SHERMAN&HOWARD

Tax Advisory

January 2018

Choosing a Business Entity After the New Tax Act and Other Important Business Tax Changes Under the New Law

A Five-Part Series

Part I: General - The Choice of Entity Decision Prior to 2018

Since the reduction of individual tax rates in the 1980's, the decision of whether to conduct a business in the form of a C corporation or in the form of a "flow-thru" entity (i.e., partnership, limited liability company or S corporation) has been a fairly easy one. Because of the lower individual tax rates, the relatively high corporate tax rate and the "double tax" on C corporations -- (i.e., once at the corporate level and a second time at the shareholder level), distributed profits of a C corporation generally have been subject to tax at rates far in excess of the rates applicable to a flow-thru entity. As a result, a flow-thru entity has almost always been the best structure to use for a non-publicly traded business. (Publicly-traded businesses generally are not eligible for flow-thru treatment.)

Because of the changes described below that have been made under the Tax Cut and Jobs Act (the "Tax Act"), the choice for a non-publicly traded business between using a flow-thru entity or using a C corporation will no longer be as simple as it once was. Instead, under the Tax Act, businesses will be required to consider a number of factors (and perhaps undertake some mathematical "modeling") in order to determine the type of business entity that will result in the lowest tax burden.

Part II: Changes to Flow-Thru Entity Taxation Made by the Tax Act

Rate Changes and Special Flow-Thru Entity Deduction

When the new tax bill was first proposed, many commentators were predicting that a flow-thru entity would no longer be a better tax structure than using a C corporation, and that many or even most flow-thru entities would convert to C corporation status after the new bill took effect. Now that the new law has been finalized, however, it does not appear that the predicted wholesale movement to convert flow-thru entities to C corporations will actually occur. Instead, for several reasons, a flow-thru structure will probably continue to be the best choice for most non-publicly traded businesses.

For example, regardless of the changes made under the Tax Act, most real estate businesses will want to continue to use a partnership or limited liability company structure, because of the ability to move properties in and out of those entities without any tax consequences, and in order to make the special allocations of profit and loss that are common in that industry but cannot be accomplished in a corporate structure. Likewise, any flow-thru business that is likely to be sold in the next few years will probably want to remain a flow-thru entity in order to take advantage of the single level of tax at capital gains rates upon such a sale.

Furthermore, the Tax Act itself includes significant changes designed to reduce the taxes paid by a business operating in a flow-thru form. First, the maximum individual tax rate (i.e., the maximum rate at which flow-thru entity profits are taxed) has been reduced, at least through the 2025 tax year, from 39.6 percent to 37 percent. In addition, the Tax Act provides for a special 20 percent deduction for profits of a business conducted in a flow-thru structure (including, for these purposes, a sole proprietorship).

In particular, for taxable years beginning after December 31, 2017 and before January 1, 2026, an individual taxpayer generally may deduct 20% of "qualified business income" earned from a trade or business conducted in a flow-thru structure. Qualified business income is generally ordinary income from a trade or business conducted within the United States and does not include investment-related income, deductions or losses (e.g., capital gains, dividends and interest income). Qualified business income is reduced by reasonable compensation paid to the taxpayer for services rendered with respect to the trade or business, which raises the question of whether the IRS will try to impute a reasonable salary to a flow-thru business owner in order to reduce the effect of the deduction.

For taxpayers with taxable income above a threshold amount (described below), the deduction of 20% of qualified business income is limited for each business to an amount that does not exceed the greater of (a) 50% of the W-2 wages paid with respect to the qualified business, or (b) the sum of 25% of the W-2 wages paid with respect to the qualified business plus 2.5% of the unadjusted basis of all tangible property of a character subject to depreciation that is held by the qualified business at the close of the taxable year and which is used in the production of qualified business income. This unadjusted basis amount does not include property that has been held for a period greater than 10 years or the depreciable period of the property, whichever is longer.

The deduction of 20% of qualified business income is also limited in the case of a "specified service business." For this purpose, a specified service business is one involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investment management services, 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. Notably, the term does not include engineering, architecture, or real estate businesses.

