CHOICE OF ENTITY

Revisiting Choice of Entity under the TCJA

The new tax law will significantly influence whether businesses choose to conduct activity as a C corporation or a pass-through.

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The Tax Cuts and Jobs Act (TCJA) **1** enacts changes to the Internal Revenue Code of 1986 that will significantly affect how taxpayers carry out their business and nonbusiness activity. One of the most significant impacts is how the TCJA will influence the choice of conducting business activity as a C corporation or a pass-through. Although there are a multitude of issues to consider, the choice will be driven to a significant degree by the favorable tax rate now provided to C corporations, the **Section 199A** deduction to pass-through owners, and the ability to deduct state and local taxes. Accordingly, this article discusses these factors and provides our initial thoughts on the choice of entity decision.

Corporate Rate Cut

Effective for tax years beginning after 2017, the tax rate for C corporations is fixed at 21% and the 21% rate does not sunset.

In contrast, without considering the impact of state/local taxes, the tax rate on the operating income of a pass-through business, assuming the owner pays tax at the new maximum noncorporate rate of 37%, **2** materially participates in the business, and can take full advantage of the new **Section 199A** 20% deduction for qualified business income, is 29.6% [(1 - .2) × .37]. **3**

The percentage quickly changes if the owners take distributions from the business, since distributions from a C corporation generally are taxed as qualified dividends at a 20% rate and will result in a combined rate of 36.8% [.21 + ((1 - .21) × .2)]. In addition, the qualified dividend generally will be subject to an additional tax of 3.8% under **Section 1411** , resulting in a combined tax rate of 39.8% [.21 + ((1 - .21) × .238)]. In contrast, the pass-through owner generally can take distributions from the pass-through entity without an additional federal income tax. Further, a taxable sale of the business assets, preferred by the buyer, produces a greater differential, since most of the gain to the pass-through owner will be taxed at the long-term capital gain rate, which remains at a maximum of 20%, **4** while the C corporation owner suffers the double tax.

An important exception applies to the sale analysis. In the case of a C corporation that is a

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"qualified small business," **Section 1202** allows the owner to exclude all or a portion of the gain on the sale of qualified small business stock held more than five years. Another situation that eliminates the gain build-up is where the stock of the corporation is held until the death of the principal owner.

20% Deduction Amount for Qualified Business Income of Pass-Through Entities

Overview

As a corollary to the rate relief given to C corporations, owners of pass-through business entities (tax partnerships, S corporations, and sole proprietorships) will be allowed a deduction under **Section 199A** generally equal to 20% of the combined qualified business income amount passed through to the owners from their pass-through entities. This provision is effective for tax years beginning after 2017, but will cease to apply for tax years beginning after 2025. **5**

This benefit applies only to the qualified business income of the pass-through entity, that is, the items of income, gain, deduction, and loss attributable to the qualified trade or business, and excludes investment income, e.g., dividends, interest income (other than interest income attributable to the trade or business), and items of short-term capital gain/loss and long-term capital gain/loss. **6** This deduction also does not apply to any foreign-source income of the business. **7**

There are significant limitations on the deduction, including:

- Generally, subject to an exception based on the owner's taxable income, specified service businesses, including professional service businesses, do not qualify. **8** This 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 other trade or business where the principal asset is the reputation or skill of one or more of its employees. The conference committee removed engineering and architecture businesses from the list.
- Subject to an exception based on the owner's taxable income, the deduction cannot exceed the greater of two amounts: (1) 50% of the owner's allocable share of the W-2 wages of the business, or (2) 25% of the owner's allocable share of the W-2 wages of the business, plus 2.5% of the unadjusted basis of the qualified property of the business (generally tangible property subject to the allowance for depreciation). **9**

There is an exception to the specified service business limitation and the W-2 wages/qualified property limitation that is based on the taxable income of the business owner. **10** Thus, generally, these limitations do not apply if the owner has taxable income of $157,500 or less ($315,000 or less for a joint return). However, this exception phases out for an owner who has taxable income exceeding $157,500 but less than $207,500 ($415,000 for a joint return). Thus, for owners who have taxable income of $207,500 ($415,000 for a joint return), the specified service business and W-2 wages/qualified property limitations are fully applicable as limitations on the 20% deduction. The $157,500/$315,000 threshold amounts are subject to an inflation adjustment. **11**

The **Section 199A** deduction is not allowed to C corporations that are owners of a pass-through business. **12** However, the conference committee changed **Section 199A** to allow trust and estates to receive the benefit of the deduction. **13**

Calculation of the 20% Deduction Amount

Under **Section 199A(a)(1)** , the 20% deduction amount is the sum of:

(1) the lesser of-

(A) the "combined qualified business income amount" (CQBIA) of the taxpayer, or
(B) the taxpayer's taxable income for the tax year (adjusted to eliminate any net capital gain and an additional adjustment related to qualified cooperative dividends), *plus*

(2) the lesser of-

(A) 20% of the aggregate amount of the qualified cooperative dividends of the taxpayer, or
(B) the taxpayer's taxable income (adjusted to eliminate any net capital gain).

The CQBIA is defined in **Section 199A(b)** and is the sum of (1) the 20% deduction amounts determined for *each* qualified trade or business of the taxpayer, and (2) 20% of the aggregate amount of the taxpayer's qualified

REIT dividends and qualified publicly traded partnership income for the tax year.

