Choice of Entity After Tax Reform

By Jason B. Freeman, JD, CPA | Column Editor

The choice of entity is a fundamental decision in structuring a trade or business. Tax considerations and state-law principles affecting owner liability, control and continuity play a role in the choice-of-entity analysis. A litany of other factors are important as well, including the capitalization structure and the necessity of accessing equity markets, debt requirements, employee compensation, the impact of foreign operations and exit strategies. The Tax Cuts and Jobs Act of 2017 (TCJA) introduced several new and important tax considerations.

While Congress and policymakers appear to have anticipated a flood of conversions to C corporations in light of the TCJA's new 21 percent flat corporate rate, the choice-of-entity decision is perhaps more contingent than ever on the particular facts and circumstances. And while it may buck conventional wisdom, for some taxpayers now may actually be the least expensive time in years to convert out of the C corporation form.

The Beginning. The most fundamental decision in the choice-of-entity context is whether to establish an entity or not – that is, whether the operation should be conducted as a sole proprietorship or through an entity. A sole proprietorship provides no personal liability protection to the owner. And from a tax perspective, the owner reports the tax activity directly on his/her personal tax return.

An entity, on the other hand, may provide owners with a degree of liability protection. The bread-and-butter state law entity structures include a limited liability company (LLC), partnership (general and limited) and corporation, although there are other more exotic structures. LLCs, limited partnerships and corporations provide owners with a degree of liability protection, but judicial doctrines – such as piercing the corporate veil and alter ego – can sometimes limit those protections where entity formalities are not properly followed.

The Federal Tax Classification Options. A single-member LLC can be taxed, for federal tax purposes, in one of two manners: as a disregarded entity or as a corporation (which, if qualified, may then be eligible to make a "S" corporation election). A multi-member LLC can be taxed as a partnership or corporation. A partnership may be taxed, again for federal tax purposes, as a partnership or a corporation, if it so elects. Finally, a corporation can generally be taxed as a "C" corporation or, if it so qualifies and elects, as a "S" corporation.

C Corporations. C corporation activities are taxed under a two-tier tax system. Corporate income is first subject to tax at the corporate level. Under the TCJA, the corporate tax rate was amended from a progressive rate structure with a top tax rate of 35 percent, to a flat 21 percent corporate rate. The new 21 percent rate also applies to personal service corporations. For some smaller corporations that were previously subject to a 15 percent rate, this new flat rate may actually result in an increased tax rate.

Income that is distributed to shareholders is then subject to a second level of tax as a dividend to the extent of corporate earnings and profits. A dividend is generally subject to a 15 or 20 percent qualified dividend rate plus (for some higher-earning taxpayers) a 3.8 percent net investment income tax. As a result of this two-tier tax system, the combined federal tax rate to get earnings out of corporate solution for a taxpayer subject to tax at the highest marginal tax rate equates to approximately 39.8 percent.

Passthroughs – Partnerships and S Corporations. Compared to the two-tier C corporation tax regime, partnerships and S corporations – even post tax reform – generally offer one level of taxation.

Partnerships. For federal tax purposes, the income and deductions from a partnership flow through to, and are reported on the returns of, its partners. Partners calculate tax based upon their applicable tax rates. Partnerships tend to offer the greatest level of flexibility in structuring partner compensation. That flexibility, however, can also create greater accounting complexities.

S Corporations. S corporations function somewhat similarly in that, with some exceptions, income and losses flow through to shareholders. S corporations, however, offer less flexibility due to restrictions that limit the number and type of shareholders, the one-class-of-stock rule, and a requirement that income and losses flow through in a pro rata manner. For some, however, this simplicity may be a virtue and may decrease accounting costs and other complexities.

The Section 199A Deduction for Qualified Business Income. The TCJA enacted new section 199A, which generally provides a deduction equal to 20 percent of "qualified business income" (QBI). QBI from flow-through entities – including sole proprietorships, partnerships or S corporations – is generally eligible for a 20 percent deduction. However, the deduction is not available to owners of entities in certain industries – so-called "specified service trades or businesses" – except to the extent that their owners have taxable income below certain thresholds.

