; capital gains rates 15% / 20%

# Partnerships

## Pros of a Partnership

- Little administration formalities beyond initial set up but a partnership agreement is recommended
- Management may be divided among the partners in flexible ways
- If partnership drops below two partners, the business can terminate; however, partnerships can have unlimited partners
- Transferability of ownership can be completed via sale of partnership interest
- Basis of partnership interest is generally fair market value at death; IRC 754 election available at partnership entity level
- If a limited partner of a partnership, generally there is no self-employment (SE) tax due; however, general partners owe SE tax
- Retirement plan must be established at partnership level; contributions passed through to partner and deductible by partner
- New for 2018 – 20% QBI deduction: subject to certain limitations and excluding specified service businesses. Deduction expires 12/31/2025

## Cons of a Partnership

- Partner liability exposure varies based on partnership structure. General partners have no protection
- Basis calculations must be kept in relation to each individual partner
- Fringe Benefits – most are not deductible, may be able to deduct 100% of qualifying health insurance premiums; possibility may exist to establish plans to benefit partners such as IRC 105 plan, however, to aid in this area
- Taxes owed can potentially be higher in this type of entity; for example, partner is subject to FICA taxes on the entire allocable share of the net income plus guaranteed payments balance up to the Social Security wage base limit, whereas in an S corporation the owner is only subject to FICA taxes via the taxpayer's W-2 wages only
- Pass-through passive income could be subject to Net Investment Income Tax (NIIT) of 3.8%
- Pass-through income could be subject to alternative minimum tax (AMT) at the individual level
- New for 2018 – Interest expense is limited to 30% of adjusted taxable income if gross receipts > \$25 million (unused amount carries over indefinitely)
- New for 2018 – Net operating losses have no carryback eligibility starting in 2018 except for farms. Farms are still eligible to use a two-year carryback provision. The carryforward becomes permanent but can only offset up to 80% of taxable income

## Neutral Factors for a Partnership

- Subject to individual graduated tax rates; starting in 2018 the highest rate is 37%; capital gains rates 15% / 20%
- Distributions that are return of tax basis are not subject to additional taxation
- Guaranteed payments can be used to equalize partners

# S Corporations

## Pros of an S Corporation

- Liability exposure is generally limited to the investment, except for personal services provided (this can change with personal guarantees due to banking regulations in some cases)
- Ownership can be one or more owners up to 100 shareholders
- Transferability of ownership can be completed via sale of shareholder stock
- Required articles of incorporation and board of directors and officers can lead to more solid business operation
- Basis of stock is generally fair market value on the date of death; the assets themselves do not receive a step up (or down) to fair market value
- Generally, there is no self-employment (SE) tax due on net income passing through to the individual shareholder via K-1, it is only paid on W-2 wages i.e. reasonable compensation paid to active shareholders
- Retirement plan is established at corporate level and deduction is made at corporate level
- New for 2018 – 20% QBI deduction: subject to certain limitations and excluding specified service businesses. Deduction expires 12/31/2025
- New for 2018 - Cash method of accounting is generally available for businesses that have average gross receipts of \$25 million or less

## Cons of an S Corporation

- Shareholder liability exposure varies based on any personal guarantees placed on borrowed monies; note that until a payment is made on a loan that is guaranteed, it does not create additional basis for the shareholder
- Basis calculations must be kept in relation to each individual shareholder
- Fringe Benefits – most are not deductible at the entity level and are taxable at the shareholder level, may be able to deduct 100% of qualifying health insurance premiums
- Pass-through passive income could be subject to Net Investment Income Tax (NIIT) of 3.8%
- Pass-through income could be subject to alternative minimum tax (AMT) at the individual level
- No exemption from payroll taxes for any family member; however, officers may potentially receive an unemployment exemption at the state level by making an election; note that this is on a state by state basis and needs to be determined separately for each
- New for 2018 – Interest expense is limited to 30% of adjusted taxable income (unused amount carries over indefinitely) if gross receipts > \$25 million
- New for 2018 – Net operating losses have no carryback eligibility starting in 2018 except for farms. Farms are still eligible to use a two-year carryback provision. The carryforward becomes permanent but can only offset up to 80% of taxable income. Note that these losses can offset other taxable income on the individual shareholder's Form 1040 (if non-passive) but may be limited if excess business loss (individual could encounter suspended losses if these losses are in excess of basis available)