The portion of the CQBIA that is composed of the amounts determined by combining the net amounts of qualified items of income, gain, loss, and deduction, computed separately for each qualified trade or business of the taxpayer, is difficult to ascertain from the language of **Section 199A** , but appears to require a calculation, or application, of three basic items as follows:

- A gain amount for any qualified trade or business (after application of any applicable W-2 wages/qualified property limitation and specified service business limitation);
- A loss amount for any qualified trade or business (although not clear, *apparently* after application of any applicable W-2 wages/qualified property limitation and specified service business limitation); and
- Any carryover loss from the taxpayer's qualified trades or businesses.

This construct and the calculation is illustrated by examples in the Conference Committee Report. **14**

The first example illustrates the effect of a carryover loss. **15** The example states that if the taxpayer's net amount of qualified business income from all qualified trades or businesses is a loss, it is carried forward and treated as a loss from a qualified trade or business in the next tax year.

In the example, in Year 1 the taxpayer has qualified business income of $20,000 from qualified business A and qualified business loss of $50,000 from qualified business B. Therefore, taxpayer has a qualified business loss of $30,000 that carries over to Year 2. In Year 2, taxpayer has qualified business income of $20,000 from business A and qualified business income of $50,000 from business B. Thus, taxpayer's **Section 199A** 20% deduction amount in Year 2 is $8,000, determined as follows:

.2 × $70,000 (combined qualified business income of businesses A and B) *minus*.2 × $30,000 (qualified business loss carried over from Year 1).

The next example **16** illustrates the application of the W-2 wages/qualified property limitation and specified service trade or business limitation where the $315,000 taxable income limitation comes into play, and also the overall taxable income limitation.

In this example, H and W file a joint return reporting taxable income of $335,000. H is a partner in qualified business A that is not a specified service business. W is the sole proprietor of business B that is a specified service business. H and W also received $10,000 in qualified REIT dividends for the tax year.

H's allocable share of qualified business income from business A is $200,000, and his share of W-2 wages with respect to the qualified business of A is $70,000. Therefore, the tentative 20% deduction amount of $40,000 (200,000 × .2) is limited by the W-2 wages limitation of $35,000 (70,000 × .5). Because H and W's taxable income exceeds the threshold by only $20,000 (335,000 - 315,000 threshold amount), the wage limitation is phased in. Under the example, the $40,000 tentative

deduction amount is reduced by 20% of the tentative deduction/limitation differential, which 20% reduction is the excess of the taxpayers' taxable income over the joint threshold amount (315,000) divided by their joint phase-out amount of $100,000 [(335,000 - 315,000 / 100,000)]. Thus, the 20% tentative deduction amount attributable to qualified business A is reduced by 20% of the difference between the tentative deduction amount ($40,000) and the W-2 wages limit (35,000), referred to as the excess amount, leaving a net 20% deduction amount of $39,000 [40,000 - (.2 × (40,000 - 35,000))].

W's business income from business B, which is a specified service business, is $200,000 and B pays W-2 wages of $100,000. Because the joint income of H and W exceeds the threshold amount, only a portion of the income from business B is qualified business income. This portion is 80% [1 - (335,000 - 315,000) / 100,000 = 1 - 20,000 / 100,000 = 1 - .2 = 80%]. Therefore, W may only take into account $160,000 as qualified business income. Additionally, W must apply the W-2 wages/qualified property limitation. In determining includable W-2 wages, W may only take into account 80% of B's wages, or $80,000 [100,000 × .8]. W's 20% deduction amount is the lesser of 20% of $160,000 (32,000) or 50% of $80,000 includable wages (40,000). Therefore, W's 20% deduction amount attributable to business B is $32,000.

H and W's CQBIA for the tax year is $73,000, consisting of $39,000 from business A, $32,000 from business B and $2,000 (20% of the qualified REIT dividend). However, because 20% of their taxable income for the year is $67,000 [.2 × 335,000], their **Section 199A** deduction is limited to $67,000.

The third example **17** illustrates the calculation of CQBIA where one qualified business has net positive qualified business income for the tax year, one qualified business has a business loss for the tax year, and the taxpayers also have a carryover qualified business loss.

In this example, H and W report taxable income of $200,000. H has qualified business income of $150,000 from his sole proprietorship A. W is a partner in qualified business B and her share of the qualified business loss is $40,000. H and W have a carryover qualified business loss of $50,000.

The 20% deduction amount attributable to business A is $30,000 [150,000 × .2]. Because the taxable income of H and W is below the $315,000 threshold amount, the W-2 wages/qualified property limitation does not apply to business A.

The 20% deduction amount attributable to business B is minus $8,000 [-40,000 × .2]. The example also states that the W-2 wages limit does not apply to business B because H and W's taxable income is below the $315,000 threshold amount.

H and W's CQBIA is $12,000, comprised of the $30,000 deduction amount for business A, the reduction to the deduction for business B of $8,000, and the reduction of $10,000 attributable to the qualified carryover business loss [(50,000 × .2]. Because 20% of H and W's taxable income is $40,000, their **Section 199A** deduction for the tax year is limited to $12,000, which is their CQBIA for the tax year.

In addition to the mechanics of the computation of CQBIA, another ambiguity under **Section 199A** is the scope of the term *qualified trade or business.* Under **Section 199A(b)(1)(A)** , a computation is made for *each* qualified trade or business of the taxpayer. **Section 199A** does not further clarify what is meant by *each* qualified trade or business of the taxpayer. Thus, it is not absolutely clear whether operations/activities of technically separate persons, e.g., separate tax partnerships, are treated as separate trades or business or may be grouped as one trade or business.

