

Don't Let 2018 Be Taxing:

How Changes to the Tax Laws Change How We
Counsel Businesses

March 15, 2018

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Agenda

- Introduction
- C corporation overview
- Pass-through overview
- Comparison

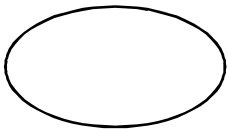


Introduction

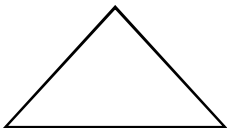
Types of entities



- Corporation (C or S)

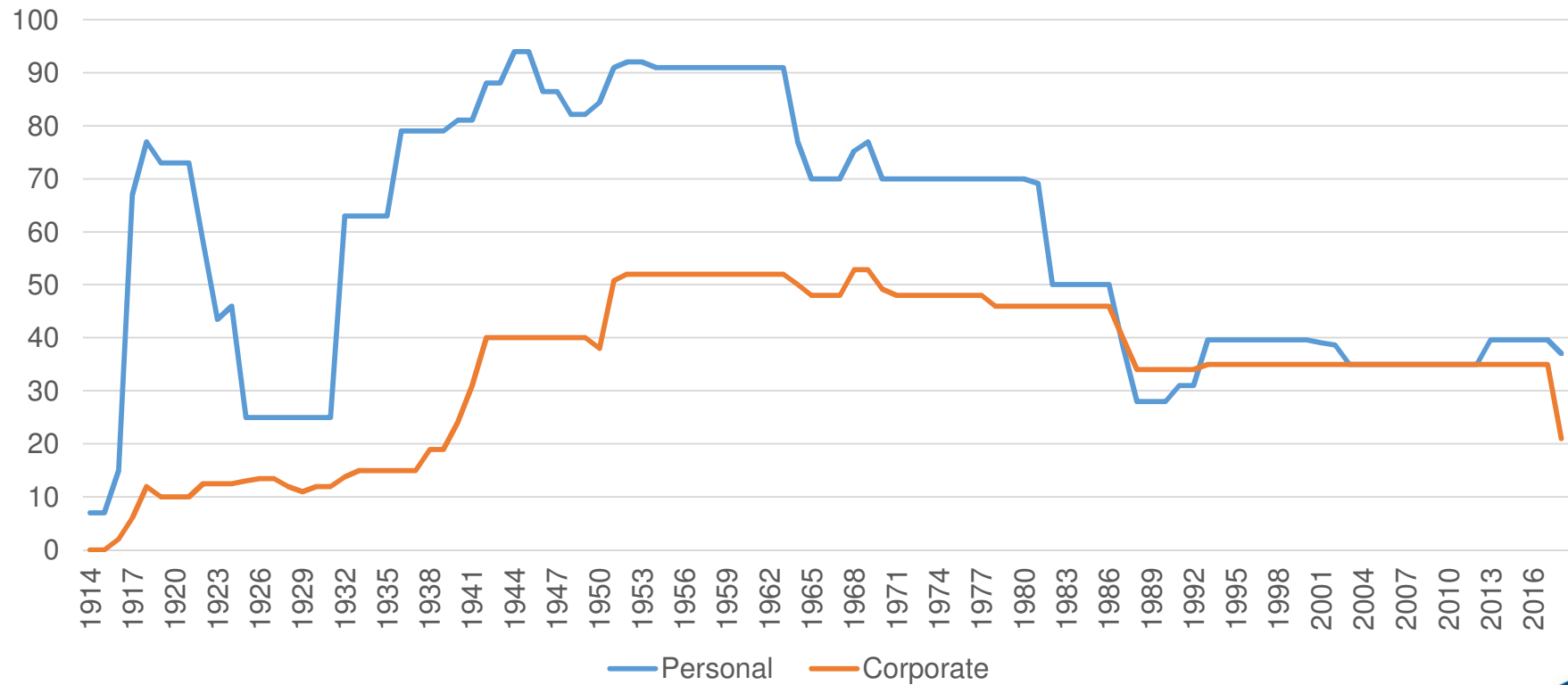


- Disregarded entity/branch/single-member LLC



- Partnership/multi-member LLC

Historical tax rates



TCJA

- Tax Cuts & Jobs Act (“TCJA”) - H.R. 1
 - Nov. 2, 2017 – Introduced in the House
 - Nov. 9, 2017 – Introduced in the Senate
 - Nov. 16, 2017 – House passed TCJA
 - Dec. 2, 2017 – Senate passed TCJA
 - Dec. 15, 2017 – Conference committee reached agreement
 - Dec. 20, 2017 – House and Senate passed TCJA conference agreement
 - Dec. 22, 2017 – President signed TCJA into law



