THE TAX CUTS AND JOBS ACT: CHOICE OF ENTITY ISSUES

Presented by: Bryan E. Slone & Jeffery R. Schaffart

January 10, 2018

KOLEY JESSEN

ATTORNEYS

Speaker Introductions

Bryan E. Slone
402.343.3897
bryan.slone@koleyjessen.com

Jeffery R. Schaffart
402.343.3716
jeff.schaffart@koleyjessen.com

Agenda

- Historic Choice of Entity Issues
- Impact of TCJA Provisions
- Review of Common Scenarios
- Process for Analyzing if a Business Should Convert to a C Corporation Structure
- Questions

Historic Choice of Entity Issues
Legal Forms of Business

Pass-Through Entities:

- Sole proprietorships
- General partnerships
- S corporations
- LLCs (disregarded entity, partnership, or S corporation for federal income tax purposes)
- LPs / LLPs (partnerships for federal income tax purposes)

Non-Pass-Through Entities:

- C corporations
- LLCs that elect to be taxed as associations / C corporations
- Certain cooperatives that are taxed as associations / C corporations

Historic Choice of Entity Issues
Pass-Through Advantages/Disadvantages

Partnerships

- Pass-through taxation
- Flexible allocations of income and losses/waterfalls
- No ownership restrictions
- Ability to issue profits interests
- Prohibition on being a partner and employee
- Basis step-up of internal assets on death of a partner or transfer of a partnership interest
- Complicated anti-abuse rules under Sections 704, 751, etc.

Sub-S Corporations

- Pass-through taxation
- Ownership limitations
  - No more than 100 shareholders
  - Only qualified shareholders
  - One class of stock limitation
  - Inflexible distribution and allocation rules
- Some ability for self-employment tax planning
- No basis step-up of internal assets on death of a shareholder or transfer of shares

Historic Choice of Entity Issues
C Corporations Advantages/Disadvantages

Advantages

- Formal governance structure
- Ability to attract capital
  - No ownership limitations
  - Public company status
  - Marketability of shares
- Tax-free reorganizations
- Limited liability of all owners
- Consolidated return

Disadvantages

- No pass-through/double taxation
- No basis step-up of internal assets on death or transfer of ownership interests
- Property distributions taxable
- NOLs captured within entity rather than allocated to individual owners

Impact of TCJA Provisions

Lowering of C-Corp Effective Rate

Prior Law Effective C-Corp Rate*	
Taxable Income	$100.00
C-Corp Tax	-$35.00
Net Distribution	$65.00
Individual Tax (20%)	-$13.00
After Tax Cash	$52.00
Effective Tax Rate	**48%**

TCJA Effective C-Corp Rate*	
Taxable Income	$100.00
C-Corp Tax	-$21.00
Net Distribution	$79.00
Individual Tax (20%)	-$15.80
After Tax Cash	$63.20
Effective Tax Rate	**36.8%**

*Assuming all taxable income is distributed as dividend income

Impact of TCJA Provisions
Pass-Through Deduction

20% Pass-Through Deduction for specified income from pass-through businesses

Three exceptions / limitations

- Service business
- W-2 and capital expenditures
- Compensatory payments

TCJA Effective Pass-Through Rate	
Taxable Income	$100.00
Entity Level Tax	$0.00
Net Distribution	$100.00
20% Deduction	-$20.00
Taxable Income	$80.00
Individual Tax (37%)	-$29.60
After Tax Cash	$70.40
Effective Tax Rate*	**29.60%**

*But limitations could increase effective rate up to 37% for some businesses!

Impact of TCJA Provisions

Other Selected Provisions

$10,000 SALT Deduction Limit

- TCJA caps an individual's deduction for state and local income and property taxes at $10,000
  - Limit does not apply to business property taxes
- A C corporation's deduction of SALT taxes is not limited
- Differing SALT treatment may make C corporations more attractive

Repeal of Corporate AMT

- Corporate AMT is repealed
- Individual AMT is retained with increased exemption amounts

Impact of TCJA Provisions

Other Selected Provisions

100% Bonus Depreciation

- Bonus depreciation increased to 100% of new and used assets placed into service until 2023
  - May have a significant impact on taxable income and tax assumptions
    - Lower for next several years
    - Reversal in later years
  - May have balance sheet effect

Net Operating Loss Deduction

- No carryback period except for certain farming losses and P&C insurance companies
- Indefinite carryforward
- Deduction limited to 80% of taxable income generally
- New excess business loss rules apply to non-C corporation taxpayers to limit ability to offset excess business losses with income from other activities

Common Scenarios – Start-ups

Key Attributes:

- More likely to generate tax losses, especially with new expensing rules
- Pass-through of losses may be beneficial to owners, subject to new NOL and excess business loss rules
- 1202 Qualified Small Business Stock
- State of Nebraska gain exclusion
- Often times larger financial contributors will want preferred returns and flexibility in allocations and distributions
- IPO vision – What is the exit strategy?
- Is this a specialized service company?
- W-2 payroll expectations?
- Equity-based compensation arrangements?