The statutory language of **Section 199A(b)(1)(A)** suggests that a trade or business conducted by an entity that is treated separately from another entity for tax purposes will be a separate trade or business. This interpretation would treat an entity that is not a disregarded entity as the taxpayer for this purpose. The fact that partners and S shareholders apply **Section 199A** at the partner or shareholder level, respectively, does not necessarily suggest otherwise, since application at the partner/shareholder level is necessary to apply the limitation on the deduction. Nevertheless, this interpretation is not certain and how the scope of the qualified trade or business is finally resolved may have a significant effect on the calculation of the 20% deduction amount. For example, grouping across entities could have a significant impact on calculation of the 20%

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deduction amount, particularly where the W-2 wages/qualified property limitation comes into play, or where a specified service trade or business is involved.

W-2 Wages/Qualified Property Limitation-Phase-In

W-2 wages are the amounts described in **Sections 6051(a)(3)** (the total amount of wages as defined in **Section 3401(a)** , i.e., remuneration paid by the employer to an employee for services performed by the employee) and 6051(a)(8) (the total amount of elective deferrals within the meaning of **Section 402(g)(3)** and compensation deferred under **Section 457** , including the amount of designated Roth contributions (as defined in **Section 402A**)). The amount of W-2 wages for the tax year is the amount paid by the qualified business with respect to employment of employees by the qualified business during the calendar year ending during the tax year of the qualified business. An amount will not be included in the computation of W-2 wages if it is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.

The fact that this component of the limitation is restricted to W-2 wages may be problematic in certain cases for businesses operated as tax partnerships or sole proprietorships. In this respect, the IRS has consistently maintained that remuneration received by a partner from a partnership or the owner of a sole proprietorship is not wages with respect to employment. **18** Thus, in certain cases, an S corporation may be a preferred entity where W-2 wage payments to the owners may enhance the limitation.

Qualified property is defined in **Section 199A(b)(6)** and means certain tangible personal property of a character subject to the allowance for depreciation. To be counted, the property must be (1) held by, and available for use in, the qualified trade or business at the close of the tax year, (2) used at any point in

time during the tax year in the production of qualified business income, and (3) property, the depreciable period for which has not ended before the close of the tax year. The depreciable period for a taxpayer's qualified property is the period beginning on the date that the property was first placed in service by the taxpayer and ending on the later of (1) the date that is ten years after the placed in service date, or (2) the last day of the last full year in the applicable recovery period that would apply to the property under **Section 168** , but determined without regard to the alternative depreciation periods under **Section 168(g)** .

Section 199A(h) requires the Secretary to prescribe certain anti-abuse rules to prevent manipulation of the qualified property rules. Under this provision, the Secretary is required to apply rules similar to the rules under **Section 179(d)(2)** in order to prevent the manipulation of the depreciable period of qualified property by using transactions between related taxpayers. The Secretary also is directed to prescribe rules for determining the unadjusted basis of qualified property immediately after its acquisition in a like-kind exchange or involuntary conversion.

The W-2 wages/qualified property limitation begins to phase-in when a taxpayer has a threshold amount of taxable income, which is $157,500 (and $315,000 for a joint return). Under **Section 199A(e)(2)(B)** , the threshold amount is adjusted for inflation for any tax year beginning after 2018.

The phase-in of the limitation occurs over the next $50,000 of taxable income of a taxpayer ($100,000 in the case of a joint return). The Conference Committee Report provides an illustration of the W-2 wages/qualified property phase-in. **19**

In the example, H and W file a joint return in which they report taxable income of $335,000, W has a qualified trade or business that is not a specified service business, and 20% of the qualified business income of the business is $15,000. W's share of the W-2 wages paid by the business is $20,000. Because 50% of W's share of the W-2 wages ($10,000) is less than the $15,000 tentative deduction amount, the tentative amount is reduced by 20% of the excess of the tentative amount over the wage limit amount or $10,000 [20% × (15,000 - 10,000)]. The 20% reduction amount is the percentage determined by dividing the taxpayer's taxable income exceeding the threshold by the $100,000 phase-out amount for taxpayers filing a joint return [(335,000 - 315,000) / 100,000].

A similar phase-in limitation also applies to determine the portion of income, gain,

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deduction, and loss and the W-2 wages/qualified property from a specified service business that is treated as attributable to a qualified trade or business. This percentage is called the applicable percentage. Under **Section 199A(d)(3)(B)** , the applicable percentage is 100%, reduced (not below zero) by a percentage equal to the ratio of (1) the taxable income of the taxpayer for the tax year in excess of the threshold amount to (2) $50,000 ($100,000 in the case of a joint return).

The Conference Committee Report provides an example of this phase-in of the limitation. **20** In the example, taxpayer has taxable income of $187,500, of which $140,000 is attributable to an accounting

sole proprietorship. The accounting sole proprietorship paid $80,000 W-2 wages to employees. The taxpayer's applicable percentage is 40% [1 - (187,500 - 157,500) / 50,000 = 1 - 30,000 / 50,000 = 1 - .6 = 40%]. In determining taxable income qualified for the 20% tentative deduction, the taxpayer takes into account 40% of $140,000, or $56,000. In determining includable W-2 wages, the taxpayer takes into account 40% of $80,000, or $32,000. The taxpayer calculates the deduction amount by taking the lesser of 20% of $56,000 ($11,200) or 50% of $32,000 ($16,000). Thus, taxpayer is allowed a 20% deduction amount of $11,200.