### Neutral Factors for an S Corporation

- Subject to individual graduated tax rates, starting in 2018 the highest rate is 37%; capital gains rates 15% / 20%
- Distributions that are return of tax basis are not subject to additional taxation; however, caution must be exercised if distributions exceed tax basis, these excess distributions are typically subjected to long term capital gains treatment at the shareholder level based on the length of ownership
- Distributions must be made to keep shareholders equal
- S corporations typically need to establish accountable plans to move expenses paid out of the owner's pocket to business expenses. Accountable plans are reimbursement arrangements adopted by the S corporation that requires employees (including owner employees) to substantiate their business-related expenses to the company.

Significance of March 15 Deadline – Calendar year S corporations that determine they want to revoke their S elections must do so by March 15 of the year they want the election to be effective. For the revocation to be effective as of January 1, 2018, it must have been completed by March 15, 2018.

# C Corporations

## Pros of a C Corporation

- Liability exposure is generally limited to the investment.
- Required articles of incorporation and board of directors and officers can lead to more solid business operation
- Ownership can include one or more owners
- Transferability of ownership can be completed via sale of shareholder stock
- Basis of stock is generally fair market value on the date of death; assets themselves do not receive a step up (or down) to fair market value
- Retirement plan is established at corporate level and deduction is made at corporate level
- Fringe Benefits – most are deductible at the entity level and are not taxable to the C corporation shareholder
- Corporate Alternative Minimum Tax (Corporate AMT) was repealed via TCJA starting with January 1, 2018 calendar year entities
- New for 2018 – 21% flat tax on corporation taxable income (made permanent via TCJA)
- New for 2018 - Cash method of accounting is available for businesses that have average gross receipts of \$25 million or less

## Cons of a C Corporation

- Shareholder liability exposure typically rests inside the C corporation; however, upon liquidation state law could require shareholders to assume debts of the C corporation if they aren't paid in full prior to liquidation
- Capital losses are allowed only to the extent of capital gains; any net capital loss for the year is carried back three tax years as short term capital loss then forward five years; no special rate for capital gains and losses
- Double taxation – Net income is taxed within the entity itself and monies distributed out of a C corporation are considered dividends subjected to dividend tax rates at the individual shareholder level receiving the dividends distributed from the C corporation
- No exemption from payroll taxes for any family member
- Can be very difficult to get out
- New for 2018 – Interest expense is limited to 30% of adjusted taxable income (unused amount carries over indefinitely; this is true for all entity structures) if gross receipts > \$25 million
- New for 2018 – Net operating losses have no carryback eligibility starting in 2018 except for farms. Farms are still eligible to use a two-year carryback provision. The carryforward becomes permanent but can only offset up to 80% of taxable income. Note that these losses stay at the corporate level and are not passed through to the individual shareholders

## Neutral Factors for a C Corporation

- Subject to a FLAT tax rate of 21% beginning as of January 1, 2018; this rate has been made permanent in the IRC

- Qualified dividends taxed at long term capital gains rates 15% / 20% to the individual shareholder; nonqualified dividends taxed at individual graduated rates with the highest rate being 37%
- Corporations are not subject to NIIT, however, dividends paid to C corporation shareholder could be subjected to the NIIT of 3.8%



# Transitioning Real Estate out of a C Corporation

1. Completely dissolve the entity and pay the taxes at both the C corporation level and the individual level (via dividends and/or increased compensation) while continuing to retain ownership in the real estate.