Neither the wage/asset limit nor the limitation on specified service businesses applies to taxpayers with taxable income below a threshold amount, and the deduction is then phased out ratably (in the case of a

specified service business), or gradually becomes subject to the wage and asset limitation (for businesses that are not specified service businesses), to the extent the taxable income of the taxpayer exceeds the threshold amount. For 2018, the threshold amount is $157,500 for a single taxpayer and $315,000 in the case of a joint return, and is indexed for inflation for future years. The deduction is phased out completely (for a specified service business), and becomes subject to the full wage and asset limitation (for a business other than a specified service business) once taxable income exceeds the threshold amount by $50,000 in the case of a single taxpayer, or $100,000 in the case of a joint return.

To summarize, assuming a flow-thru entity can avoid the "specified business" and wage/asset limitations described above, the maximum tax rate on its profits will be approximately 29.6 percent (i.e., 80% times 37%). This represents a full 10 percent reduction from the current maximum tax rate on flow-thru business profits, which will continue to provide businesses with a strong incentive to operate in flow-thru entity form. As described below, however, other changes in the Tax Act will encourage a business to at least consider whether a C corporation might be a better form of entity to choose.

Limitation on the Use of Business Losses

Not all of the changes made to flow-thru entity taxation under the Tax Act are favorable. One significant benefit of using a flow-thru entity over a C corporation -- the ability to offset flow-thru business losses against other non-business income of the taxpayer -- will be strictly limited under the new law.

In particular, under the Tax Act, taxpayers will be permitted to use no more than $250,000 of flow-thru business losses from all flow-thru entities each year to offset their non-business income. Any business loss in excess of that limitation will be carried forward as a net operating loss (NOL), and will be subject to the new limitations on the deductibility of NOLs that are described further below. As a result of this new limitation, flow-thru entities have become a somewhat less favorable business structure than they were before the new law was enacted, at least for companies that generate significant losses.

Finally, it should be noted that C corporations will not be subject to these excess business loss limitations. Thus, a C corporation will be permitted to offset losses it realizes from business activities (including partnerships or limited liability companies in which the C corporation is an owner) against any non-business income it may have, including capital gains.

Part III: Changes to C Corporation Taxation Under the Tax Act

General

The Tax Act contains a number of significant changes to how C corporations are taxed, most of which will have the effect of making a C corporation a more attractive entity choice for conducting a business.

Corporate Rate Reduction

The most significant change to C corporation taxation is, of course, the major reduction in the corporate tax rate (i.e., the first level of tax in the C corporation “double tax”). Effective for the 2018 tax year, the corporate rate has been reduced from 35 percent to 21 percent. Coupled with the 23.8 percent tax on corporate dividends and liquidating distributions (which does not change under the Tax Act), the effective blended tax rate for immediately-distributed corporate profits has now been reduced from more than 50% before the Act to approximately 39.8% today (i.e., 100% minus (79% x 76.2%)). While a 39.8% rate is still much higher than the 29.6% flow-thru rate described above, under many circumstances, the effective C corporation tax rate may actually end up being lower than the rate at which flow-thru entities are taxed.

First, as noted above, the reduction of the top individual rate to 37% is only temporary, and it reverts to 39.6% after 2025 without further Congressional action. In addition, the special 20% deduction that allows a flow-thru entity to reduce its maximum tax rate to 29.6% is subject to significant limitations based on the nature of the business being conducted and the amount of wages paid and/or assets owned by the business. Thus, in many circumstances (and depending upon the nature of the business), the full 20 percent flow-thru deduction may not be available, which will have the effect of increasing the tax rate on a flow-thru business to an amount higher than 29.6%.

More importantly, with a C corporation structure, a taxpayer may have significant control over when the second, shareholder level of tax is actually incurred. To the extent that distributions of profits to shareholders can be delayed for a significant period of time, the actual effect of the second level of tax can be greatly reduced, in certain cases to almost zero. The most obvious way to delay the shareholder level of tax is by reinvesting profits back into the operation of the business, something that usually makes business sense even without considering any tax advantages of doing so. Likewise, if a taxpayer owning C corporation stock can avoid distributing profits until he or she dies and receives a step up in the stock’s adjusted basis, it may be possible to avoid the second level of tax altogether. In addition, more creative methods for delaying corporate dividend distributions will almost certainly be resurrected from back in the days prior to 1981 when individual tax rates were much higher than corporate tax rates. In this regard, however, the IRS tools for combatting such deferral efforts (most notably, the personal holding company tax and the accumulated earnings tax) are likely to acquire newfound importance as well.