C corporation overview

Basics of corporate taxation

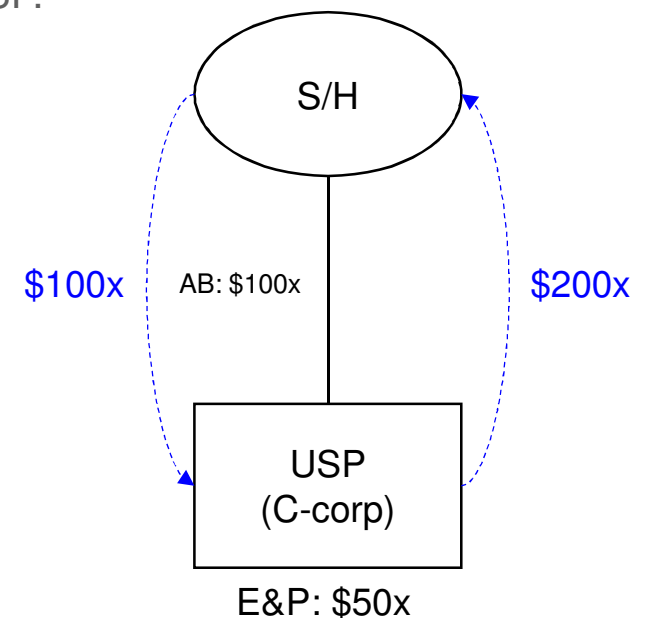
- Double taxation (two levels of tax)
 - Entity level – corporation pays tax on profits
 - Shareholder level – shareholder pays tax on distributions (including net investment income tax)
- Possibility of deferral
 - Second level of tax not incurred until distributions are made
 - Potential issues – personal holding company (“PHC”) tax and accumulated earnings tax (“AET”) may apply to undistributed corporate earnings (so-called anti-deferral rules)
 - Potential exclusion for gain from sale of qualified small business stock

Basics of corporate taxation (example)

- Year 1:
 - S/H contributes \$100x to USP in exchange for stock of USP.
- Year 2:
 - USP has net income of \$50x.
- Year 3:
 - USP distributes \$200x to S/H.

- First, a dividend to the extent of E&P
- Second, a return of basis
- Third, a capital gain

\$50x
\$100x
\$50x
\$200x



Anti-deferral rules

- Personal Holding Company provisions:
 - 20% tax assessed on undistributed passive income of a PHC
 - PHC tax applies to C corporations that meet two tests:
 - Income test – at least 60% of the corporation’s “adjusted ordinary gross income” is PHC income (ex: interest, dividends, rents, royalties, personal service contracts)
 - Stock ownership test – more than 50% of the value of the corporation’s outstanding stock is owned by 5 or fewer individuals on any day during the last half of the corporation’s tax year
 - Extensive related party attribution rules apply in implementing the more than 50% rule

Anti-deferral rules (cont.)

- Accumulated Earnings Tax:
 - 20% tax assessed on a corporation's accumulated taxable income ("ATI") in excess of "the reasonable needs of the business"
 - Applies if ATI is accumulated to avoid shareholder-level tax
 - Requires government to prove intent
 - Failure to make shareholder distributions indicates avoidance
- Does not apply to PHCs
- Tax is not self-assessed – it is imposed only if there is a deficiency assessment

Anti-deferral rules (cont.)

