Revisiting TCJA, 199A, Entity Selection, and Tax Reform 2.0

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Covered Topics

- Tax Cuts and Jobs Act Summary
  - Individuals
  - Estate and Gift
  - Business / International
- Section 199A
  - Summary
  - Proposed Regulations
- Entity Selection
- Tax Reform 2.0

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A Summary of the Tax Cuts and Jobs Act

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Tax Brackets for Single Taxpayers

2017: If Taxable Income is Between:	2017: The Tax Due Is:
0 - $9,325	10% of taxable income
$9,326 - $37,950	$932.50 + 15% of the amount over $9,325
$37,951 - $91,900	$5,226.25 + 25% of the amount over $37,950
$91,901 - $191,900	$18,713.75 + 28% of the amount over $91,900
$191,651 - $416,700	$46,643.75 + 33% of the amount over $191,650
$416,701 - $418,400	$120,910.25 + 35% of the amount over $416,700
$418,401 +	$121,505 + 39.6% of the amount over $418,400

2018: If Taxable Income is Between:	2018: The Tax Due Is:
0 - $9,525	10% of taxable income
$9,526 - $38,700	$952.50 + 12% of the amount over $9,525
$38,701 - $82,500	$4,453.50 + 22% of the amount over $38,700
$82,501 - $157,500	$14,089.50 + 24% of the amount over $82,500
$157,501 - $200,000	$32,089.50 + 32% of the amount over $157,500
$200,001 - $500,000	$45,689.50 + 35% o the amount over $200,000
$500,001 +	$150,689.50 + 37% of the amount over $500,000

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Tax Brackets for Married Filing Joint Taxpayers

2017: If Taxable Income is Between:	2017: The Tax Due Is:
0 - $18,650	10% excess of taxable income
$18,651 - $75,900	$1,865 + 15% of the amount over $18,650
$75,901 - $153,100	$10,452.50 + 25% of the amount over $75,900
$153,101 - $233,350	$29,752.50 + 28% of the amount over $153,100
$233,351 - $416,700	$52,222.50 + 33% of the amount over $233,350
$416,701 - $470,700	$112,728 + 35% of the amount over $416,700
$470,700 +	$131,628 + 39.6% of the amount over $470,701

2018: If Taxable Income is Between:	2018: The Tax Due Is:
0 - $19,050	10% of taxable income
$19,051 - $77,400	$1,905 + 12% of the amount over $19,050
$77,401 - $165,000	$8,907 + 22% of the amount over $77,400
$165,001 - $315,000	$28,179 + 24% of the amount over $165,000
$315,001 - $400,000	$64,179 + 32% of the amount over $315,000
$400,001 - $600,000	$91,379 + 35% of the amount over $400,000
$600,001 +	$161,379 + 37% of the amount over $600,000

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Tax Brackets for Married Filing Separate Taxpayers

2017: If Taxable Income is Between:	2017: The Tax Due Is:
0 - $18,650	10% of taxable income
$18,651 - $75,900	$1,865 + 15% of the amount over $18,650
$75,901 - $153,100	$10,452.50 + 25% of the amount over $75,900
$153,101 - $233,350	$29,752.50 + 28% of the amount over $153,100
$233,351 - $416,700	$52,222.50 + 33% of the amount over $233,350
$416,701 - $470,700	$112,728 + 35% of the amount over $416,700
$470,701 +	$131,628 + 39.6% of the amount over $470,000

2018: If Taxable Income is Between:	2018: The Tax Due Is:
0 - $9,525	10% of taxable income
$9,526 - $38,700	$952.50 + 12% of the amount over $9,525
$38,701 - $82,500	$4,453.50 + 22% of the amount over $38,700
$82,501 - $157,500	$14,089.50 + 24% of the amount over $82,500
$157,501 - $200,000	$32,089.50 + 32% of the amount over $157,500
$200,001 - $300,000	$45,689.50 + 35% o the amount over $200,000
$300,001 +	$80,689.50 + 37% of the amount over $300,000

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Standard Deduction & Personal Exemptions

- Standard deduction increased to the following:
  - $12,000 – Single and married filing separate
  - $18,000 – Head of household
  - $24,000 – Married filing jointly and surviving spouse
- Amounts are adjusted for inflation after 2018
- Personal exemptions suspended until 2026

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Itemized Deductions

The Good

- Pease limitations of overall itemized deduction suspended (3% of Adjusted Gross Income (AGI))
- AGI floor for deductible medical expenses decreased from 10% to 7.5% until 2019
- Charitable contributions now deductible up to 60% of AGI rather than 50%

The Bad

- Miscellaneous itemized deductions that are subject to the 2% floor are suspended
- State, local, and real estate tax deduction limited to $10,000
- Increased limitations on deductible mortgage interest expense (750K)
- Home equity interest deduction disallowed unless used to buy, build, or substantially improve home securing loan

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Other Individual Changes

- Alimony paid under agreements executed after Dec. 31, 2018, is not deductible by payer spouse nor taxable to payee spouse
- The Affordable Care Act (ACA) individual mandate is permanently repealed after Dec. 31, 2018
- AMT retained but at substantially higher exemption levels as follows:
  - $109,400 for joint
  - $70,300 for single
  - $54,700 for married filed separately
- Kiddie tax “eliminated” - now uses trust/estate rates (a standard deduction still exists)

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Other Individual Changes (Cont.)