-This is considered a deemed sale and requires cash flow inside the C corporation

2. Completely dissolve the entity and pay the taxes at both the C corporation level and the individual level (via dividends and/or increased compensation to the shareholder) by selling the real estate out of the C corporation to a third party and taking a distribution of the cash within the C corporation as a dividend

-Even if double taxation of C corporation earnings can be justified for both tax and non-financial reasons, there remains the problem of managing double taxation of C corporation earnings when disposing of the entity. The tax inefficiencies of C corporations on the disposition of the entity through an asset sale concerns both inside and outside taxation. Gain on the sale of business assets, including land, is taxed inside the corporation. There is also tax outside the corporation to the individual shareholder from the distribution of the proceeds on the sale of corporate assets. This statement is true for both third party asset sales and deemed sales of assets within the corporation. Thus, whether the C corporation sells all of its assets and distributes the proceeds in liquidation or all of its assets are distributed via the deemed sales rule in liquidation (IRC § 336), the tax consequences to both the corporation and its shareholders are substantially the same. Therefore, Options 1 and 2 provide generally the same end result.

3. Elect S corporation status and wait for the 5 year BIG tax (now 21 percent at the federal level) to be removed; this needs to be weighed against the potential total sales price of the land and the combination with the taxpayer's other income; it could impact the capital gains rate, AMT and possibly NIIT at the individual level

-This is the easiest and least costly method to exit a C corporation but as in all things tax it has its challenges. A few items to note is that not every C corporation is eligible to be an S corporation. Only domestic corporations are allowed and there are shareholder requirements as well. One class of stock, less than 100 shareholders who are US citizens, and passive income restrictions (disclaimer, this is not an exhaustive list). These considerations must be explored to be certain the C corporation is eligible to be converted first.

4. Sell the C corporation stock to a third party with a potentially discounted value with an understanding that the buyer can immediately convert the C corporation to an S corporation

-There is a general reluctance of a buyer to purchase the shares of a C corporation for various reasons - depreciation isn't available for the business assets, buyer could inherit undisclosed issues such as liabilities, and cash flow concerns top the list. However, there are cases where the buyer may have little choice to buy shares rather than the underlying assets such as when a non-transferrable contract is held. Remember, the buyer is purchasing the stock whereby the stock basis is the purchase price paid for the stock. The underlying assets would remain at their historic basis. This causes an issue because upon later sale of these underlying assets, the new purchaser of the shares would be subject to tax on the gain upon sale of these assets. Further, the purchaser would be carrying a tax cost in the form of reduced depreciation or amortization.

5. Convert the C corporation to an LLC

-The major difference between the conversion from C corporation to S status and the conversion to an LLC is that the latter has immediate tax consequences. This must be considered in the decision making process.

Typically a conversion from a C corporation to an LLC can take one of four forms:

- i. Assets up form: In the assets up form of conversion, the C corporation is liquidated and its assets are transferred to its shareholders who then transfer them to the LLC. This is similar to the tax consequences and form in Options 1 and 2 above with S Corporations.
- ii. Interests over form: In the interests over form, there is an actual transfer of the shares of the C corporation to an LLC (which is then the sole shareholder of the C corporation) followed by an actual liquidation of the C corporation with its assets being distributed to the LLC. Again, this is similar to Options 1 and 2 above explained with S corporations.
- iii. Assets over form: In the assets over form, the C corporation transfers its assets to an LLC in exchange for all the interests in the LLC, followed by an actual liquidation of the C corporation in which the C corporation distributes the LLC interests to its shareholder.
- iv. Merger or statutory conversion under state law: The merger of a C corporation into an LLC or its statutory conversion into an LLC under applicable state law are forms of conversion available in only some states. Where allowed, a C corporation can merge into an LLC or can be converted to an LLC by election. This structure will not be explained further here.