Application to Partnerships and S Corporations

Under **Section 199A(f)** , **Section 199A** is applied at the partner or shareholder level. Each partner or shareholder takes into account the person's allocable share of each qualified item of income, gain, deduction, and loss. This appears relatively easy in the case of an S corporation shareholder, as the allocable share is determined by the shareholder's pro rata share of an item. **21** Therefore, the pro rata share of a shareholder should be determined under the rules of **Section 1377(a)** and **Reg. 1.1377-1** . The determination for a partner will be much more complex, and seemingly based on the rules of **Section 704** and the regulations issued thereunder.

For purposes of the W-2 wages/qualified property limitation, a partner's or shareholder's allocable share of W-2 wages is determined in the same manner as the partner's or shareholder's allocable share of wage expense. Regarding determination of a partner's or shareholder's allocable share of the unadjusted basis immediately after acquisition of qualified property, that determination is based on the partner's or shareholder's allocable share of depreciation.

Section 199, repealed by the TCJA for tax years beginning after December 31, 2017, **22** provided a deduction for the taxpayer's qualified production activities income for the tax year. Generally, Section 199 was applied at the partner or shareholder level and each partner or shareholder took into account his allocable share of the relevant entity items. **Reg. 1.199-5** addresses the application of Section 199 to pass-through entities and should be relevant to the manner in which **Section 199A** is applied to partners and S corporation shareholders.

Section 199(b) also contained a similar W-2 wages limitation for purposes of the qualified production activities deduction of the taxpayer. This limitation was applied at the partner or shareholder level and **Reg. 1.199-5** addresses the allocation of W-2 wages to partners and shareholders and includes an example of a permitted special allocation of W-2 wage expense of a partner. **23**

The allocation of qualified property to partners may be difficult. In this respect, as applied to a partner in a partnership, the determination of a partner's allocable share of depreciation may involve significant complexities, particularly where **Section 704(c)** and reverse **Section 704(c)** allocations are involved or where the property is debt financed.

Another difficult situation may involve partnerships using complex economic sharing arrangements (e.g., internal rate of return based waterfalls), and targeted capital account allocation schemes. In these cases,

determination of a partner's allocable share of qualified items, including both W-2 wages and depreciation, may involve complex economic effect analysis.

This complexity is apparently anticipated under **Section 199A(f)(4)** , which provides that the Secretary shall prescribe such regulations necessary to carry out the purposes of **Section 199A** , including specifically, (1) regulations for requiring or restricting the allocation of items and wages and such reporting requirements as the Secretary determines appropriate, and (2) regulations addressing application of **Section 199A** to tiered entities.

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Specified Service Trade or Business

Except for owners who meet the taxable income limitations under **Section 199A(d)(3)** , a specified service trade or business is not a qualified trade or business. Thus, the pass-through owner may not get a 20% deduction amount for the net positive amount of items attributable to a specified service trade or business.

A specified service trade or business includes businesses described in **Section 1202(e)(3)(A)** , modified to exclude engineering and architecture from the definition. Thus, a specified service trade or business 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 other 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.

A specified service trade or business also includes a business which 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 (as defined in **Section 475(e)(2)**). **24**

As indicated, the list of specified service businesses is derived by incorporating by reference the list of service businesses in **Section 1202(e)(3)(A)** , which are denied the benefits of **Section 1202** .

It is worth noting that **Section 1202(e)(3)** further lists as ineligible for the benefits of **Section 1202** "(B) any banking, insurance, financing, leasing, investing, or similar business," as well as "(C) any farming business (including the business of raising or harvesting trees)," conspicuously not included in the cross reference in **Section 199A(d)(2)** to **Section 1202(e)(3)(A)** . Therefore, it appears that banking and farming businesses will generate CQBIA eligible for the benefits of **Section 199A** . A further omission of "any banking business" in the incorporation by reference of only the "service trades" of **Section 1202(e)(3)(A)** implicitly excludes investment banking as a specified trade or business under **Section 199A(d)(2)** , meaning income from investment banking will generate CQBIA, unless investment banking

falls under "financial services" or the catchall category involving the reputation and skill of employees or owners. Further guidance will be required.

The Conference Committee Report cites to regulations issued under **Temp. Reg. 1.448-1T(e)(4)** , in connection with the list of excluded service businesses, specifically with reference to health, performing arts, and consulting. For example, regarding health, the Conference Committee Report states:

> A similar list of service trades or business is provided in section 448(d)(2)(A) and Treas. Reg. sec. 1.448-1T(e)(4)(i). For purposes of section 448, Treasury regulations provide that the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers. See Treas. Reg. sec. 1.448-1T(e)(4)(ii). **25**

The reference to **Section 448(d)(2)(A)** in the Conference Committee Report is somewhat confusing. **Section 448** provides limitations on the use of the cash method of accounting and provides an exception for qualified personal service corporations. Qualified personal service corporations are defined as any corporation "*substantially all of the activities of which* involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting...." **26** This contrasts with the specified service trade or business exclusion under **Section 199A(d)(2)(A)** , which applies to a trade or business involving the performance of services in the designated field, thus eliminating the requirement that substantially all of the activities involve the performance of designated services.

The application of the specified service trade or business exclusion may be difficult where the business involves an activity that is ancillary to a designated excluded activity. For example, as applied to healthcare, where the specific activity of the business does not include the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals, but the service is used in connection with the specified service business. As previously discussed, the determination of what activities comprise the trade or business will have a significant impact on this issue.

