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Choice of Entity After Tax Reform – The New Normal (Outline)

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CHOICE OF ENTITY AFTER TAX REFORM –

THE NEW NORMAL

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I. Legislative Provisions in the Tax Cuts and Jobs Act ("TCJA")

A. Rate changes

1. Corporate

(a) Prior graduated rates of 15% - 35% reduced to a single flat rate of 21%. IRC §11(b).

2. Individual

(a) Prior graduated rates of 10% - 39.6% replaced with graduated rates of 10% - 37%, generally with lower rates applying to lower income bands. Rate reductions presently apply only for tax years 2018 through 2025. IRC §1(j).

3. Basic rate comparison matrix for business income

	C corporations	Passthrough Entities
• Base rate (federal only)	21.0%	Up to 29.6%[1]
- With distributions	36.8%[2]	0
- With §1411 NII Tax	39.8%[3]	0
• Sale of assets	36.8%[2,4]	20.0% (LTCG)[5]

B. Section 199A – Deduction for Qualified Business Income ("QBI")

1. Basic principle

(a) Subject to limitations discussed below, deduction generally allowable for 20% of "qualified business income."

(i) Deductible amount. Statutory standard in §199A(a) is "an amount equal to the lesser of -

(1) The combined qualified business income amount of the taxpayer, or

[1] Maximum rate of 37% with utilization of §199A 20% deduction for QBI [(1-.2) x .37]. [Does not include impact of SE tax]
[2] [.21 + (1-.21) x .2].
[3] [.21 + (1-.21) x .238].
[4] Sales of stock may result in significant savings if §1202 applies (i.e., stock is "Qualified Small Business Stock") or stock is held until death and sold with basis step-up.
[5] Assumes no built-in gains tax for S corps.

(2) An amount equal to 20 percent of the excess (if any) of –

(A) The taxable income of the taxpayer for the taxable year, over

(B) The net capital gain (as defined in Section 1(h)) of the taxpayer for such taxable year."

(ii) CQBIA. Section 199A(b)(1) provides that "combined qualified business income amount" (CQBIA) means the sum of the deductible amount(s) for each qualified trade or business plus 20% of the aggregate qualified REIT dividends and qualified publicly traded partnership income for the year.

(iii) Potential Wage-Based Limitation. Section 199A(b)(2) provides that the deductible amount for each trade or business is the lesser of -

(A) 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or

(B) The greater of –

1. 50 percent of the W-2 wages with respect to the qualified trade or business, or

2. The sum of 25 percent of the W-2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property."

(iv) Threshold for Limitations. Section 199A(b)(3)(A) provides that the deductible amount is 20%, without further limitation, for taxpayers whose taxable income for the year does not exceed the "threshold amount."

(A) Current threshold amounts are $157,500 for individual taxpayers and $315,000 for married filing jointly taxpayers. IRC §199A(e)(2).

(v) Limitation Phase-In. Section 199A(b)(3)(B) provides that for taxpayers whose taxable income exceeds the threshold amount, the wage calculation may work a potential partial limitation on the deductible amount, up to taxable income of $207,500 for an individual and $415,000 for married filing jointly taxpayers. Above those amounts, the limitation of Section 199A(b)(2) is fully applicable.

2. <u>Eligible entities</u>

(a) LLC

(b) Partnership

(c) S corporation

(d) Sole proprietorship

3. <u>Determination of "Qualified Business Income"</u>

(a) <u>General rule</u>. Qualified Business Income ("QBI") is the "net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer," but does not include qualified REIT dividends or qualified publicly traded partnership income. IRC §199A(c)(1).

(b) <u>Losses</u>. If QBI is less than zero, the amount shall be treated as a loss in the succeeding taxable year. IRC §199A(c)(2).

(c) <u>Inclusions</u>. Qualified items of income, gain, deduction and loss include all such items to the extent they are effectively connected with a trade or business in the United State under the standards of IRC §864(c).

(d) <u>Exclusions</u>. Qualified items do not include any items of short or long-term capital gain or loss, any dividend income, interest income (other than interest properly allocable to a trade or business) and certain other specified items. IRC §199A(c)(3).

(e) <u>Reasonable compensation and guaranteed payments</u>. QBI does not include reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to that business. Similarly, guaranteed payments described in IRC §707(c) paid to a partner for services, and some §707(a) payments paid to a partner for services rendered with respect to the trade or business, are not includible in QBI.

4. <u>Qualified Trade of Business</u>

(a) Deduction generally allowed for any trade or business, other than a "specified service trade or business" or the trade or business of performing services as an employee. IRC §199A(d)(1).

(b) “Specified service trade or business” means any business involving the performance of services in health, law, consulting, athletic, financial services or brokerage activities primarily involving the reputation or skill of an employee. Engineering and architecture services are specifically exempted from the prohibition and are generally eligible for the deduction.

(c) What constitutes a “trade or business”? For example, what types of real estate investment qualify?

5. §199A Decision Matrix

(a) *Taxable income under threshold*? Deduction available for 20% QBI.

(b) *Service business*? Deduction available at declining amount for income over threshold up to full phase-in amount, above which no deduction.