- 529 plan distributions can be used to pay up to $10,000 in expenses for public, private, or religious elementary or secondary school
- Repealed provisions for IRA recharacterizations
  - The ability to change your mind after converting a traditional IRA to a Roth IRA is gone
  - Converting from a nondeductible IRA to a Roth IRA remains unchanged
- Increased the child tax credit and increased limitation thresholds
  - Credit is worth up to $2,000 per qualifying child, of which $1,400 is refundable
  - AGI phase-out for the credit increased to $400,000 (joint filers)

Estate and Gift Tax

- Increased the estate, gift, and Generation Skipping Tax (GST) exemptions to approximately $11,200,000 per person
  - Applies to estates and gifts after Dec. 31, 2017 and before Jan. 1, 2026
  - Husband and wife have $22,400,000 combined exemption
- Gift tax exemption amount for 2018 increased to $15,000
- Exemptions are indexed for inflation

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Summary of Key Changes - Businesses

- Entertainment, amusement, or recreation expenses are no longer deductible unless for the benefit of employees
- 100% bonus depreciation for eligible property for property acquired and placed in service after Sept. 27, 2017 and before Jan. 1, 2023
- Section 179 expensing increased to $1 million (phase-out begins at $2.5 million)
  - Expanded definition of Section 179 eligible property to include HVAC
- Limitation on deduction of business interest when average receipts over the last 3 years exceeds $25 million
  - Expenses in excess of 30% of the business' adjusted taxable income (add back interest, depreciation, amortization, and depletion)
  - Depreciation not added back after 2021
- Domestic production activities deduction (DPAD) repealed

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Summary of Key Changes - Businesses (Cont.)

- Any producer or reseller that meets the $25 million gross receipts test (average of preceding three years) is exempt from the application of Code Sec. 263A UNICAP rules
- Taxpayers meeting the $25 million gross receipts test may also use completed contract method for contracts to be completed within 2-years instead of percentage of completion method for contracts entered into after 2017
- Taxpayers meeting the $25 million gross receipts test may also use cash basis method of accounting
- An accounting method change under this rule is a change in the taxpayer's accounting method for purposes of Code Sec. 481
- Like-kind exchanges are no longer permitted except for real estate

Changes Specific to C-Corporations

- Created flat tax rate of 21% (including capital gain income)
- Corporate AMT repealed
  - Prior year AMT credits are refundable in an amount equal to 50% of the excess credit for the tax year over the amount of credit allowable for the year against regular tax liability
- Net operating losses no longer have 2-year carryback option except for certain farming and insurance businesses
- Net operating losses arising in tax years beginning after Dec. 31, 2017 are limited to 80% of taxable income

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Changes Specific to C-Corporations (Cont.)

- Dividend received deduction reduced to 50%, from 70%, for less than 20% owned domestic corporations
- Dividend received deduction reduced to 65%, from 80%, for 20% or more owned of domestic corporations

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Changes Specific to Pass-Through Entities

- Technical termination rule repealed (Partnership Only)
  - Under old tax law, a 50% or more transfer of ownership within a 12-month period would trigger a technical termination
- Section 199A: Qualified Business Income Deduction – discussed later
- Business losses limited to threshold amounts
  - $250,000 for single filers & $500,000 for joint filers
  - Excess loss “rolls” into NOL carryforward, which is subject to an 80% annual limit
  - Losses and income from all businesses are first netted against each other
  - Sunsets in 2026

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International Changes

- Introduction of a one-time repatriation tax (Section 965)
  - Calculate a 15.5% tax on accumulated post-1986 earnings in foreign entities
  - Tax can be paid over 8 years
  - Can be deferred until a triggering event on the shareholder level (Pass-throughs only)
  - Should already be accounted for by most businesses on their Dec. 31, 2017 tax returns
- Dividends received from foreign corporations owned 10% or more are eligible for a 100% dividend received deduction to due the switch to a territorial system
- Various topics that are outside the scope of this webinar