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While there is scant authority on the scope of excluded businesses under **Section 1202(e)(3)(A)** , a recent private letter ruling suggests that avoidance of the limitation where the service is ancillary to a defined excluded business involves threading a small needle. In **Ltr. Rul. 201717010** , a corporation uses a proprietary technology "X" to detect an undefined "B." The Company's employees perform the X testing and Company provides healthcare providers a laboratory report determining whether the tested for items were detected. Company does not discuss diagnosis or treatment with any healthcare provider.

Company employs a physician as its laboratory director and also employs and trains well-educated individuals to perform the testing. These individuals are not classified as healthcare professionals and their skills are not useful to other employers.

Ltr. Rul. 201717010 concludes that the Company is not a trade or business involving the performance of services in the field of health and that its principal asset is not the reputation or skill of one or more of its employees. Among the factors cited to reach its conclusion are: (1) the laboratory reports do not discuss diagnosis or treatment, (2) the Company does not take orders from or explain laboratory results to patients, (3) none of the Company's revenue is earned in connection with patients' medical care, and (4) other than the laboratory director, Company's employees are not classified as healthcare professionals by any applicable state or federal law or regulatory authority.

State and Local Income Taxes

For tax years beginning after 2017 and before 2026, the TCJA limits the deduction for taxes allowed to an individual **27** under **Section 164** . Under new **Section 164(b)(6)(B)** , the aggregate amount of taxes taken into account by an individual for the tax year under **Sections 164(a)(1)** (state and local real property taxes), 164(a)(2) (state and local personal property taxes), 164(a)(3) (state and local, and foreign, income, war profits, and excess profits taxes), and 164(b)(5) (general sales tax deduction allowed in lieu of state and local income tax deduction) may not exceed $10,000 ($5,000 in the case of married individuals filing a separate return). This limitation does not apply to *foreign* income, war profits, or excess profits taxes, state, local, and foreign real property taxes, and state or local personal property taxes provided these taxes are paid or incurred in carrying on a trade or business or an activity described in **Section 212** . As a result, since the trade or business/investment property exception to the limitation for income taxes only applies to foreign taxes described in **Section 164(a)(3)** , state or local income taxes that an individual incurs by reason of ownership of a pass-through business do not qualify for the trade or business/investment property exception and are subject to the $10,000 aggregate taxes limitation.

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There is no similar limitation applicable to corporations. As a result, a state or local income tax paid or incurred by a C corporation remains fully deductible to the C corporation, but state or local income tax incurred by an individual pass-through owner by reason of the pass-through of trade or business income to the owner is not fully deductible. It appears that the limitation would apply to state and local income taxes that a partnership or S corporation pays on behalf of its owners, including withholding taxes and

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composite return taxes. The Conference Committee Report clarifies that taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in an owner's distributive or pro rata share of income or loss on a Schedule K-1 will continue to reduce the owner's

distributive share of income. **28**

Choice of Entity

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Until now, the pass-through entity has been the entity of choice for most closely or privately held businesses. In this respect, the maximum marginal rates of tax on operating income were fairly close, 35%/corporate versus 39.6%/individual. In contrast, the pass-through structure generally avoided any additional tax on distributions to owners, while C corporation owners generally paid tax at a rate of 20% on qualified dividends. Further, the 3.8% **Section 1411** tax on net investment income, subject to income

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limitations, applied to dividend distributions to C corporation owners as well as to capital gains on the sale of their stock. While **Section 1411** tax also applied to pass-through owners who did not materially participate in the trade or business of the pass-through entity, for pass-through owners who materially participated in the trade or business, **Section 1411** did not apply to the flow-through business income or to the net gain when either the trade or business assets were

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sold or the pass-through ownership interests were sold.

Relatively, as a result of the TCJA, C corporations appear a more attractive option for operating a private business entity. In this respect, the basic rate for a C corporation decreased by 40% (from 35% to 21%) compared with a 25.25% decrease for pass-through owners (39.6% to 29.6%), the rate for C corporations is permanent, at least for now, and C corporations can fully deduct state and local income taxes.

Nevertheless, given that many private entity owners ultimately require either distributions from the business or a sale/exit from the business, pass-through entities generally still have a tax efficiency advantage. This is due primarily to two important factors: (1) earnings can be distributed from the pass-through without a second level of tax, and (2) to the extent earnings are not distributed, the earnings result in a basis build-up, so that a tax is not effectively paid on the earnings when the business is sold, whether through an asset sale or a sale of the entity interests.

Also, pass-through business owners have more flexibility in structuring a sale of the business. Buyers prefer a taxable sale of the business assets to obtain a basis step-up. However, a taxable sale of the business produces a hefty double tax for C corporation shareholders of 39.8%. To avoid this, C corporation owners generally bargain for a stock sale, which results in a discount tied to the present value of the buyer's lost tax deductions. In contrast, in most cases pass-through owners generally have comparable federal tax results whether the sale is a sale of business assets or a sale of entity interests.

Further, the **Section 1411** tax continues to apply without modification. Therefore, a C corporation shareholder will be subject to this tax on distributions and on a sale of the C corporation stock, while a materially participating pass-through owner generally avoids this tax.