(c) *Non-service business*? Deduction available at declining amount for income over threshold up to full phase-in amount, above which deduction equals lesser of (1) 20% QBI or (2) greater of (x) W-2 wages x 50% or (y) W-2 wages x 25% plus 2.5% of unadjusted basis.

6. Proposed Regulations

(a) Extensive proposed regulations under Section 199A were recently issued by IRS, including numerous examples illustrating the workings of the qualification standards and limitations. See 83 Fed. Reg. 40884 *et seq*. (August 16, 2018).

C. Section 83(i) – Qualified Equity Grants

1. Basic Principle

(a) Qualified stock transfer. If an eligible corporation transfers “qualified stock” to a “qualified employee” who makes an election pursuant to §83(i)(4), the income inclusion provided in §83(a) shall be applied in the taxable year determined under §83(i)(1)(B). IRC §83(i)(1)(A).

(b) Taxable year determination. Taxable year for income inclusion is the taxable year of the employee which includes the earliest of –

(i) first date stock becomes transferable (including to employer),

(ii) first date employee becomes an “excluded employee,”

(iii) first date any stock of the issuing corporation becomes readily tradable on an established securities market (as determined by Secretary),

(iv) the date that is 5 years after first date employee's rights in stock are transferable or not subject to substantial risk of forfeiture, whichever occurs earlier, or

(v) the date on which the employee revokes the election with respect to such stock. IRC §83(i)(1)(B).

2. Qualified Stock

(a) General. "Qualified stock," with respect to a qualified employee, means any stock of the employer corporation if (i) stock is received in connection with exercise of an option or in settlement of a restricted stock unit ("RSU") and (ii) such option or RSU was granted in connection with the performance of services as an employee and during a calendar year in which the corporation was an "eligible corporation." IRC §83(i)(2)(A).

(b) Limitation. Qualified stock does not include any stock that the employee may sell to the corporation or otherwise receive cash in lieu of stock at the time the employee's stock rights first become transferable or not subject to a risk of forfeiture. IRC §83(i)(2)(B).

(c) Eligible corporation. An "eligible corporation" is any corporation if none of its stock was readily tradable on an established securities market in a prior year and if it has a written plan under which no less than 80% of all employees who provide services to the corporation are granted stock options or RSUs with the same rights and privileges to receive qualified stock, as determined in the same manner for employee stock purchase plans under Section 423(b)(5).

3. Qualified Employee

(a) Generally. Any individual who is not an excluded employee and who agrees in his 83(i) election to meet any withholding requirements with respect to qualified stock. IRC §83(i)(3)(A).

(b) Excluded employee. Any individual who is or has been a 1% owner of the corporation at any time during the 10 preceding calendar years, who has been the CEO or CFO or acting in such capacity at any prior time, who bears a family relationship to a CEO or CFO under IRC §318(a)(1), or who is or has been one of the 4 highest compensated officers of the corporation during the 10 preceding calendar years. IRC §83(i)(3)(B).

4. <u>Election and Compliance Requirements</u>

(a) Time for making election. Election must be made no later than 30 days after the first date the rights of the employee in qualified stock are transferable or not subject to a risk of forfeiture, whichever occurs earlier. Election shall be made in a manner similar to Section 83(b) elections. IRC §83(i)(4)(A).

(b) Limitations. No election may be made under §83(i) if the employee has made an election under §83(b) with respect to the qualified stock, if any of the issuing corporation's stock is readily tradable on an established securities market, or if such corporation purchased any outstanding stock in the year preceding the first date the rights of the employee in such stock are transferable or not subject to substantial risk of forfeiture, subject to certain limitations. IRC §83(i)(4)(B).

D. Section 1061 – Partnership Interests Held in Connection with Performance of Services

1. In general. In the case of an "applicable partnership interest," the excess (if any) of the taxpayer's net long-term capital gain with respect to such interests for the taxable year, over the taxpayer's net long-term capital gain with respect to such interests for the taxable year computed by utilizing a 3-year rather than a 1-year holding period shall be treated as short-term capital gain, notwithstanding Section 83 or any election in effect under Section 83(b). In other words, the TCJA provides for a 3-year holding period in the case of certain net long-term capital gain with respect to an applicable partnership interest. IRC §1061(a).

2. Portfolio investment limitation. To the extent provided by the Secretary, the general rule shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors. IRC §1061(b).

3. Applicable partnership interest.

(a) Generally. Subject to certain exceptions, "applicable partnership interest" means "any interest in a partnership which, directly or indirectly, is transferred to (or held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business. IRC §1061(c)(1).

(b) Applicable trade or business. The term "applicable trade or business" means "any activity conducted on a regular, continuous and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of –

(A) raising or returning capital, and

(B) either -

(i) investing in (or disposing of) specified assets for such investing or disposition, or

(ii) developing specified assets."
IRC §1061(c)(2).