- Unclear how the anti-deferral regimes will be applied in regard to the TCJA
- IRS has advised that guidance on the AET should be revisited as a result of tax reform
- No news on the PHC regime, but it applies only when passive income exceeds 60% of total income – almost meaningless if the subject entity is an active business

TCJA

- Corporate tax rate permanently reduced from a maximum rate of 35% to a flat rate of 21%
- Corporate AMT permanently repealed
- Dividends received deduction reduced: 65% (from 80%) for 20% shareholders and 50% (from 70%) for less-than-20% shareholders
- State and local taxes (“SALT”), including state and local income taxes, continue to be fully deductible
- Net operating losses (“NOLs”):
 - Previously could be carried back 2 years and carried forward 20 years. Now, generally cannot be carried back but may be carried forward indefinitely
 - Previously could offset 100% of taxable income (ignoring AMT limitations). Now, NOLs can only offset 80% of taxable income

Pros/cons of corporate status

■ Pros

- Lower rate on earnings at corporate level (additional funds for reinvestment)
- Ability to engage in tax-free reorganizations
- Granting equity to key employees is an established and well understood practice
- Potential exemption of capital gains on sale of qualified small business

■ Cons

- Double tax on distributed profits (ETR: 39.8%)
- Potential limits on deferral (cash needs of shareholders and application of anti-deferral rules)
- Audit risk related to “reasonable compensation” issues
- Difficulty in moving assets out of corporate form without triggering tax
- Burden of tracking E&P



Pass-through overview

Types of pass-through entities

- Sole proprietorship/disregarded entities
 - Includes sole proprietorships and domestic single-member LLCs that do not elect corporate status
 - Income and expenses are reported on the owner's tax return (e.g., Form 1040)
- Tax partnership
 - Includes state law partnerships and multi-member non-corporate entities (such as LLCs) that do not elect corporate status
 - Income and expenses are reported on Form 1065, with partners receiving Schedule K-1s
- S corporation
 - Election made by filing Form 2553 with the consent of all shareholders
 - Net income reported on Form 1120-S, with shareholders receiving Schedule K-1s
 - Ineligible if more than 100 shareholders or two classes of stock

Basics of pass-through taxation

- Single level of federal income tax
 - No tax on profits at the entity level
 - Certain exceptions (e.g., BIG tax) for S corporations that were previously C corporations
 - Instead, owners report an allocable share of profits and losses on their personal income tax returns
- Income is taxable to owners whether or not distributed
 - Partnerships can distribute cash to partners to cover any tax liability but non-controlling partners cannot force tax distributions unless the governing company agreement provides for them
 - Partnerships have flexibility in allocating income, expenses and tax credits provided allocations have “substantial economic effect”

TCJA

- Highest marginal federal income tax rate on individuals decreased from 39.6% to 37% until Dec. 31, 2025, after which rates revert to pre-TCJA rates
- New 20% “pass-through deduction” in §199A
- Non-corporate “excess business losses” in excess of \$250,000 (\$500,000 for joint return filers) can be carried forward but only offset against 80% of taxable income in succeeding taxable years
- Generally, individuals may only deduct up to \$10,000 of SALT
 - An exception allows individuals to deduct unlimited state and local property (but not income) taxes attributable to a trade or business or investment
- Miscellaneous itemized deductions are no longer deductible

§199A

- New deduction available for certain income from pass-through entities through 2025
- All non-corporate taxpayers (including estates and trusts) eligible for deduction
- Maximum deduction is 20% of “qualified business income” (“QBI”), REIT dividends (other than capital gain dividends), and income from publicly traded partnerships (“PTPs”)
- Can effectively reduce highest rate on qualifying pass-through income from 37% to 29.6%

§199A (cont.)

- QBI means the net amount of “qualified items of income, gain, deduction, and loss” with respect to a “qualified trade or business” of the taxpayer
- QBI excludes:
 - Income not effectively connected with a US trade or business
 - Certain investment items (capital gains/losses, dividends, interest, etc.)
 - Reasonable compensation paid to the owner for services rendered (including W-2 wages paid to S corporation shareholders and guaranteed payments to a partner, etc.)

§199A (cont.)

- Qualified trade or business excludes:
 - The trade or business of performing services as an employee
 - A specified service trade or business, which includes 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 1 or more of its employees or owners
 - Engineering and architecture services are specifically excluded from the listed services
 - Any trade or business involving the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities
- Exception to the specified services limitation for taxpayers with taxable income under the threshold amounts of \$157,500 or \$315,000 for joint filers (with phase-out)
 - Phases out to \$0 deduction for single-filing taxpayers with taxable income of \$50,000 over threshold amount (or \$100,000 over threshold amount for joint filers)

§199A (cont.)