To verify these conclusions, we prepared a hypothetical comparison for a business operated for eight years and sold at the close of the eighth year or beginning of the ninth year. The examples compare: (1) a C corporation (Part I of Exhibit 1), (2) an S corporation with the owner materially participating in the business and taking the full 20% deduction amount on the pass-through income attributable to the trade or business (Part II of Exhibit 1), (3) an S corporation with no material participation by the owner and no 20% deduction amount (Part III of Exhibit 1), and (4) a C to S

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conversion at the beginning of the fourth year (Part IV of Exhibit 1).

In our examples, the S corporation owner (materially participating and getting the full 20% deduction amount) receives 1.32 more net sale/cash distribution proceeds as compared with the C owner. Further, even an S owner that does not materially participate in the business or get the 20% deduction amount still ends up with 1.16 more in net sale/cash distribution proceeds as compared with the C owner.

There are situations where the C corporation produces a better result. For example, if the C corporation qualifies as a qualified small business under **Section 1202(d)** , a sale of qualified small business stock held for more than five years allows the owner to exclude all or a portion of gain from the sale or exchange of such stock. In our example, where the **Section 1202** exclusion applies to exclude all of the gain, the C corporation owner received the largest net amount of sale/cash distribution proceeds, exceeding the S corporation (owner materially participates/full 20% deduction amount) by a multiple of 1.11. A similar result would occur where the C stock receives a fair market value basis step-up at the death of the owner.

The examples demonstrate that C corporations generally will be able to grow faster because of the lower aggregate federal income tax burden while earnings are maintained in the corporation. However, the advantage disappears and becomes a detriment once the earnings are distributed or the business is sold.

In another example (Part IV of Exhibit 1), the C corporation converts to an S corporation at the beginning of year 4, and the stock is sold (with a **Section 338(h)(10)** election) immediately after the close of the five-year recognition period, thus avoiding any **Section 1374** tax on built-in gain. In this example, the net sale/cash distribution proceeds to the owner of the converted entity is 5% less than the amount received by the S corporation owner in Part II of Exhibit 1. This example suggests that a C to S conversion may be a viable alternative where additional capital may be required in the business to fund growth in the early years, and an S election can be made as the business matures and internal capital for growth is no longer required.

Relief for Eligible Terminated S Corporations

Interestingly, the TCJA enacts provisions to help S corporations that voluntarily revoke their S election. First, TCJA section 1354 adds Code Section 481(f). Under this provision, if an eligible terminated S corporation, as a result of revoking its S election, must change from the cash method of accounting (i.e., because of limitations applicable to C corporations, it no longer qualifies under **Section 448** to use the cash method of accounting), the corporation may take the adjustment required by **Section 481(a)(2)** into account ratably during the six-tax year period beginning with the year of change.

Second, TCJA section 1354 adds Code **Section 1371(f)** . Under **Section 1377(b)(1)(A)** , when an S corporation voluntarily revokes its S election, it has a "post-termination transition period" (PTTP) that begins after the last day of its S year and ends on the later of the day which is one year after such last day, or the due date for filing the return for such last year as an S corporation (including extensions). This allows distributions of money by the C corporation during the PTTP to be applied against and reduce the adjusted basis of the shareholder's stock to the extent the distribution does not exceed the corporation's accumulated adjustments account (AAA). **29**

Under new **Section 1371(f)** , an eligible terminated S corporation, after the PTTP, may still avoid dividend treatment on all or a portion of the distribution. In this respect, after the PTTP, the AAA will be allocated to the distribution, and the distribution will be chargeable to the corporation's accumulated earnings and profits in the same ratio as the amount of such AAA bears to the amount of such accumulated earnings and profits.

These relief provisions only apply to an "eligible terminated S corporation." **Section 481(d)(2)** defines an eligible terminated S corporation as any C corporation which was an S corporation on the day before enactment of the TCJA, and during the two-year period beginning on the date of such enactment makes a voluntary revocation of its election under

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Section 1362(a) . Additionally, to qualify as an eligible terminated S corporation, the owners of the stock of the corporation, determined as of the date the revocation is made, must be the same owners and in identical proportions to the owners of the corporation on the date of enactment of TCJA.

Based on these relief provisions, apparently Congress believes the 21% corporate tax rate will provide a powerful incentive for S corporations to voluntarily give up their pass-through status and that the S corporation relief provisions will facilitate that change.

Conclusion

The TCJA is a game-changer. While pass-through status seems to remain the entity of choice for most

privately owned business activity, the choice is now much closer, and in certain situations, the C corporation may be the more tax-efficient form of operation. Further, even where pass-through status appears to be the better choice, the operation of an owner's pass-through business activity still needs to be thoroughly analyzed to determine whether the 20% deduction amount can be enhanced or the business made more tax-efficient in response to the myriad and significant changes of the TCJA.

These are critical decisions, yet both choice of entity and many other decisions under **Section 199A** will require further guidance and clarification from the IRS. Hopefully, this guidance will be forthcoming so that taxpayers and their advisers can make informed decisions with respect to the myriad issues not clearly addressed by the statutory language.

Exhibit 1. Comparison Chart: C Corporation vs. S Corporation

Assumptions:

1. Business is a qualified business under Section 199A and owner will qualify for the full 20% deduction if corporation is taxed as an S corporation.
2. Corporation's taxable income, before any federal or state taxes, is $700,000/year.
3. C corporation pays state tax at 8% rate, and tax is fully deductible.
4. S corporation owner pays state tax at 8% rate and tax is not deductible by owner.
5. Owner materially participates in the business and is taxed at 37% federal rate on ordinary taxable income, and 20% federal rate on capital gains.
6. S corporation makes a distribution at 37.8% (29.6 + 8) of the flow-through taxable income to allow owner to pay federal and state income taxes.
7. Net cash remains in business. Two-thirds of net cash is reinvested in business and earns a return of 10%. One-third of net cash is used for nonbusiness investment and earns a return of 5%.
8. Sale is a sale of stock of S corporation, parties make Section 338(h)(10) election.
9. Sale is a sale of stock of C corporation. Buyer discounts purchase price multiple by 12.5% because no basis step-up. Note—buyer should not require a full 21% discount because a large portion of purchase price should be allocated to goodwill/going concern value, which remains amortizable over 15 years.

