Proper Tax Planning is Key for Small Businesses After the Tax Cuts and Jobs Act

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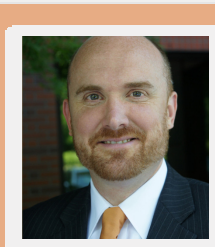
Note from Adam Rose:

The TCJA creates dramatic planning opportunities for operating businesses, business owners, and professional service providers. Whether you are looking to save money on income tax in 2018, hoping to create a more efficient estate plan, or wondering how the new tax law will impact your business ownership transition plan, Rose Law can assist you in evaluating how you can use the provisions in the new law to minimize your tax liability. Please contact us at **503-278-7618** or **arose@rose-law**.com to schedule a time for us to assist you in evaluating your individual situation.



Coby Hyman is not employed by nor a member of Rose Law Firm. Coby practices law from a separate and independent law firm. However, Coby associates with Rose Law Firm to serve specific clients of Rose Law Firm on discrete matters.

The Tax Cuts and Jobs Act of 2017 (the "TCJA") was signed into law by President Trump on December 22, 2017. The TCJA contains numerous changes to the Internal Revenue Code (the "Code"). The two most sweeping changes made to the Code under the TCJA for domestic small businesses are the following:

- It allows taxpayers that qualify for the "pass-through deduction" for up to 20% of "qualified business income" that is received from a sole proprietorship, partnership, or S corporation (i.e., income flowing through to the taxpayer from pass-through entities), and

- It reduces the corporate federal income tax rate (that applies only to C-corporations) to a flat 21 percent for all tax years beginning after Dec. 31, 2017 (previously, the top marginal rate for C-corporations was 35 percent).

An overwhelming majority of small businesses in the U.S. are organized as "pass-through" entities such as S corporations, partnerships, and limited liability companies, which has generally enabled taxpayers to pay lower taxes by avoiding the double taxation regime that applies to C-corporations. Prior to the TCJA becoming law (effective January 1, 2018), the highest corporate federal income tax rate (35%) has remained only a few percentage points lower than the highest individual federal income tax rate (39.6%). Thus, little incentive has previously existed for taxpayers to attempt to "arbitrage" the

differential between individual income tax rates and the corporate income tax rate. The TCJA changes this dynamic, as discussed below.

The shareholders of a C-corporation are typically subject to two levels of federal income tax:

- The corporate level federal income tax, which is imposed on a C-corporation's taxable income in the year in which such income is earned, and

- The individual shareholder-level federal income tax, which is imposed: (a) in the year that the C-corporation distributes its accumulated profits to its shareholders in the form of paying a dividend or (b) in the year that a shareholder actually sells its stock in the C-corporation for a capital gain.

The historic combination of (i) a small differential between the highest marginal corporate income tax rate and the highest marginal individual income tax rate and (ii) two levels of federal income tax being imposed on C-corporations has encouraged small businesses to avoid the traditional corporate form of business and to instead organize as pass-through entities that only subject small business owners to one level of federal income tax.

The TCJA's significant reduction in the highest marginal corporate federal income tax rate from 35% to 21% is likely to incentivize many small businesses to consider converting to a C-corporation structure in the future. Many small businesses will soon make the decision to analyze whether the new law makes it possible to "arbitrage" a material portion of the 16% differential in tax rates that now exists between the highest corporate federal income tax rate (21%) and the highest individual federal income tax rate (37%).

Small businesses should carefully evaluate numerous factors early in the 2018 tax year to determine whether (and precisely when) it may be advantageous for a pass-through business to restructure its operations to be taxed as a C-corporation moving forward. For the owners of many small businesses, the tax planning focus will remain on minimizing taxable income under their existing pass-through structures. However, many other small businesses are likely to conclude that it will be advantageous to convert to a C-corporation structure as a result of the recent changes in the law pursuant to the TCJA. Both options are discussed in this article along with the relevant factors that should be considered by small businesses to determine the most tax-efficient organizational structure after the effective date of the TCJA.