(c) Specified assets. A "specified asset" includes the following:

(i) securities, as defined in IRC §475(c)(2) (shares of stock; partnership interests in widely held or publicly traded partnership or trust; notes, bonds, debentures and other evidence of indebtedness; interest rate, currency, or equity notional principal contracts; evidence of interest or derivative instrument in other securities or currency, including options, forward contracts, short positions, etc.; and certain hedges),

(ii) commodities, as defined in IRC §475(e)(2),

(iii) real estate held for rental or investment,

(iv) cash or cash equivalents,

(v) options or derivative contracts with respect to any of the foregoing, and

(vi) an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing. IRC §1061(c)(3).

(d) Exceptions. "Applicable partnership interest" does not include

(i) any interest in a partnership held directly or indirectly by a corporation,

(ii) any capital interest in a partnership which provides the taxpayer with a right to share in partnership capital commensurate with (x) the amount of capital contributed, or (y) the value of such interest subject to tax under §83 upon receipt or vesting of the interest, or

(iii) an interest held by a person employed by another entity that is conducting a trade or business (other than an applicable trade or business) and only provides services to such other entity.
IRC §§1061(c)(1), (c)(4).

(e) Third party investor. "Third party investor" means a person who (x) holds an interest in the partnership which does not contribute property held in connection with an applicable trade or business, and (y) is not (and has not been) actively engaged, and is and was not related to a person so engaged, in providing (directly or indirectly) substantial services for such partnership or any applicable trade or business. IRC §1061(c)(5).

4. Transfers to related person

(a) Generally. If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a related person, the taxpayer shall include in gross income, as short-term capital gain, the excess (if any) of -

(i) So much of taxpayer's long-term capital gain with respect to such interest for such year attributable to the sale or exchange of an asset held for not more than 3 years which is allocable to the interest, over

(ii) Any amount treated as short-term capital gain under §1061(a) with respect to the transfer. IRC §1061(d)(1).

(b) Related person. A person is related to the taxpayer if (x) the person is a member of the taxpayer's family under §318(a)(1) (spouse, children, grandparents, parents), or (y) the person performed a service during the year or the preceding three calendar years in any applicable trade or business for which the taxpayer performed a service. IRC §1061(d)(2).

II. Choice of Entity Considerations Particularly Affected by TCJA

A. Rates

1. Which Entities Are Favored?

(a) Considering only the impact of applicable rates, the use of passthrough entities appears most favored. Analysis quickly becomes more complex when other factors are considered, and the decision can become a much closer call.

2. Sunsets

(a) Modified individual rates effective for tax years beginning after 2017 and before 2026. Corporate rate reduction is permanent under TCJA.

(b) 199A deduction effective for tax years beginning after 2017 and before 2026.

3. Importance of Projections

(a) Knowledge of business is crucial, though certainty is impossible (both as a matter of economics and future legislation).

(b) Your accountant is your friend. Robust, well-thought out models of likely alternative scenarios can focus thinking.

B. Complexity & Flexibility

1. Multifactor analysis (rates, business type, income type, etc). Choice of entity is complicated, and has been made more so by TCJA. Simple directives like "flow through entities are always better," which were never particularly accurate or helpful, can now be singularly unhelpful. Thorough analysis is required, with consideration of all relevant factors. Like math, choice of entity is hard.

2. Entity operational aspects. The complexities of LLC and partnership distribution and allocation provisions, and the costs of compliance with respect to K-1 preparation for larger entities, should not be overlooked, particularly as compared to the relative straightforwardness of corporate tax reporting.

3. Impact of changed circumstances. Consideration should be given to the relative likelihood of any future change in business or ownership that would favor change of entity type. Converting from a partnership or LLC to a corporation can usually be accomplished at little tax cost, while converting from corporate form to a passthrough entity typically involves an actual or deemed liquidation that can be costly.

C. Utilization of Losses

1. Timing issues. In a passthrough entity, losses typically flow through and are usable by the owners to offset income from other sources, subject to certain limitations such as the passive loss and basis limitation rules. On the other hand, losses incurred in a corporation are generally trapped in corporate solution and can be carried forward and used to offset future income if and when realized.

D. Access to Capital & Market Acceptance

1. Preference for passthrough form. Passthrough entities have been the predominant choice for many years because of tax rates, utilization of losses and flexibility. Passthroughs have enjoyed increasing market acceptance as owners have become more comfortable with the format, particularly since the widespread acceptance of LLCs as a corporate alternative with limited liability.

2. Venture fund preference for corporations. In the venture capital space, however, corporations have enjoyed a resurgence. Venture capital investors often include foreign and tax-exempt investors who do not wish to invest directly in a passthrough and instead invest through blocker corporations. Funds also express a preference for the corporate form to facilitate exit strategies such as an IPO.

E. Equity Grants

1. Enhanced opportunities under §83(i). The addition of the election to defer income from option or RSU stock in new Section 83(i) provides a helpful new incentive to employees of corporations. This is an additional factor favoring the corporate form in some circumstances.

2. Increased certainty for capital gains treatment of partnership interest grants. New Section 1061 is the culmination of efforts to provide more definite and favorable tax treatment for gains from carried interests. This is a new factor favoring the partnership form for businesses that utilize the carried interest model.

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