Part I. C Corporation

Year	Taxable Income	State Income Tax	Federal Income Tax	Net Cash	Reinvestment/ Accum	Cash/Accum
1	700,000	<56,000>	<135,240>	508,760	339,173	169,587
2	700,000 33,917 8,479 742,396	<59,392>	<143,431>	539,573	359,715 698,887	179,858 349,445
3	700,000 69,889 17,472 787,361	<62,969>	<152,118>	572,254	381,503 1,080,390	190,751 540,196
4	700,000 108,039 27,010 835,049	<66,804>	<161,331>	606,914	404,609 1,484,999	202,305 742,501
5	700,000 148,500 37,125 885,625	<70,850>	<171,103>	643,672	429,115 1,914,114	214,557 957,058
6	700,000 191,411 47,853 939,264	<75,141>	<181,466>	682,657	455,105 2,369,219	227,553 1,184,838
7	700,000 236,902 59,242 996,164	<79,6931>	<192,459>	724,012	482,675 2,851,894	241,337 1,429,175
8	700,000 285,189 71,459 1,056,648	<84,532>	<204,144>	767,972	511,981 3,334,875	255,991 1,685,166

C Corporation

- Assume sale at 5.6875 multiple [6.5 x .875]
- Assume that Buyer will discount portion of sale price at 12.5% to account for no step up
- Sale Price = Operating Earnings (excludes investment earnings) 985,189 x 5.6875 = 5,603,262
- Aggregate Sale Price/Cash Distribution
  [5,603,282 + 1,685,166 (accumulated cash)] = 7,288,428
- Seller's Tax
  7,288,428 x .318 (tax rate) (.2 + .038 + .8) = 2,317,720
- Net to Seller 4,970,708
- If sale qualifies for Section 1202 exclusion, net to Seller 7,288,428

Part II. S Corporation
(Owner Materially Participates)

Year	Taxable Income	State Income Tax	.376 Dist. to owner to pay tax ((.488 distribution for investment income)	Net Cash	Reinvestment/ Accum	Cash/Accum
1	700,000	0	<263,200>	436,800	291,200	145,600
2	700,000 29,120 7,280 736,400	0	<277,701>	458,699	305,800 597,000	152,900 298,500
3	700,000 59,700 14,925 774,625	0	<292,930>	481,695	321,130 918,130	160,565 459,065
4	700,000 91,813 22,953 814,766	0	<308,923>	505,843	337,229 1,255,359	168,614 628,679
5	700,000 125,536 31,384 856,920	0	<325,717>	531,203	354,135 1,609,494	177,068 803,747
6	700,000 160,949 40,187 901,136	0	<343,328>	557,808	371,872 1,981,366	185,936 989,683
7	700,000 198,137 49,484 947,621	0	<361,848>	585,773	390,516 2,371,882	195,258 1,184,941
8	700,000 237,188 59,247 996,435	0	<381,296>	615,139	410,093 2,781,975	205,046 1,389,987

S Corporation

- Assume sale at 6.5 multiple
- Operating Earnings (excludes investment earnings) 937,188 x 6.5 = 6,091,722
- Aggregate Sale Price/Cash Distribution
  [6,091,722 + 1,389,987 (accumulated cash)] = 7,481,709
- Tax—((6,091,722 – 2,781,975 [basis build-up on reinvestment]) x .28 = 926,729
  Note—no tax on distribution of 1,389,987 accumulated cash
- Net to Seller - 6,554,980 (7,481,709 - 926,729)

Part III. S Corporation
(Owner Does Not Materially Participate)

Year	Taxable Income	State Income Tax	.488 (.37 + .038 = .8) Dist. to owner to pay tax	Net Cash	Reinvestment/ Accum	Cash/Accum
1	700,000	0	<341,600>	358,400	238,933	119,467
2	700,000 23,893 5,973 729,866	0	<356,178>	373,691	249,127 488,060	124,564 244,031
3	700,000 48,806 12,202 761,008	0	<371,372>	389,636	259,757 747,817	129,879 373,910
4	700,000 74,782 18,696 793,478	0	<387,217>	406,261	270,840 1,018,657	135,420 509,330
5	700,000 101,866 25,467 827,330	0	<403,738>	423,591	282,394 1,301,051	141,197 650,527
6	700,000 130,105 32,526 862,631	0	<420,964>	441,667	294,445 1,595,496	147,222 797,744
7	700,000 159,550 39,888 899,417	0	<438,915>	460,502	307,001 1,902,497	153,501 951,250
8	700,000 190,250 47,563 937,813	0	<457,653>	480,160	320,107 2,222,604	160,05 1,111,303

