C Corporations and Pass-Through Entities Under the New Tax Regime

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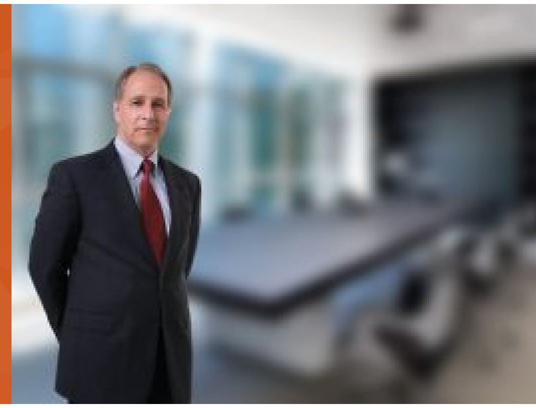

I. Introduction.

In selecting the form of organization for a business or investment entity, the owners typically must choose from among a C corporation, an S corporation and an entity, such as a limited liability company ("LLC"), classified as a partnership for tax purposes. A C corporation is separately taxed on its income, with the owners generally reporting only any dividends they receive and any gains or losses they have on sales of their shares. The income or loss of an S corporation or partnership, on the other hand, is reported by the entity's owners, which is why S corporations and partnerships are sometimes referred to as "pass-through entities."[1] The Tax Cuts and Jobs Act of 2017 (the "TCJA") significantly affected choice of entity decisions by, primarily, reducing the rates applicable to the income of C corporations and individuals. This article compares how the earnings of C corporations and pass-through entities are taxed federally in the wake of the TCJA.

II. Taxation of C Corporations and their Shareholders.

a. Income and loss.

The income of a C corporation is now taxed at a flat rate of 21%.[2] Neither income nor loss of a C corporation passes through the corporation to its shareholders. In general, a C corporation can carry a "net operating loss" (or "NOL") it has for any year forward indefinitely (subject to various special rules, including a rule that limits a C corporation's ability to use its NOL carryforwards following an "ownership change").[3] A C corporation (i) can use its capital losses only to offset capital gains but (ii) can generally carry a net capital loss back 3 years and forward 5 years (individuals can use capital losses to offset limited amounts of ordinary income and can carry net capital losses forward, but not back, indefinitely). Because the income and losses of a C corporation are reported by the corporation and not by the shareholders, the income and losses have no effect on the bases of the shareholders in their shares.[4] Distributions made by a corporation to its shareholders are not deductible by the corporation (even to the extent that they are dividends).

b. Distributions.

Any cash distribution made by a C corporation to its shareholders with respect to their shares is treated as a dividend to the extent the distribution is made from the corporation's current or accumulated "earnings and profits."[5] A U.S. individual's dividends from a domestic (or qualified foreign) corporation are generally taxable at a maximum rate of 15% or, for individuals with taxable incomes exceeding $425,800 ($479,000 if married filing jointly), 20% (plus, if applicable, an additional 3.8% tax on net investment income).[6] Thus, the earnings of a C corporation are subject to tax at the corporate level when earned and then again at the shareholder level when distributed.[7] This "double-taxation" of the distributed earnings of a C corporation (including gain from an asset sale) has historically been cited as a disadvantage of the C corporation as compared to a pass-through entity. The reduction of the corporate rate to 21%, however, has reduced the maximum effective federal rate applicable to earnings of a C corporation distributed to individual shareholders from over 50% to 39.8% (assuming the applicability of the highest corporate and individual rates and the 3.8% tax on net investment income).

III. Taxation of Pass-Through Entities and their Owners.

a. Income and loss.

1. Pass-through to owners.

In general, a pass-through entity is not subject to federal income tax.[8] Instead, the owners of the entity report their shares of the entity's income or loss, with character passing through as well (as if the owners had realized or incurred the items of income or loss directly) and without regard to the amounts of distributions they receive from the entity.[9] The TCJA reduced the maximum rate applicable to a U.S. individual's ordinary income from 39.6% to 37% (with the top rate applying to individuals with taxable income exceeding $500,000, or $600,000 if married filing jointly). The TCJA did not, however, change the rates applicable to an individual's long-term capital gains, which continue to be taxed at a maximum federal rate of 15% or, if the individual has taxable income exceeding $425,800 ($479,000 if married filing jointly), 20% (although higher rates can apply to certain types of long-term capital gain such as "unrecaptured Section 1250 gain" with respect to depreciated real estate). For purposes of the 3.8% tax on net investment income, an individual's net investment income includes his or her share of the income or gain of a pass-through entity if the entity is a passive activity for the individual. The maximum federal rate applicable to an individual's share of the income of a pass-through entity, therefore, is 37% or, if the pass-through entity is a passive activity for the individual so that the income is subject to the income is subject to the tax on net investment income, 40.8%.