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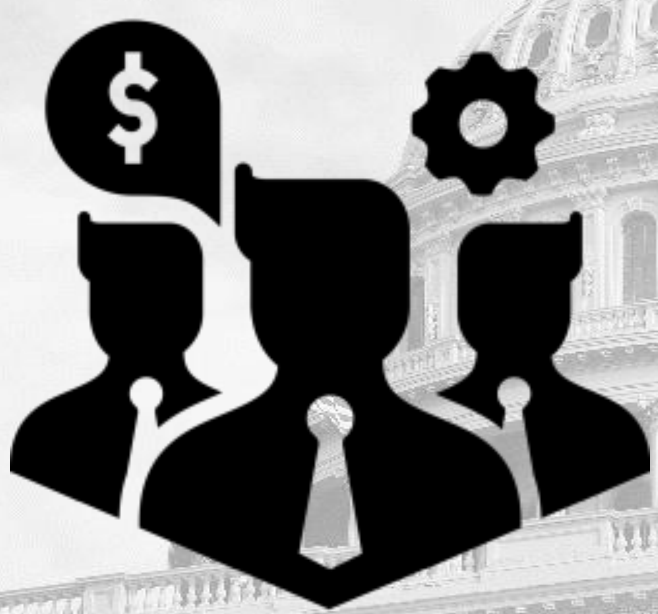
Section 199A



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Section 199A – In General

- New “below the line” deduction for “qualified business income”(QBI) from pass-through entities (S-corporations and partnerships) and sole proprietorships
- Maximum deduction is 20% of QBI
- Non-corporate taxpayers (including estates and trusts) are eligible to claim the deduction
- Effectively reduces the rate on pass-through income to eligible taxpayers to 29.6%
- Sunsets in 2026
- One of the most complicated, least understood aspects of the new tax law will have the greatest effect on pass-through businesses

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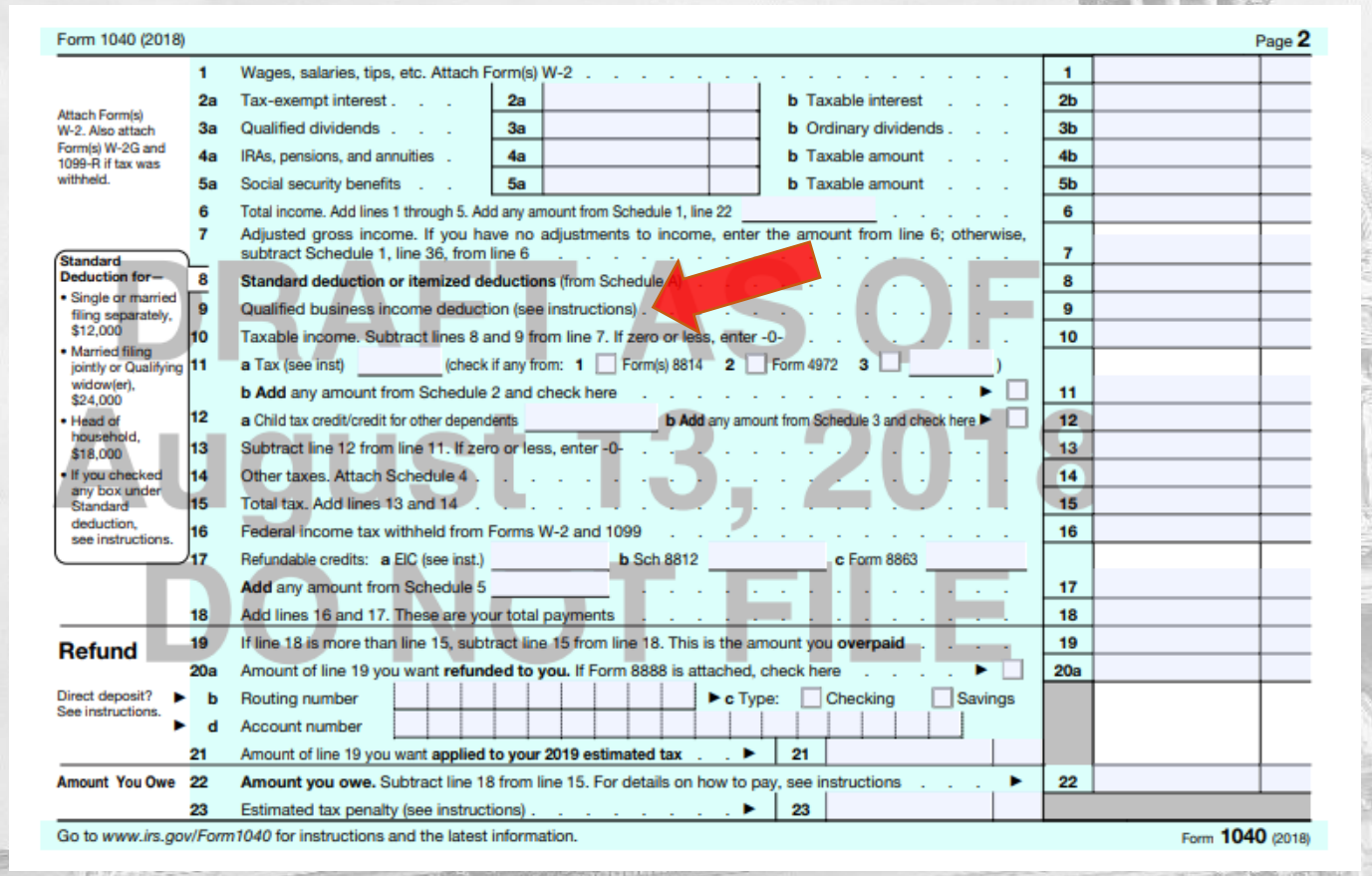
Section 199A – Location on Form 1040