Specified service trades or businesses include any trade or business engaged in the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of one or more of its employees, or that involves the performance of services that consist of investing and investment management, trading or dealing in securities (as defined in section 475(c)(2)), partnership interests or commodities.

Where it applies, the 20 percent QBI deduction effectively provides for a top marginal tax rate of 29.6 percent on QBI. But as demonstrated above, the availability of the QBI deduction can vary depending on the passthrough's industry and the income levels of its owners – factors that add a layer of complexity into the mix.

Tax Rates. In comparing entity structures, advisors should consider the different tax rates that apply. However, advisors should

also recognize that corporations may present opportunities to mitigate the two-tier tax system, such as through wage payments to shareholder/employees or through debt arrangements. Moreover, advisors should factor in the time value of money and the owner's exit strategy and time horizon. For example, where owners intend to reinvest earnings over a lengthy period of time, the lower 21 percent corporate tax rate may create a significant tax advantage depending on the time horizon.

The Bipartisan Budget Act. When considering the partnership form, advisors should also consider the implications of the Bipartisan Budget Act (BBA). The new partnership audit rules under the BBA repeal the TEFRA audit rules and dramatically change the regime that currently governs partnership tax audits, assessments and collection. The BBA imposes a new, centralized partnership audit regime that generally provides for the assessment and collection of tax at the partnership level. These new rules will have a dramatic impact on partner rights and the valuation of partnerships, creating a number of complexities for partnerships and impacting the choice-of-entity analysis.

Other Tax Considerations. Other tax factors should be considered, as well. For example, only corporations provide owners with the potential exclusion of gain on the sale of qualified small business stock under section 1202. C corporations, however, must also consider the accumulated earnings tax, which can impact corporations that retain funds beyond their reasonable needs. The ability to deduct losses is another factor that is relevant to the choice-of-entity analysis.

Foreign Operations. Foreign operations have always complicated the choice-of-entity analysis. This is particularly true after the TCJA. While a more in-depth analysis of the foreign factors is beyond the scope of this article, practitioners should be aware that the TCJA introduced a number of new considerations. Notably, the TCJA created a quasi-territorial system of taxation. Domestic C corporations now receive a 100 percent deduction with respect to the foreign-source portion of dividends received from certain foreign subsidiaries. This deduction is not available to passthrough entities. Other tax law changes, such as clarification on the impact of a foreign partner's sale of a partnership interest, may also be relevant.

Conversions

In light of these and other considerations, some entities may consider converting into another form. Below is a high-level summary of the general potential tax impact related to such conversions.

Partnership to Corporation. Partnership conversions into a corporation (C or S corporation) are generally tax free. Tax may be triggered, however, if partnership liabilities exceed the partnership's basis in its assets at the time of conversion.

S Corporation to C Corporation. An S corporation may convert into a C corporation on a tax-free basis. S corporations that convert to C corporation status are allowed to attribute distributions during the post-termination transition period to the accumulated adjustment account (AAA). For distributions occurring after that period, the distribution is treated as in part from the AAA and in part from prior C corporation earnings and profits.

NOTABLY, THE TCJA CREATED A QUASI-TERRITORIAL SYSTEM OF TAXATION

C Corporation to Partnership. A conversion by a C corporation into a partnership is treated as a taxable liquidation, leading to a potential tax event at both the corporate and shareholder level. The cost of such a conversion, however, is historically relatively low in light of the reduction in corporate tax rates under the TCJA.

C Corporation to S Corporation. Finally, with certain limited exceptions, a C corporation's conversion to an S corporation generally does not result in immediate tax liability. However, such a conversion may lead to built-in-gain taxation to the extent the new S corporation disposes of assets during a five-year period following the conversion.

Concluding Remarks

As the factors above make clear, the choice-of-entity decision is not a one-size-fits-all analysis and is, perhaps more than ever, dependent upon the particular facts and circumstances. Taxpayers and advisors should consider the applicable effective tax rates in light of decreases in corporate tax rates and the enactment of Section 199A's deduction for qualified business income. They must, however, also consider other factors, such as the impact of the BBA, section 1202 and other unique factors, as well as the impact of foreign operations. ■

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