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CT

ESSENTIAL COMPLIANCE INSIGHTS

How the New Tax Law Will Affect Your Client's Choice of Legal Entity

By Andrew Whelan

HOW THE NEW TAX LAW WILL AFFECT YOUR CLIENT'S CHOICE OF LEGAL ENTITY

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The Tax Cuts and Jobs Act (TCJA) of 2017 has made sweeping changes to our nation's tax code, impacting many business decisions.

The Tax Cuts and Jobs Act (TCJA) of 2017 has made sweeping changes to our nation's tax code, impacting many business decisions. One example is how business owners and their tax advisors approach the question of choosing an entity's legal structure.

> *From sole proprietors to LLCs, partnerships to corporations, the 2017 tax overhaul has law offices and their clients scrambling to understand how the changes affect their choice of legal entity. Much of 2018 will be spent figuring out the implications, but that doesn't stop anxious businesses turning to you now to find out what it all means to them.*
>
> *— Mark Luscombe, J.D., LL.M.*
> *CPA and Principal Analyst for Wolters Kluwer Tax & Accounting*

Law firms should familiarize themselves with the details of the TCJA and how it affects their clients' choice of business structure. Here's what you need to know.

REDUCTION IN CORPORATE TAX RATE – A TAX BOON FOR CORPORATIONS

One of the most widely talked about provisions in the TCJA is corporate tax reform and the rate reduction to 21% for tax years beginning after 2017. For your clients that operate as C corporations, or are considering incorporation, there are tax benefits. The provision will increase the after-tax profitability of corporations and is intended to give them greater income to invest.

Investments may come in the form of jobs or capital assets, as well as investments in other businesses, setting the stage for M&A activity. Just one month after the corporate tax rate was reduced, 287 companies announced plans to increase wages or expand investments in the U.S.*

THE DEDUCTION FOR PASS-THROUGH INCOME (AND ITS COMPLEXITIES)

To balance the corporate tax rate reduction and help level the playing field, the TCJA created a temporary eight-year deduction (Section 199A deduction, effective January 1, 2018-December 31, 2025) for taxpayers with income from pass-through entities (sole proprietorships, partnerships, LLCs taxed as partnerships, and S corporations). The deduction—20% of qualified business income earned—is open to taxpayers with taxable income under $315,000 (filing jointly) or $157,500 (other filers), regardless of their trade or business.

However, the 20% deduction is not guaranteed to all business taxpayers.

Let's break down some of the key exceptions:

- **The Specified Service Trade or Business Limitation:** If a client files jointly with taxable income over $315,000, or if they file under any other status with taxable income over $157,500, then the nature of their trade or business is factored into eligibility for the deduction. After a phase-out, the deduction is reduced to zero for high-earning taxpayers in specified service trades or business (SSTBs) once taxable income reaches $415,000 for joint filers and $207,500 for other filers.

  An SSTB is defined as the following:

  – any trade or business involving 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 of such trade or business is the reputation or skill of one of more of its employees or owners;

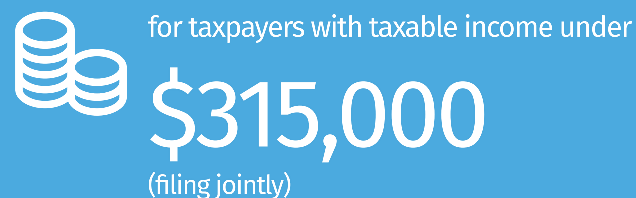
  or

  – any trade or business which involves the performance of services that consist of investing and investment management, trading or dealing in securities, partnership interests or commodities.

Taxpayers with Income from Pass-through Entities

Sole Proprietorships, Partnerships, LLCs Taxed as Partnerships, and S Corporations

Effective January 1, 2018-December 31, 2025



High-income taxpayers may not qualify for the Section 199A deduction and find themselves at a tax and competitive disadvantage compared to other businesses. For this reason, taxpayers in specified trades or business may want to consider changing their entity selection.

There are also several ways around this limitation. Some examples include spinning off equipment or real estate into a separate entity to generate a pass-through deduction from that entity. (This decision is complicated and must be discussed with tax professionals to ensure there are no unintended adverse effects. It may also depend on what the IRS regulations interpreting this provision will state when promulgated later this year.)

- **What About Non-SSTBs?** While there isn't a bar on claiming the deduction among non-SSTBs, as the taxpayer's income increases, the amount allowed as a deduction switches from a relatively simple 20% of qualified business income to a two-pronged test to determine the amount. Determining what is "qualified business income" may still be fairly complex.

If the taxpayer's taxable income exceeds $415,000 (joint filers) or $207,500 (all other filers), the deduction is limited to the lesser of

– up to 20% of Qualified Business Income (QBI)

or

– the greater of (a) 50% of W-2 wages from the qualified trade or business, or (b) 25% of W-2 wages from the qualified trade or business, plus 2.5% of the unadjusted basis immediately after the acquisition of all qualified property. Qualified items include income, gains, losses, and deductions connected with the conduct of a qualified trade or business. Qualified business income does not include investment-type income (e.g., capital gains, dividends and non-business interest), reasonable compensation and guaranteed payments.