Finally, it should be noted that taxpayers will be permitted to continue to take advantage of existing rules that allow up to a 100% exclusion on the gain from the sale of certain stock of a corporation that has less than $50 million of gross assets. This exclusion seems likely to become more important now that C corporations appear to be a more attractive type of structure for small, non-publicly traded businesses.

Alternative Minimum Tax Changes

Another change that is likely to make the C corporation structure look more attractive in the future is the complete elimination of the corporate alternative minimum tax. In contrast, the individual alternative

minimum tax, which will continue to apply to individual owners of interests in flow-thru entities, will remain in place, although exemption levels have been increased so that fewer individual taxpayers will be subject to the alternative minimum tax in the future.

Accounting Method Changes

Yet another change under the Tax Act that may make C corporations somewhat more attractive is a provision designed to expand the number of businesses that can use the cash method of accounting for determining their annual tax obligations. For profitable businesses (i.e., those businesses where receivables generally exceed payables), the cash method of accounting is usually a more favorable method than the accrual method of accounting. However, prior to the Tax Act, a C corporation (or a partnership with a C corporation partner) was permitted to use the cash method of accounting only if (i) it had average annual gross receipts of $5 million or less; and (ii) it was not required to maintain inventories in operating its business. Under the Tax Act, C corporations can now use the cash method of accounting, regardless of whether or not they use inventories, so long as their average annual gross receipts do not exceed $25 million.

Advantages of Using a C Corporation Under the New International Tax Regime

One of the most significant changes made by the Tax Act is the movement of the United States from a so-called “worldwide” tax system (where U.S. taxpayers are taxed on all their profits regardless of where those profits are generated) towards a modified “territorial” system (where profits attributable to operations in foreign countries are not subject to U.S. tax, even when repatriated). This major change in the structure of the international tax provisions is accomplished by providing domestic C corporations with a 100 percent “dividends received deduction” on dividends from foreign subsidiaries that conduct active businesses outside the U.S. The new rules are subject to a number of special exceptions, including a special new tax on global intangible income. Likewise, U.S. taxpayers will continue to be subject to the existing “subpart F” rules that provide for immediate U.S. taxation of passive income and certain related party active income earned by controlled foreign subsidiaries.

In any event, the new 100 percent dividends received deduction will be available only to companies that conduct their U.S. operations in C corporation form. U.S. partnerships and S corporations with foreign subsidiaries will continue to be subject to U.S. tax when the earnings of their foreign affiliates are brought back into the United States. In short, the new territorial regime for international taxation provides a strong incentive for any domestic company with foreign operations to be structured as a C corporation rather than as a flow-thru entity.

Part IV: Making the Choice Between the Different Types of Flow-Thru Entities

If a business ultimately decides that a flow-thru entity structure is better than using a C corporation, it will still have to decide what type of flow-thru entity to use -- i.e., partnership, limited liability company, sole

proprietorship, or S corporation. That decision will largely be made by considering the tax and non-tax factors that have always been relevant, including the extent of limited liability protection, self-employment tax consequences, state income tax considerations, flexibility of ownership, etc. Although the Tax Act makes a few miscellaneous changes to the S corporation rules and the partnership rules, none of those changes would appear to have any material effect on making a choice between the various types of flow-thru entities available.

Part V: Significant Business Tax Changes Under the Tax Act That Do Not Directly Affect the Choice of Entity Decision

Changes to the Use of Net Operating Loss Deductions

Three important changes have been made concerning the use of net operating losses (NOLs) by businesses.

First, the ability to carry back NOLs for up to two years from the year the NOLs are generated has been eliminated. Consequently, all NOLs must now be carried forward and used in years after those losses are generated.

Second, the 20 year limit for NOL carryforwards has also been eliminated. Consequently, NOLs can now be carried forward indefinitely and used in any future tax year to offset taxable income of the taxpayer.

Third, and most importantly, taxpayers will no longer be able to use NOL carryforwards to offset all of their taxable income in future years. Instead, beginning in 2018, taxpayers will be permitted to use NOL carryforwards from prior years to offset no more than 80 percent of their taxable income. This new limitation will apply regardless of whether the taxpayer is an individual operating a business through a flow-thru entity or is a C corporation.

