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Major Changes in Taxation of Business Under Tax Cuts and Jobs Act: Is Pass-Through Right for You?

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Effective for tax years beginning in 2018, the tax rates for C corporations will be reduced from 35 percent to 21 percent. The stated top rate for individuals, trusts and estates, including owners of pass-through businesses, such as S corporations and most partnerships and LLCs, will be reduced from 39.6 percent to 37 percent.

New Section 199A for Pass-Through Businesses

Lower Effective Rate. Because of a newly enacted deduction available to all taxpayers other than a C corporation, the qualifying business income (QBI) of these taxpayers will have a different effective rate than other types of ordinary income. The deduction under new Section 199A of the Code may not exceed 20 percent of QBI and may be less in many circumstances. In the most favorable situations, QBI will be taxed at an effective top rate of 29.6 percent (80 percent x 37 percent).

Qualified Trade or Business. The Section 199A deduction will be available to both itemizers and non-itemizers. This deduction will be equal to 20 percent of the sum of qualified REIT dividends, qualified cooperative dividends, qualified publicly traded partnership income and, subject to the possible reductions as discussed below, QBI from each qualified trade or business (QTB). The deduction may not exceed 20 percent of overall taxable income (not including any net capital gain). In general, each category of income is limited to income from a business effectively connected with the United States and does not include non-business or investment income or capital gains of the QTB, REIT, cooperative or publicly traded partnership.

Thresholds. In the case of a taxpayer with taxable income at or below the threshold amounts ($315,000 in the case of joint returns and $157,500 in the case of other returns), the deduction is simply 20 percent of QBI from a QTB. In the case of a taxpayer with taxable income above the fully-phased-in amount ($415,000 in the case of joint returns and $207,500 in the case of other returns), the deduction may not exceed the greater of (i) 50 percent of "W-2 wages" paid to employees of the QTB (which term includes some types of deferred compensation) or (ii) 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis of "qualified property" (depreciable tangible property which is less than ten years old or which is still being depreciated over a period in excess of ten years). The limitation on the deduction is phased in for taxpayers with taxable income above the threshold amount but below the fully-phased-in amount.

Exclusions. An employee is never considered to be engaged in a QTB with respect to his employment. Moreover, a taxpayer engaged in a specified service trade or business (SSTB) and who has taxable income above the fully-phased-in amount (same as above) may not treat any of the income from the SSTB as QBI. A taxpayer with taxable income at or below the threshold amounts (same as above) may treat all qualified income items from a SSTB as QBI. The effect of the limitation with respect to income from a SSTB is phased in for a taxpayer above the threshold amount but below the fully-phased-in amount.

An SSTB is any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, investment management, trading or dealing in securities, etc. or "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners." The SSTB definition was modified expressly to exclude engineering and architecture services from the list of professions treated as an SSTB.

A business owner of a QTB, which is not an SSTB and which pays substantial W-2 wages or owns substantial qualified property (or some combination of the two), may still take a full deduction equal to 20 percent of QBI regardless of his income level.

Types of Entities and Owners. A QTB may be conducted as a sole proprietorship, a partnership, a single-member LLC, a multi-member LLC or an S corporation. Where multiple owners are involved, the W-2 wages and a qualified property basis are proportionately allocated among the owners. The threshold amounts and fully-phased-in amounts are determined at the owner level. If a trust or estate is an owner of a QTB, it is treated the same as any other taxpayer not filing a joint return.

If the QTB is conducted through an S corporation, then the IRS may reduce the amount of QBI (hence the amount of the Section 199A deduction) if reasonable compensation is not being paid to the S corporation shareholders. If the QTB is conducted through an entity treated as a partnership for federal income tax purposes, any guaranteed payments to the partners will not be included in QBI.

Observations

Employee Versus Contractor Status. Section 199A gives individuals a new incentive to be self-employed service providers or otherwise to participate in the "gig economy," instead of being an employee. The rules designed to prevent taxpayers from migrating from employee status to self-employed status are much less restrictive below the threshold amounts and most individual taxpayers are below the threshold amounts. However, the advantage of claiming a 20 percent Section 199A deduction as a self-employed worker may be offset by the loss of non-taxable employee benefits (health insurance, qualified retirement plan contributions, etc.) by other costs of being self-employed or by the need to pay self-employment taxes instead of only the employee's share of FICA taxes.

Whether the workers at a C corporation are employees or independent contractors should make little or no difference to the income taxes of the C corporation, but the owners of a pass-through business may have their Section 199A deduction reduced if the business does not pay enough W-2 wages. Of course, numerous other rules treat employees differently than contractors (withholding obligations, participation in health, retirement and other benefits, wage and hour pay rules, etc.) and the service recipient must consider all of these rules, plus the potential adverse consequences if workers are misclassified.

C Corporations Versus Pass-Through Tax Entities. Converting an existing pass-through entity to C corporation status should be considered with caution. Although the reduction of the corporate tax rate to 21 percent and the Section 199A deduction are both "permanent," these provisions may be repealed or amended in the future and there is no guarantee that the optimal structure in 2018 will remain the optimal structure for many years to come.

In general, businesses that intend to retain most profits for reinvestment in the business should consider converting to a C corporation to take advantage of the 21 percent tax rate. Non-corporate businesses and S corporations that intend to distribute most profits to the owners should likely not

convert to C corporations, but rather consider how to maximize the Section 199A deduction to achieve an effective top tax rate of 29.6 percent. To some extent, these same considerations applied when the corporate and individual tax rates were 35 and 39.6 percent (a 4.6 percent difference), but the larger difference between the effective rates beginning in 2018 (8.6 percent) may affect a decision regarding the most tax-efficient structure. In some cases, the optimal structure may involve some portions of the business being conducted by a C corporation and other portions conducted by another entity.

Converting Tax Status. Generally speaking, a conversion of a partnership or LLC to a C corporation can be done tax-free. However, the conversion of C corporation to a pass-through entity (other than an S corporation) is a taxable event that will trigger taxes on appreciated assets. In many situations, it may be possible for the shareholders of a C corporation to elect S corporation status at the beginning of each new tax year without adverse tax consequences, but if an existing S corporation decides to revoke its S corporation election, it generally may not file a new S corporation election for five years.

Differences between Pass-Throughs. As noted earlier, the QBI generated by an S corporation may be reduced by the IRS if reasonable compensation is not paid. For example, if an existing S corporation reduces the compensation paid to shareholder-employees in 2018 compared to what it paid in previous years, the IRS may assert that reasonable compensation is not being paid in 2018. If the QBI is conducted through a partnership or an LLC treated as a partnership for federal income tax purposes, then as long as the partners are allocated income based on their distributive share of profits rather than receiving any guaranteed amounts, all of the ordinary business income appears to be QBI without regard to any imputed compensation amount. In the case of a sole proprietorship or a single member LLC treated as a sole proprietorship, the statute does not appear to contain any provisions that would reduce QBI based on some assumed amount of imputed compensation.

Family Ownership. A high income QTB owner who is subject to the loss of some of the Section 199A deduction above the threshold amount should consider gifts or other transfers of interests in the QTB to family members (other than spouses) or to trusts for family members. Limitations may apply to reduce any income tax benefits in some cases. Licensing restrictions on transfers of interests in professional service businesses may also apply.

Conclusion

Generalizations as to the best tax strategy are particularly difficult after the enactment of the tax cuts and jobs act. The best tax planning takes into account your particular circumstances. Each business owner is encouraged to seek advice from tax professionals as to his or her best course of action.

If you have questions regarding the content of this alert, please contact William Fones or any member of Baker Donelson's Tax Group.