A. The Complex "Pass-Through" Deduction for "Qualified Business Income"

A key provision that was enacted as part of the TCJA is new Section 199A of the Code, which generally allows a taxpayer (other than a corporation) to receive a deduction for any taxable year of up to 20% of "qualified business income" (QBI) received from a sole proprietorship, partnership, or S corporation (i.e., income flowing through to the taxpayer from pass-through entities). The remaining portion of such QBI is subject to taxes at regular rates, up to the new top individual income tax rate of 37%. Unfortunately, the new rules permitting deductions for pass-through businesses have numerous restrictions in place, and many taxpayers will be unable to qualify for this pass-through deduction.

The restrictions on qualifying for the pass-through deduction include the following:

- The rules explicitly exclude many items of investment income from a pass-through business as not being eligible for the QBI deduction.

- The rules exclude from QBI any W-2 wages received for services performed by an employee. This exclusion for wages may give many employees a strong incentive to recategorize their wages as "business income" in an attempt to qualify for the QBI deduction.

- The rules limit the QBI deduction to the lesser of 20% of its business income or 50% of the total wages paid by the business to its employees. For capital-intensive businesses with very few employees (e.g., real estate firms, equipment-intensive businesses, etc.), the TCJA imposes an alternative wage limit, which is 25% of W-2 wages plus 2.5% of the basis of depreciable property (e.g., equipment, real estate, etc.). However, these wage limits apply only if the taxpayer's taxable income exceeds a threshold ($157,500 for individuals and $315,000 for married couples).

- The QBI deduction does not apply to "specified service" businesses – which includes those performing services in various professional fields, including health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, or any other trade or business where the principal asset of the business is the reputation or skill of one or more of its employees. Similar to the W-2 wage limits, the specified service business limit will only apply to those whose taxable income exceeds defined thresholds ($157,500 for individuals, and $315,000 for married couples). For many taxpayers who are performing services in a "specified service" business, being phased-out of the QBI deduction will create a material incentive for such taxpayers to consider converting their existing pass-through business to a C-corporation structure.

Each of the above-mentioned restrictions are complex, so qualifying for the pass-through deduction is a very taxpayer specific exercise that requires careful planning to be implemented to maximize the tax benefit to the relevant pass-through business owner. The potential benefits of the pass-through deduction should be weighed by small businesses against the anticipated benefits of converting to a C-corporation structure.

B. The Impact of the Significant Reduction in Corporate Tax Rates

While the pass-through deduction discussed above is clearly important to many small businesses, the arguably even more important provision of the TCJA to many small business owners is the reduction in the highest marginal corporate tax rate by an astounding 14% (from the previous highest marginal corporate tax rate of 35%). Numerous issues must be addressed to determine whether it advantageous for a small business owner to convert to a C-corporation structure. Many of those issues are briefly discussed below.

1. Does the business's owner's marginal income tax rate exceed the new 21% corporate tax rate?

First of all, it is important to note that the federal income tax rate that applies to C-corporations under the new law is a 21% flat tax rate. There is no longer a graduated tax rate structure for C corporations.

The largest determinant of whether to remain a pass-through business or convert to a C-corporation will be the tax rate that applies to a business when it eventually distributes its earnings. A significant part of the calculus is deciding between a higher effective rate (in a pass-through business scenario) and a lower effective rate with a potential double level of tax (in a C-corporation scenario). Since the second level of tax doesn't occur until a shareholder receives a distribution from a C-corporation, a small business owner must carefully analyze two key questions:

- Is it possible to reduce (or eliminate) the second layer of tax?
- How much money will the business owner need to distribute and how long can he/she wait to distribute the earnings of the C-corporation?

These two key questions are discussed briefly below.

2. Can the taxpayer successfully minimize the second layer of individual federal income tax? What action(s) can a taxpayer take to make this possible?

There are a number of different strategies (discussed below) that a taxpayer can employ in an attempt to increase the likelihood that he or she will be able to successfully minimize (and possibly eliminate) the second layer of federal income tax. The strategies discussed below are different methods that can potentially be employed by a taxpayer in an attempt to minimize the second layer of tax that normally applies to distributions received by a shareholder in a C-corporation.

a) Anticipating a stepped-up basis at the taxpayer's death.