Limits on Business Interest Deductions

Beginning in 2018, businesses (regardless of whether they are operated in C corporation or flow-thru form) will be permitted to take a deduction for business interest incurred during the taxable year only to the extent that the total amount of such interest does not exceed the sum of (i) the interest income of the business during that year; plus (ii) 30 percent of the business's earnings before interest, tax, depreciation, and amortization (EBITDA). For tax years beginning after 2021, the EBITDA measurement will be replaced with earnings before interest and taxes (EBIT), which will have the effect of further restricting the deduction of business interest. Any interest that is disallowed in a taxable year as a result of the new limitation will be carried forward and can be used in any future year, subject to the limitation in that future year.

Among other planning techniques to reduce the burden of this new limitation, businesses will now look for additional ways to generate interest income and other types of income from financial products that might be considered interest income under IRS guidance that has yet to be issued.

Changes to Depreciation and Other Cost Recovery Provisions

Under the Tax Act, the currently-permitted deduction for "bonus depreciation" on new equipment and other tangible personal property will be increased to 100 percent (i.e., full expensing) for any assets purchased and placed in service during the tax years from 2018 through 2022. The bonus depreciation deduction will then be reduced by 20% per year in the years 2023 through 2026, and will no longer be available at all beginning in 2027. In addition, bonus depreciation deductions will now apply to used as well as new equipment. Special rules will apply to reduce the deduction for property purchased before 2018, but not placed in service until after the new Tax Act takes effect.

In addition to the changes in bonus depreciation, the limitations on the use of the "Section 179 deduction" (which has always allowed an immediate 100 percent deduction for certain items of new equipment), have been increased, which will allow more businesses to take advantage of that deduction for more of their property purchases. In particular, eligible businesses can now fully expense up to $1,000,000 of their purchases (increased from the previous $500,000 limit), and the deduction will not begin to be phased out until the total of such purchases during the year exceeds $2,500,000 (up from the $2,000,000 threshold in place before the Tax Act). In addition, certain improvements to real property (including roofs, HVAC equipment, and security and alarm systems) will now be eligible for the Section 179 deduction.

One other important change to the cost recovery provisions provides that most research and development ("R&D") expenditures will no longer be fully deductible in the year they are incurred. Instead, beginning in 2022, such R&D expenditures must be amortized over a five-year period.

Changes to Capital Asset Treatment for Self-Created Assets

Because of the favorable capital gains rates that have existed since 1997, it has always been important when selling the assets of a business to make sure that the purchase price is allocated to the extent possible to assets that are considered "capital assets" for tax purposes. For the seller of the business, this has generally meant avoiding allocations of the purchase price to cash basis receivables, covenants not to compete, inventory, and personal property subject to ordinary income recapture. The Tax Act adds another significant category of assets that will generate ordinary income upon sale.

In particular, under the Tax Act "capital assets" will no longer include any "patent, invention, model or design (whether or not patented), secret formula or process," to the extent that such property was created by the personal efforts of the taxpayer. This new ordinary income category would seem, at least at first glance, to cover a wide variety of a business's property, although it remains to be seen precisely how broad this new category will be.

Changes to Section 1031 "Like-Kind" Exchanges

Beginning in 2018, the ability to do a tax-deferred like-kind exchange will be limited to exchanges of real property. Exchanges of personal property (including exchanges of business units) will no longer be eligible for tax deferred treatment.

Elimination of Deduction for Entertainment Expenses

Under the Tax Act, businesses will no longer be permitted to take deductions for the expenses of entertaining clients or customers, regardless of the connection between the entertainment and the business. Consequently, the always-cumbersome determination of whether an entertainment or recreational activity "directly precedes or directly follows a substantial and bona fide business discussion" will no longer be relevant.

For more information on this topic, please contact:

Denver	Mike Dubetz	303.299.8464	mdubetz@shermanhoward.com
Denver	Steven Miller	303.299.8144	smiller@shermanhoward.com
Denver	John Birkeland	303.299.8225	jbirkeland@shermanhoward.com
Aspen	Joe Krabacher	970.300.0123	jkrabacher@shermanhoward.com

Sherman & Howard has prepared this advisory to provide general information on recent legal developments that may be of interest. This advisory does not provide legal advice for any specific situation and does not create an attorney-client relationship between any reader and the Firm.

©2018 Sherman & Howard L.L.C.

January 4, 2018