S Corporation

- Assume sale at 6.5 multiple
- Operating Earnings (excludes investment earnings) 890,250 x 6.5 = 5,788,625
- Aggregate Sale Price/Cash Distribution
  [5,788,625 + 1,111,303 (accumulated cash)] = 6,897,928
- Tax—((5,788,625 - 2,222,604 [basis build-up on reinvestment]) x .318 = 923,955
  [.2 + .038 + .8] = 1,127,635
- Net to Seller—5,770,293 (6,897,928 - 1,127,635)

Part IV. C Corporation (Converting to S Corporation Effective January 1, Year 4)
(Owner Materially Participates)

Year	Taxable Income	State Income Tax	Federal Income Tax	Net Cash	Reinvestment/ Accum.	Cash/Accum
1	700,000	<56,000>	<135,240>	508,760	339,173	169,587
2	700,000 33,917 8,479 742,396	<59,392>	<143,431>	539,573	359,715 698,887	179,858 349,445
3	700,000 69,889 17,472 787,361	<62,969>	<152,118>	572,254	359,715 698,887	190,751 540,196
4	700,000 108,039 27,010 835,049	0	Dist. to owner to pay tax (.376) / (.488 on investment income) <317,003>	518,046	345,364 1,425,754	172,682 712,878
5	700,000 142,575 35,644 878,219	0	<334,202>	544,017	362,678 1,788,432	181,339 894,217
6	700,000 178,943 44,711 923,054	0	<352,364>	571,290	380,860 2,169,292	190,430 1,084,647
7	700,000 216,929 54,232 971,211	0	<371,230>	599,981	399,987 2,569,279	199,994 1,284,641
8	700,000 256,608 64,232 1,021,135	0	<391,150>	630,005	420,004 2,989,283	210,002 1,494,643

S Corporation (After Conversion from C Corporation)

- Assume sale at 6.5 multiple
- Operating Earnings (excludes investment earnings) 956,923 x 6.5 = 6,220,000
- Aggregate Sale Price/Cash Distribution
  [6,220,000 + 1,494,643 (accumulated cash)] = 7,714,643
- Tax—[(6,220,000 + 1,494,643) - (1,908,893 + 954,447)
  [basis build-up during S period)] x .28 = 1,358,365
  no tax on distribution of $1,400,333 accumulated cash
- Net to Seller - $6,356,278 (7,714,643 - 1,358,365)

1 Pub. L. No. 115-97, 131 Stat. 2054 (Dec. 22, 2017). The official name of the Act is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

2 The modified individual rates are effective for tax years beginning after 2017 and before 2026.

3 Employment taxes, self-employment taxes, and the **Section 1411** tax (3.8%) remain fully applicable under the TCJA. A pass-through owner who does not materially participate in the business generally will be subject to the **Section 1411** tax (3.8%). Further, a self-employed owner or partner who materially participates in the business may still be subject to self-employment taxes on the pass-through income.

4 The 20% rate on the flow-through long-term capital gain applies to an owner who materially participates in the pass-through business. A passive owner will be subject to an additional 3.8% tax under **Section 1411** .

5 Section 199A(i) .

6 Section 199A(c) .

7 Under **Section 199A(c)(3)(A)(i)** , qualified items of income, gain, deduction, and loss must be effectively connected with the conduct of a trade or business within the United States (within the meaning of **Section 864(c)**), determined by substituting "qualified trade or business (within the meaning of **Section 199A**)" for "nonresident alien individual or foreign corporation" or for "a foreign corporation" each place it appears.

8 Sections 199A(d)(1) and (2).

9 Section 199A(b)(2) .

10 Section 199A(b)(3) (exception to W-2 wages/qualified property limitation based on owner's taxable income); **Section 199A(d)(3)** (exception to specified service business exclusion based on owner's taxable income).

11 Section 199A(e)(2)(B) . The inflation adjustment applies to any tax year beginning after 2018.

12 Section 199A(a) .

13 Section 199A(f)(1)(B) . The Conference Committee Report explains that rules similar to the rules under Section 199 (repealed by the TCJA) apply for apportioning between fiduciaries and beneficiaries any W-2 wages/qualified property under the limitation based on W-2 wages/qualified property.

14 H. Rep't. No. 115-466, 115th Cong., 1st Sess. (2017) (Conf. Rep.), Joint Explanatory Statement of the Committee. The examples in the Conference Committee Report are based on the initial bill passed by the Senate and employ a 23% deduction amount and a greater threshold limitation than the provisions that passed in the TCJA. The illustrations in this article are adjusted to apply the limitations as included in the TCJA.

15 *Id.* at 214.

16 *Id*. at 220, 221 (referred to in the conference report as Example 1).

17 *Id.* at 221, 222 (referred to in the conference report as Example 2).

18 Rev. Rul. 69-184, 1969-1 CB 256 , **Temp. Reg. 301.7701-2T(c)(2)(iv)(C)(2)** , **TD 9766** , 81 Fed. Reg. 26693 (May 4, 2016).

19 H. Rep't. No. 115-466, *supra* note 14, at 218.

20 *Id*. at 217.

21 Section 199A(f)(1)(A) .

22 TCJA section 13305.

23 Reg. 1.199-5(b)(6), Example (3) .

24 Section 199A(d)(2)(B) .

25 H. Rep't. No. 115-466, *supra* note 14, at 216, fn 44.

26 Section 448(d)(2)(A) (emphasis added).

27 Under **Section 641(b)** , an estate or trust computes its taxable income in the same manner as an

individual. The Conference Committee Report specifically notes this. H. Rep't. No. 115-466, *supra* note 14, at 260, fn 171.

28 *Id.* at 260, fn 172.

29 Section 1371(e) .