2. Deduction for "qualified business income."

Although the TCJA did not reduce individual rates as dramatically as it reduced corporate rates, it introduced new Section 199A of the Internal Revenue Code (the "Code"). Section 199A permits an individual (or other non-corporate) taxpayer to deduct up to 20% of his or her "qualified business income" ("QBI") from any "qualified trade or business" conducted by a pass-through entity in which he or she holds an interest.[10] With respect to any qualified trade or business in which a taxpayer holds an interest through a pass-through entity, however, the amount of QBI deductible by the taxpayer for any year may not exceed the greater of (i) the taxpayer's share of 50% of the "W-2 wages" paid by the qualified trade or business for the year or (ii) the taxpayer's share of 25% of the W-2 wages paid by the qualified trade or business for the year plus the taxpayer's share of 2.5% of the unadjusted basis of all "qualified property" of the qualified trade or business.[11] The deduction for QBI can have the effect of reducing the maximum federal rate applicable to an individual owner's share of the income of a pass-through entity from 37% to as low as 29.6%.[12]

A. "QBI."

"QBI" is the net amount of qualified items of income, gain, deduction and loss with respect to any "qualified trade or business" of the taxpayer to the extent effectively connected with the conduct of a U.S. trade or business and included or allowed in determining taxable income, but with exceptions for, among other things, (i) capital gains and losses (both short- and long-term), (ii) dividends, (iii) interest income not allocable to a trade or business, and (iv) deductions and losses allocable to excluded income. QBI also excludes reasonable compensation for services and "guaranteed payments" to partners for services rendered to their partnerships.

B. "Qualified trade or business."

> A "qualified trade or business" is any trade or business other than a "specified service trade or business" or the trade or business of performing services as an employee. A "specified service trade or business" is any trade or business involving the performance of services (i) in the field of health, law, accounting, actuarial services, performing arts, consulting, athletics, financial services or where the principal asset of the business is the reputation or skill of one or more of its employees (but with a specific exception for architectural and engineering services), or (ii) that consist of investing and investment management, trading, or dealing in securities, partnership interests or commodities.[13]

3. Loss deductibility limitations.

Although a pass-through entity's losses pass through to its owners, an individual owner's ability to use his or her share of any loss against other income he or she may have may be subject to certain limitations. More specifically, and among other potential limitations, an individual owner may not use his or her share of a loss for any year to the extent the loss exceeds (i) his or her adjusted basis in his or her interest in the entity,[14] (ii) his or her amount "at risk" with respect to the entity as of the end of the year,[15] (iii) if the entity is a "passive activity" for the owner, his or her income from other passive activities[16] or (iv) to the extent the loss is a capital loss, his or her capital gains plus a small amount of ordinary income. In addition to those limitations, the TCJA added new Code Section 461(l), which disallows any "excess business loss" of an individual (or other non-corporate taxpayer) for any year and treats it as an NOL carryforward to the following year.[17]

4. Effect on basis.

The adjusted basis of an owner of an interest in a pass-through entity is generally increased by the owner's share of the entity's income and decreased (but not below zero) by the owner's share of the entity's losses. An owner's adjusted basis is also increased by any contributions he or she makes to the entity and reduced by any distributions he or she receives from the entity.[18]

b. Distributions.

In general, any cash distribution made by a pass-through entity to an owner first reduces the owner's basis in his or her interest in the entity (and is not taxable to the owner) until the owner's basis in his or her interest has been reduced to zero.[19] Any portion of a distribution to an owner that exceeds the owner's basis in his or her interest is treated as gain to the owner from the sale or exchange of his or her interest. Thus, single-level taxation is effected in the pass-through context by the rules that (i) tax the owners directly on their shares of the entity's income, (ii) increase the owners' bases in their interests in the entity by their shares of the entity's income, and (iii) treat a cash distribution to any owner as taxable to the owner only to the extent in excess of his or her adjusted basis in his or her interest in the entity.