These limits start to phase-in when taxable income exceeds $315,000 for joint filers and $157,500 for other filers.

The W-2 wages test may prompt higher-income non-SSTB taxpayers to consider electing S corporation status, where "reasonable compensation" is already a fairly established concept. This test is particularly likely to be prejudicial to high-income sole proprietors who have no employees.

High-income taxpayers may not qualify for the Section 199A deduction and find themselves at a tax and competitive disadvantage compared to other businesses. For this reason, taxpayers in specified trades or business may want to consider changing their entity selection."

Here's an example of how an S corporation election can help with income tax liability. (Note: this is also a saving based on employment tax liability.)

> ***Example (1):*** *Bob's Architecture, LLC, has a qualified business income of $800,000. There are two members in the LLC. The company's payroll is $150,000.*
>
> *His deduction is limited to $75,000 because he can only deduct the lesser of QBI x 20% ($800,000 x 20% = $160,000) or W-2 wages x 50%. ($150,000 x 50% = $75,000).*
>
> *However, if he makes an S corporation election and pays the members a salary of $150,000 each, his deduction is $160,000 (the lesser of QBI x 20% or W-2 income x 50% [$450,000 x 50% = $225,000].*

Note that this example does not address the complexities introduced by the "qualified property" computation.

NON-CORPORATE TAXPAYERS ARE LIMITED IN WHAT THEY CAN DEDUCT FOR LOSSES

Under the newly enacted Section 461(I) tax code, non-corporate taxpayers (LLCs, S corporations, limited partnerships) can only offset $250,000 ($500,000 on joint returns) of losses from income in the current tax year. There is no limitation posed on C corporation taxpayers.

Furthermore, the current law limitations on passive activity losses (PALs) are unchanged. The active business activity limitation is in addition to the PAL rules. This limitation is applied after the basis-limitation, at-risk, and passive loss rules.

In addition, effective December 31, 2017 through January 2, 2026, losses can be carried over but are subject to new net operation loss (NOL) limitations. Generally, NOLs will be limited to 80% of taxable income for losses arising in tax years beginning after Dec 31, 2017. The 80% limit on carryovers also applies to C corporations. Carryback is eliminated, but losses can be carried forward indefinitely, subject to the percentage limitation.

Newly Enacted Section 461(I) Tax Code

Non-corporate Taxpayers

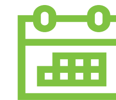
(LLCs, S Corporations, Limited Partnerships)

Can only offset

$250,000 single return

$500,000 joint return

of losses from income



in the current tax year

THE CARRIED INTEREST RULE

The TCJA introduced the concept of an applicable partnership interest, which means that holders of carried interest, or profits interest, held by a general partner, will only be eligible for long-term capital gains rate on dispositions of capital assets held for more than three years. Previously, carried interest holders would benefit from long-term capital gains on assets held over one year. Now, interests disposed of before the three-year holding period is met are taxed at ordinary income rates, rather than the more favorable capital gains rates. This new rule has no expiration date, and there is no grandfather clause for existing carried interests.

It's important to note that the longer holding period doesn't apply when the interest is held by a "corporation". Some have argued that the term "corporation" should include S corporations. However, on March 1, 2018, the Treasury Secretary and IRS moved to close this loophole issuing a notice clarifying that S corporations are subject to the longer holding periods and that it will soon issue regulations in accordance with this. There are some commentators who question the IRS interpretation, and there may be litigation on the issue unless Congress provides a clarification.

Federal tax changes aside, state law is also an important consideration for your clients when choosing a legal entity.

*Americans for Tax Reform

THE BOTTOM LINE

The TCJA has far-reaching implications for how your clients legally structure their businesses. As with all things tax law related, nothing is simple.

As we discussed in this article, the Act raises the question of how pass-through entities navigate the 20% tax deduction and its many exceptions. For many of these entities, it's important that they re-evaluate their active-versus-passive activity. For other business owners, a conversion to a C corporation should be considered.

Federal tax changes aside, state law is also an important consideration for your clients when choosing a legal entity. Some states have different tax rates for different entities. For example, the state of Florida only taxes C corporations; there is no individual income tax. States are also taking different approaches in the extent to which they conform to TCJA for state income tax purposes. These nuances underscore the importance of seeking advice from a professional who is able to balance all the ramifications of any decision.

No matter the tax situation, business considerations should always be the driving factor in any decision made about entity choice.

› ABOUT THE AUTHOR

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Andrew Whelan is the Vice President and Law Firm Segment Leader for CT Corporation. He is responsible for strategic development and oversight of the customer experience for CT's law firm clientele.

Andrew has held a number of positions at CT, including leading operations and sales teams. He's led key company initiatives, including the launch of CT's suite of compliance services for business licenses and the creation of the organization's Customer Relationship Management program. Immediately prior to his current role, he led CT Corporation's Funds and Alternative Investment Segment.

Andrew graduated with an MBA from the University of Colorado at Denver and with a B.A. in public relations from Colorado State University.

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