- Potential threshold question – do we have to first consider if we have a “trade or business” before analyzing whether such a trade or business is “qualified” for purposes of §199A?
- §199A does not define “trade or business” – what do we look for as guidance? (§162 business vs. §212 investment)

§199A (cont.)

- Wage/asset based limitation – deduction of 20% of QBI is subject to a cap equal to the greater of:
 - 50% of W-2 wages paid by the pass-through entity, or
 - 25% of W-2 wages paid by the pass-through entity plus 2.5% original basis of “qualified property”
- Exception to wage/asset limitation for taxpayers with taxable income under the threshold amounts (\$157,500 for single filers; \$315,000 for joint filers)
 - Phases in to the wage/asset limitation amount for single-filing taxpayers with taxable income of \$50,000 over threshold amount (or \$100,000 for joint filers)

Pros/cons of pass-through status

- Pros

- If §199A deduction applies, lower aggregate tax burden than on distributed C corporation profits
- Pass-through of losses
- For partnerships:
 - Flexibility in allocating tax benefits and burdens
 - Possibility of asset basis step-up on transfer of interest
 - Greater flexibility in making distributions
 - Basis increase for allocable share of partnership debt

- Cons

- No possibility of deferral
- For S corporations:
 - Restrictions on ownership and distributions
 - Must pay owner-employees a “reasonable” compensation
- For partnerships:
 - Complex
 - Complicated to give key employees equity
- State and local income taxes imposed on pass-through income subject to
- \$10,000 limit on SALT deduction
- Complex audit provisions



Comparison

Considerations

- Economics
- Permanency of 21% corporate rate
- Deductibility of state and local income tax for corporation
- Corporations are not eligible for the §199A deduction
- Estate planning
- Flexibility
- Sale of business

Economics

Inputs:

Taxable income in Year 1	1,000,000
Corporate tax rate	21%
Flow through tax rate*	29.6%
Personal state and local income tax rate	8.82%
Corporate state and local income tax rate	6.50%
Federal dividend rate	23.8%

Corporation

<u>Tax paid on income (in Year 1)</u>		<u>Tax paid on dividend (if paid in year 1)</u>	
Federal**	196,350	Federal	175,799
SALT	65,000	SALT	65,149
Total	261,350	Total	240,948
ETR	26.14%	ETR	32.62%
Net cash	738,650	Net cash	497,702
Combined ETR		50.23%	
Total tax		502,298	
Total net cash		497,702	
Net cost if dividend paid in Year 1		(118,098)	

Flow through entity

<u>Total tax paid on income (in Year 1)</u>	
Federal	296,000
SALT	88,200
Total	384,200
ETR	38.42%
Net cash	615,800

* Assumes 20% deduction under section 199A

** Includes state and local income tax deduction

Economics (cont.)

Analysis of deferral

Flow through entity

Current cash amount	615,800
Growth rate	5%
Number of years of growth	20
Future value of net cash	\$1,633,901
Less: Tax on appreciation***	(\$332,104)
Net cash	\$1,301,796

Corporation

Current cash amount	738,650
Growth rate	5%
Number of years of growth	20
Future value of net cash	\$1,959,858
Less: Tax on appreciation	(\$319,163)
Less: Tax on distribution	(\$535,195)
Net cash	\$1,105,501

*** Assumes all appreciation will qualify from preferential federal rate (20%)

Estate planning

- Exemption amount
 - Through Dec. 31, 2025, exemption amount increased from \$5 million to \$10 million (as indexed from inflation, \$5.49 million to \$11.2 million)
- Basis step-up
 - Under §1014, an individual's income tax basis in property that he or she inherits from a decedent is the FMV of the property as of the decedent's date of death
 - This includes property passing in the "gross estate," meaning anything that is subject to estate tax (whether or not actual tax is owing)

Sale of business

- §168(k): Temporary 100% expensing for certain capital expenditures
 - Bonus depreciation rules amended to allow taxpayers to deduct 100% of the cost of most tangible property (other than buildings and some building improvements) and most computer software in the year placed in service
 - Applies to property acquired and placed in service after September 27, 2017 (with no written binding contract for acquisition in effect on September 27, 2017)
 - Such property eligible for bonus depreciation can be new or used as long as it is “new” to the taxpayer

Questions?



THANK YOU!

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