IV. Entity Choice Post-TCJA.

The rate differentials introduced by the TCJA are historic and significantly impact entity choice decisions. Given the 21% corporate rate, when might an entity nevertheless want to be a pass-through entity?

a. When the entity's income will include significant amounts of long-term capital gain.

Because the TCJA did not change the preferential rates applicable to long-term capital gains of individuals, entities that might earn significant amounts of long-term capital gain should consider being pass-through entities. These types of entities would include entities formed to invest in assets such as securities.[20] An entity that might be a target for acquisition by asset purchase might also want to consider being a pass-through entity if the acquisition could generate a significant amount of long-term capital gain (on account of the nature of its assets), particularly if the entity might not generate a significant amount of earnings that would be retained through the time of the acquisition that it would want to have taxed at only the 21% corporate rate.[21]

b. When the entity will earn QBI, pay significant amounts of wages and/or have significant amounts of qualified property, and make distributions to its owners.

The new 20% deduction for QBI can reduce the maximum federal rate applicable to an individual's share of the QBI of a pass-through entity to as low as 29.6% (without regard to the distributions made by the entity).[22] While the income of a C corporation is now taxed at only a 21% rate, the effective rate applicable to the distributed earnings of a C corporation can be as high as 36.8%.[23] Thus, entities with significant amounts of QBI eligible for the special pass-through rate provided by new Code Section 199A in the hands of its owners should strongly consider being pass-through entities if they intend to distribute their earnings to their owners from time to time.[24]

c. When the entity will generate losses that the owners can use against other income.

Losses, as well as income, of a pass-through entity pass through to the entity's owners. Unfortunately, as described in III.a.3. above, an individual owner's ability to use his or her share of a loss may be limited under certain circumstances. If a loss is generated by an individual owner's equity contributions, however, it may be that the only applicable limitations are that the owner has insufficient income from other passive activities if the entity is a passive activity for the owner or that the loss causes the owner to have an "excess business loss" limited by new Section 461(l) of the Code. In either case, any disallowed amount of the loss carries forward for use by the owner in subsequent years and, if the loss is an ordinary loss, remains an ordinary loss in the hands of the owner.[25]

d. When other tax characteristics of pass-through entities make a pass-through entity a good choice.

The maximum rates applicable to the distributed earnings of C corporations and pass-through entities are now fairly comparable (36.8% to 39.8% for C corporations, depending on the applicability of the 3.8% tax on net investment income, and 37% to 40.8% for pass-through entities, depending on the applicability of the 3.8% tax on net investment income), except where the earnings are long-term capital gains or QBI eligible for the new 20% deduction in the hands of the owners. While these rates may seem to give a slight edge to the C corporation even where the plan is to distribute earnings periodically, there are many other differences among C corporations, S corporations and partnerships in terms of the tax treatment of their operations and transactions. Most of those differences were not affected by the TCJA, and some may weigh in favor of a pass-through entity. For example, a partnership may provide greater flexibility than a C corporation (or an S corporation) in structuring owner admission, retirement and other buy-sell transactions. Depending on the circumstances, it may be important to consider more than just rates.[26]

e. When it's not clear what the entity should be.

With a few exceptions, a pass-through entity can become a C corporation for tax purposes without much trouble, at least from a tax standpoint.[27] Going from a C corporation to a pass-through entity, on the other hand, can (i) trigger gain at the corporate and shareholder levels if the pass-through entity is a partnership or (ii) if the conversion is to an S corporation and there are "built-in" gains with respect to any of the assets of the corporation at the time of the conversion, subject the S corporation to corporate-level tax on the built-in gains if it sells any of the assets with built-in gains within five years after the conversion.[28] Thus, if it's not clear what the entity should be, it may be better to have the entity be a pass-through entity initially.[29]

If you would like to discuss choice of entity issues, please contact **Chip Wry**, **Dave Czarnecki**, or **Joe Hunt**.

Footnotes.