Common Scenarios – Cash Cows

Key Attributes:

- Business that generates substantial extra capital to owners
- High margins on sales
- Large distributions of cash to owners expected
- May be able to benefit from new pass-through deduction, especially if business pays significant salaries or has significant capital expenditures

Common Scenarios – Have & Hold

Key Attributes:

- Financial assets
- Long-term investments – buy and hold
- Reinvest excess capital and maintain large entity-level capital
- Owners expectation – long-term capital gains, not dividends
- Potentially acquisitive – stock acquisitions/reorganizations
- Large numbers of owners/investors
- Formal governance structure

Common Scenarios – Farm Business

Key Attributes:

- Family ownership
- Cyclical business with large loss and profit years
- Large investments in land and equipment
- Estate planning is critical to family succession planning
- Potential for liquidity event in the event children don’t continue to farm
- Cash method of accounting
- Significant debt financing
- High property taxes
- Large inventories at certain times of the year

Common Scenarios – Potentially Good Candidates for C Corporation Status

- Businesses that retain and reinvest excess capital
- Businesses that have investor base that prefers C corporation structure
- Businesses that are likely going to be able to achieve a sale of stock exit
- Businesses that generate losses
- Larger financial and services industry businesses

Common Scenarios – Potentially Good Candidates for Pass-Through Status

- Businesses that can materially qualify for the 20% pass-through deduction
- Businesses that distribute a large portion of excess capital to their owners
- Businesses that are likely to generate material long-term capital gain income
- Businesses that generate losses that their owners can use to offset other income
- Businesses that use flexible partnership allocation and distribution models

Process for Evaluating Whether a Business Should Become a C Corp

- Historically, a pass-through business reliably generated more efficient results
- Following the TCJA, results are not as intuitive or certain
- It appears likely that, at least some in some instances, a C corporation will be relatively more attractive than a pass-through structure
- Making an informed decision to covert to a C corporation from a pass-through requires a complex analysis
- International operations will make evaluation process more difficult

Process for Evaluating Whether a Business Should Become a C Corp

- **Factors to consider whether a business should be structured as a C corporation include:**
  - Double taxation of C corporation income
  - Relative tax rates imposed on income received by C corporations and individuals
  - Ability of the business to use the new 20% pass-through deduction
  - Likelihood of removing appreciated assets from the business
  - Short-term and long-term effects of 100% bonus expensing
  - Impact of any accounting method changes

Process for Evaluating Whether a Business Should Become a C Corp

- **Factors to consider whether a business should be structured as a C corporation include (cont'd):**
  - Plans for and tax consequences from the sale of a business
  - Application of employment-related taxes and so-called Medicare tax
  - Limitations on individual's ability to deduct state and local taxes
  - Possibility of future changes in law (including tax rates)
  - Impact on owners' estate planning, especially leveraged GRATs

Process for Evaluating Whether a Business Should Become a C Corp

- **Information to model whether a business should be a C corporation includes:**
  - At least three years of financial information and tax returns
  - Review of pass-through tax attributes that could trigger tax
    - BIG, C corporation E&P,704(c), 751, etc.
  - Five years of taxable income projections
  - Economic assumptions
  - Distribution assumptions
  - Capital expenditure/assets assumptions
  - Review of current legal documents
  - International tax implications if business has international operations

Process for Evaluating Whether a Business Should Become a C Corp

- **Methods for converting to C corporation status**
  - S corporation (including LLCs taxed as S corporations)
    - File letter and “statement of consent” with IRS to terminate election
    - Must be submitted to IRS by no later than the 15th of the 3rd month to be effective as of January 1
    - “Eligible Terminated S corporations” have 6 years to ratably take into account any § 481(a) accounting method changes triggered by termination under new § 481(d)
  - Limited liability companies taxed as partnerships or DREs
    - “Check the Box” on Form 8832
    - Must be submitted to IRS by no later than the 15th of the 3rd month to be effective as of January 1
    - If an LLC taxed as a partnership elects to be a corporation, there is a series of deemed steps under Reg. § 301.7701-3(c)(l)(i)
    - Deemed steps follow the “assets over” construct of Rev. Rul. 84-111

Thank You For Attending!

Questions?

***Presentation Disclaimer*:** This presentation should not be considered as legal, tax, business, or financial advice. This presentation is intended for educational and informational purposes only. It is provided with the understanding that while the authors are practicing attorneys, neither they nor Koley Jessen has been engaged by the attendee/reader to render legal advice or other professional services. If legal advice or other expert assistance is needed by the attendee/reader, the services of a competent professional should be sought.

Tax Reform Webinar Series

- **Recordings and slides will be emailed out on <u>Thursday, January 11, 2018</u>**

- **If you have any questions please contact events@koleyjessen.com**