# Should I Change Entity Structure?

## Thoughts and Questions to Consider

1. C corporation income is taxed at 21% rate, whereas pass through income to an individual is subject to a maximum 37% rate (without considering employment taxes, net investment income taxes or alternative minimum taxes at the individual level)
2. Pass through income for S corporations, proprietorships, and partnerships may be eligible for a 20% qualified business income (QBI) deduction; the highest effective tax rate generally becomes 29.6% if your income is eligible for the deduction.
3. C corporations can fully deduct state and local taxes (SALT), whereas an individual's deduction is limited to a \$10,000 maximum starting with the 2018 tax calendar year.
4. C corporations face double taxation. C corporations are subject to two levels of tax, one at the corporation level on earnings taxed inside the corporation and another at the shareholder level, typically on dividends.
  - This could be a decisive factor in remaining a certain business structure. If a business does not make distributions or dividend payments to its owners and only pays salary and benefits whereby the profits are reinvested, then a C corporation structure may result in tax savings. If the business distributes all of its profit out to its owners annually, then the double tax resulting from the C corporation structure may become a major disadvantage.
5. If the C corporation accumulates cash, it could be a target for the accumulated earnings tax and personal holding company tax. Possibly now that the corporate tax rate has been reduced to 21%, the low rate makes C corporation status beneficial, especially for companies that want to retain earnings rather than distribute them to their owners as dividends.
  - Closely held C corporations are subject to the personal holding company tax if 60% or more of their income is passive income and they retain this income inside their C corporation without distributing the monies to their shareholders.
6. Foreign C corporation: Under the new international tax rules, ownership of foreign corporations by a C corporation rather than an individual has several advantages. Dividends paid by a foreign corporation to a C corporation can escape any tax while dividends paid to an individual are fully taxable. If a foreign corporation has income that exceeds a base threshold amount (generally 10% of the book value of its assets) and the foreign corporation does not distribute those excess earnings to its US shareholder, then the new "GILTI" tax applies to treat the US shareholder as receiving a deemed taxable dividend of that excess amount.
7. Step up at Death. If an owner dies owning C corporation stock, the stock itself will receive a step up in basis to its fair market value. This will avoid a shareholder level tax when the C corporation liquidates. However, this does not avoid a tax to the corporation on any appreciated assets that are distributed in liquidation or later sold by the C corporation. S corporation stock and partnership interests also receive the step up (or step down), not the underlying assets of the entity.

8. Losses. If a pass-through entity has losses that flow through to its partners or shareholders, those losses would not flow through if the entity becomes a C corporation.
9. Timing and other related issues. A company that is an LLC can elect to be treated as a corporation for tax purposes. If a decision is made to terminate S corporation or partnership status, termination would have to be completed by March 15 to be effective in that tax year. An S corporation that terminates its S status has a five-year waiting period to convert back to S corporation status. If a C corporation converts to an S corporation status in the future, then it may be subject to a built-in gains tax and other concerns if it later converts to an S corporation and has accumulated earnings and profits.
10. Do the owners of the pass through have an exit strategy? If the S corporation owner is near retirement and plans to sell the business outright to a third party, conversion is much less attractive than for a family-owned business where the next generation plans on taking over the S corporation and continuing to run the operation.
11. Is it an all-or-nothing proposition? Should the company consider a division of business operations, possibly considering a pass through entity for some portion of the business and C corporation status for the remainder?
12. Does the entity have operations in multiple states? Does the operation have nexus in multiple states? The limitation on state tax deductions by shareholders and partners at the individual level due to the pass through income can cause significant drawbacks to multistate entities. This limitation doesn't affect C corporations.
13. Has the entity maintained accurate records during its status as a partnership or S corporation, namely basis schedules? Has the company decision to convert to or elect a new business structure been vetted by at least the majority owners?
14. What is the current value of the business and when was the last formal valuation prepared, if any? What is the total adjusted basis of company assets less liabilities? What is the ordinary income amount that would be triggered by a sale due to depreciation recapture and hot assets?
15. What are the expectations regarding distributions, returns and bottom line profits? Entities that distribute a significant portion of their cash flow to compensate owners will likely not benefit from a conversion as much as an entity that retains most of its cash flow to use in the business.
16. What is income expected to be for the next several years and what types of income will that include – interest income from the business, investment interest, capital gains, dividends, etc.? What tax brackets are the owners expected to be in?
17. How much payroll expense is the entity expecting in the next several years? What fringe benefits and payroll taxes will be impacted by the change in structure?
18. Are there any lingering S corporation issues to consider – remaining built in gain amount or C corporation losses?