1. An LLC is a partnership for tax purposes unless it has only a single equity owner (in which case

its separate existence is disregarded, and it is therefore a sole proprietorship, unless it has elected to be classified as a corporation) or has elected to be classified as a corporation. In this article, the term “partnership” refers to an LLC or other entity that is classified as a partnership for tax purposes, and the term “partner” refers to any owner of an interest in an LLC (owners of interests in LLCs are generally known as “members”) or other entity that is classified as a partnership for tax purposes.

2. Prior to the TCJA, a C corporation was taxed at rates of (i) 15% on its first $50,000 of taxable income, (ii) 25% on its taxable income from $50,001 to $75,000, (iii) 34% on its taxable income from $75,001 to $10,000,000 and (iv) 35% on its taxable income in excess of $10,000,000. In addition, prior to the TCJA, “qualified personal service corporations” were subject to a flat 35% tax on their taxable incomes. There are no preferential rates applicable to long-term capital gains of C corporations.

3. Prior to January 1, 2018, a C corporation could carry an NOL back 2 years and forward 20 years.

4. Thus, if a C corporation uses its earnings to fuel growth and development and the shareholders then sell their shares, the shareholders measure their recognized gains based on their costs for their shares without any benefit from the fact that the corporation has been separately taxed on its earnings. Of course, and on the other hand, the exclusion provided by Section 1202 of the Code for gain upon a sale of “qualified small business stock” held for more than five years applies only to stock of a C corporation (that meets certain requirements). For qualified small business stock acquired after September 27, 2010 and held for more than five years, the percentage of the gain that may be excluded is 100%, subject to a cap for any individual’s stock of any issuer equal to the greater of (i) $10 million ($5 million for a married individual filing a separate return) or (ii) ten times the taxpayer’s adjusted tax basis in the stock.

5.Dividends received by a shareholder generally have no effect on the shareholder’s basis in his or her shares. To the extent that a distribution to a shareholder is not a dividend but would be if the corporation had earnings and profits, the distribution reduces the shareholder’s basis in his or her shares and then, once the shareholder’s basis has been reduced to zero, is treated as gain from the sale or exchange by the shareholder of his or her shares.

6. Currently, any individual with “modified adjusted gross income” exceeding a threshold ($200,000 or, if the individual is married filing jointly, $250,000) is subject to a 3.8% tax on the lesser of (i) his or her “net investment income” or (ii) the amount of his or her modified adjusted gross income in excess of the threshold. “Net investment income” includes, net of “properly allocable deductions,” (a) interest, dividends, annuities, royalties and rents (with an exception for such income derived from non-passive activities), (b) income from passive activities, and (c) gains from dispositions of property (with exceptions for gains from dispositions of property held, and of interests, in non-passive activities). For high income individuals, therefore, dividends are subject to a maximum 23.8% tax. The tax on net investment income also applies to estates and trusts.

7. Earnings paid out to shareholders are not subject to double-tax to the extent they can be paid out as principal repayments on loans by the shareholders (care must be taken in structuring shareholder loans to ensure their treatment as debt rather than equity) or in some deductible way, such as compensation for services (compensation, though, must be reasonable to be deductible and is subject to employment tax). It should also be noted that C corporations may deduct portions of the dividends they receive from other domestic corporations.

8. An S corporation that has earnings or assets from when it was a C corporation can, however, be subject to corporate-level tax under certain circumstances. In addition, state tax laws may

tax pass-through entities on their income. Massachusetts, for example, taxes the income of an S corporation that has gross receipts for any year in excess of a certain threshold amount.

9. The income and loss of an S corporation is allocated among the shareholders of the corporation on a pro rata basis by share holdings. The income and loss of a partnership is allocated among the partners of the partnership in accordance with the partnership's governing agreement subject to rules requiring that the allocations have "substantial economic effect" (which basically means they have to be consistent with the economic deal among the partners).

10. The deduction also applies to qualified business income from businesses conducted as sole proprietorships.

11. "Qualified property" is depreciable tangible property held by a qualified trade or business, used in the production of QBI and as to which the property's "depreciable period" (the greater of 10 years or the property's recovery period from when it was first placed in service) has not expired.

12. Again, the income may also be subject to the 3.8% tax on net investment income if it is passive income for the owner.