The C-corporation stock can simply be held until the taxpayer's death, at which point the second level of tax is entirely wiped out (under current law) if the C-corporation stock qualifies for a "step-up" in basis under Section 1014 of the Code, which generally allows the income tax basis of property received by a person from a decedent to be "stepped-up" to a basis that is equal to the fair market value of the stock at the date of the decedent's death.

b) Using a Roth retirement account to prevent paying tax on retirement distributions.

In general, a taxpayer is allowed to hold shares in a closely held corporation in his or her Roth retirement account, which exempts future investment returns from tax. Thus, if a taxpayer has previously established a self-directed Roth retirement account, wishes to convert an existing retirement account into a Roth IRA, or is eligible to make a new contribution to a Roth IRA based on the applicable limitations that apply to new Roth IRA contributions, then the taxpayer should at least consider using available funds in a Roth IRA to acquire shares in a closely held C-corporation to which the taxpayer provides services or any other closely held C-corporation in which the taxpayer expects significant earnings to be generated from the business activities or investment activities in which the C-corporation will be engaged. In a Roth IRA account, since the taxpayer has <u>already paid income tax</u> on the funds contributed to the Roth account at the time of the original contribution or at the time of a conversion from a regular pre-tax retirement account to the Roth account, no second level of income tax would ever be imposed upon a distribution by the C-corporation to the Roth IRA.

c) Taking advantage of lower tax rates in retirement.

Even if the shares of a C-corporation are not held in a Roth account, the taxpayer may similarly attempt to reduce the individual level income tax by waiting until retirement to receive distributions, when the taxpayer may potentially be subject to lower marginal income tax rates than the marginal income tax rates that apply to the taxpayer in years prior to the taxpayer's retirement.

d) Partial or full exclusion for gains realized upon sale of an investment in "qualified small business" stock.

For taxpayers other than corporations, if the taxpayer owns "qualified small business stock" (QSB) in a C-corporation and the QSB is held for more than five years, then a specified portion (and possibly 100%) of the gain recognized on the sale or exchange of the QSB stock is excluded from gross income. Thus, if the stock of a C-corporation meets the definition of "qualified small business stock," then the shareholder of the C-corporation will not be required to pay a shareholder-level tax on a distribution from the C-corporation or on gain realized from the sale of the QSB that occurs after the required five year holding period has been met.

3. When is the taxpayer likely to need access to the profits earned by the small business?

A taxpayer that is considering converting a small business to a C-corporation structure must have a long-term focus and must plan on a recurring basis to determine the best method for accessing the earnings of the C-corporation as they will be needed by the taxpayer. Although the taxpayer of course does not have a "crystal ball" and cannot predict the future, a taxpayer that is seriously considering converting a small business to a C-corporation structure will need to attempt to forecast when the taxpayer is likely to need access to the profits earned by the C-corporation and to plan accordingly.

C. Tax Planning is Important Early in 2018

It will be important for small businesses to engage experienced tax counsel early in the New Year to evaluate the complex provisions of the TCJA that affect the decision of whether a business should continue to operate as a pass-through entity or should consider converting to a C-corporation structure.

In many cases, financial modeling under various different scenarios will need to be evaluated and careful tax planning will need to be implemented to maximize the tax-efficiency of small businesses.

Our firm can assist your small or middle market business with choosing the most tax-efficient structure for operating your business moving forward. In many cases, it will make sense for a business to continue operating as a pass-through business. In many other cases, it will make sense for a small business to convert to a C-corporation structure. Rose Law Firm can help you evaluate your options and conduct the required planning that will be necessary for your business to either (a) qualify for the pass-through deduction or (b) convert to a C-corporation structure in a manner that is most likely to minimize taxes over the long-term, given the specific goals of the relevant small business owner.

Please contact us to schedule an initial conference to discuss the most viable tax planning strategies for your small business.