13. For any taxpayer with taxable income below a "threshold amount" (initially, $157,500, or $315,000 in the case of a taxpayer filing a joint return) plus $50,000 ($100,000 in the case of a taxpayer filing a joint return), however, a specified service trade or business can be a qualified trade or business (but with the exception phasing out as income from the trade or business exceeds the threshold amount, so that the exception is completely eliminated at levels of taxable income of $207,500 for individuals and $415,000 for married taxpayers filing jointly).

14. Partners of a partnership include their shares of the partnership's debt in their bases. Shareholders of an S corporation generally may not include debt of the S corporation in their bases in their shares of stock in the S corporation, but they can deduct their shares of losses against loans they have made to the corporation (to the extent their shares of the losses exceed their stock bases).

15. The "at risk" rules limit the ability of a covered taxpayer to use losses generated by borrowings for which the taxpayer is not liable.

16. Under the "passive activity loss" rules, an individual may use a loss from an activity that is a passive activity for him or her for any year only against income he or she has from other passive activities for the year. Any disallowed loss is suspended but can be used against income the individual has from that activity or other passive activities for subsequent years or against other income generally when the individual disposes of his or her interest in the activity that generated the loss.

17. A taxpayer's "excess business loss" for any year is currently the excess of (i) the taxpayer's aggregate deductions for the year from trades or businesses of the taxpayer over (ii) the sum of (a) the taxpayer's aggregate gross income or gain attributable to such trades or businesses plus (b) $250,000 ($500,000 in the case of a taxpayer filing a joint return). In the case of a pass-through entity, the limitation is applied at the owner level.

18. Unlike shareholders of an S corporation, partners of a partnership include their shares of the partnership's debt in their bases in their interests in the partnership, even if they are not the lenders or personally liable for the debt (with increases and decreases in their shares of a debt treated as contributions by, and distributions to, them).

19. A special rule can apply to S corporations that have undistributed earnings and profits from when they were C corporations (with the rule treating distributions of those earnings as dividends). In addition, exceptions to the general rule can apply to a distribution made by a partnership to a partner if (i) the distribution is really part of a sale of property by the partner to the partnership, (ii) the partner is retiring and the distribution is not treated as a payment made in exchange for an interest of the partner in property of the partnership or (iii) the distribution is made in exchange for an interest of the partner in certain assets of the partnership that would generate ordinary income if they were sold.

20. Of course, private investment funds have historically been, and will likely continue to be, tax partnerships.

21. Purchasers often prefer to purchase assets rather than stock of target companies so that, among other things, they can "write up" the tax bases of the assets of the target companies.

22. Again, the income may also be subject to the 3.8% tax on net investment income in the hands of owners for whom the entity is a passive activity.

23. Dividends are also included in determining the amount of an individual stockholder's net investment income for purposes of the 3.8% tax on net investment income.

24. If the entity will not make distributions, the 21% rate applicable to retained earnings of C corporations is hard to compete with, as the earnings of a pass-through entity are taxed to its owners at their rates without regard to whether the entity makes distributions. With a pass-through entity, though, it should be noted that income passed-through to its owners is included by the owners in their bases in their interests in the entity, which can translate into lesser gains, or greater losses, on the sale of the entity (or the owners' interests in the entity). On the other hand, only C corporations provide their owners with the possibility of excluding, under Section 1202 of the Code, gains on sales of their shares held for more than five years if their shares are qualified small business stock.

25. In comparison, if an individual invests in a C corporation and then loses his or her investment, the loss is generally a capital loss (with a limited exception for up to $50,000, or up to $100,000 for individuals filing joint returns, under Section 1244 of the Code), which the individual can use only against capital gains and small amounts of ordinary income.

26. Even for an entity that will retain significant amounts of its earnings, some of the rate disadvantage of a pass-through entity may be reversed when the entity is sold as a result of the inclusion of the retained earnings in the owners' bases in their interests in the entity.

27. In particular, converting a partnership with debt to a corporation can trigger gain if the debt exceeds the partnership's adjusted basis in its assets.

28. There can also be a corporate-level tax, and loss of S corporation status, if the S corporation has earnings from its C corporation years and too much passive investment income.

29. As between an S corporation and a partnership, the use of a partnership may better preserve the ability of the initial owners to have their shares of stock in a C corporation to which the entity is ultimately converted be "qualified small business stock."