Form 1040 (2018) Page 2

Attach Form(s) W-2. Also attach Form(s) W-2G and 1099-R if tax was withheld.	1	Wages, salaries, tips, etc. Attach Form(s) W-2			1	
	2a	Tax-exempt interest	2a	b Taxable interest	2b	
	3a	Qualified dividends	3a	b Ordinary dividends	3b	
	4a	IRAs, pensions, and annuities	4a	b Taxable amount	4b	
	5a	Social security benefits	5a	b Taxable amount	5b	
	6	Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22			6	
	7	Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 36, from line 6			7	
Standard Deduction for— • Single or married filing separately, $12,000 • Married filing jointly or Qualifying widow(er), $24,000 • Head of household, $18,000 • If you checked any box under Standard deduction, see instructions.	8	**Standard deduction or itemized deductions** (from Schedule A)			8	
	9	Qualified business income deduction (see instructions)			9	
	10	Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-			10	
	11	a Tax (see inst) (check if any from: 1 ☐ Form(s) 8814 2 ☐ Form 4972 3 ☐)			11	
	12	**b Add** any amount from Schedule 2 and check here ▶ ☐			12	
	13	a Child tax credit/credit for other dependents **b Add** any amount from Schedule 3 and check here ▶ ☐			13	
	14	Subtract line 12 from line 11. If zero or less, enter -0-			14	
	15	Other taxes. Attach Schedule 4			15	
	16	Total tax. Add lines 13 and 14			16	
	17	Federal income tax withheld from Forms W-2 and 1099			17	
	18	Refundable credits: a EIC (see inst.) b Sch 8812 c Form 8863 **Add** any amount from Schedule 5			18	
	19	Add lines 16 and 17. These are your total payments			19	
Refund	20a	If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you **overpaid**			20a	
Direct deposit? See instructions.	b	Amount of line 19 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐				
	d	▶ b Routing number ▶ c Type: ☐ Checking ☐ Savings				
	21	▶ d Account number				
Amount You Owe	22	Amount of line 19 you want **applied to your 2019 estimated tax** ▶	21			
	23	**Amount you owe.** Subtract line 18 from line 15. For details on how to pay, see instructions ▶			22	
		Estimated tax penalty (see instructions) ▶	23			

Go to *www.irs.gov/Form1040* for instructions and the latest information. Form **1040** (2018)

DRAFT AS OF August 13, 2018 DO NOT FILE

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Section 199A – Qualified Business Income

- Generally, the QBI is ordinary income, gain, deduction, and loss of qualified trade or business
- Excluded items – the taxpayer's wages (or reasonable compensation), guaranteed payments, and investment-type income (capital gains, interest, dividends)

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Section 199A – Calculation

- Subject to certain limits and thresholds, the deduction generally is the sum of:
  - The lesser of:
    - 20% of the taxpayer's qualified business income; or
    - The greater of:
      - 50% of the W-2 wages with respect to the business, or
      - 25% of the W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified depreciable property
  - Plus 20% of REIT dividends and distributions from publicly traded partnerships

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Section 199A – Limits

- Availability and/or calculation of the deduction is subject to limits based on the taxpayer's income and the type of business conducted:

Total Taxable Income	If taxable income does not exceed threshold (Single - $157,500/ Joint - $315,000):	If taxable income is at the threshold plus a phase in:	If taxable income is over the threshold (Single - $207,501/ Joint - $415,001) :
Specified Service	Full 20% deduction, no W2/basis limit	20% deduction subject to phase-out, W2/base limit phased in	No deduction permitted
Non-specified Service	Full 20% deduction, no W2/basis limit	20% deduction subject to phase-in of W2/basis limit	20% deduction permitted but fully subject to W2/basis limit

Specified Service Trade or Business defined: A trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performance arts, consulting, athletics, financial services, brokerage services and where the principal assent of the business is the reputation of skill of one or more of its employees, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests or commodities.

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Section 199A – Examples

- Example 1: A wholly-owned business purchases an office building for $4 million ($2 million building, $2 million land). The building generates annual net rental income of $400,000.
  - The maximum potential allowable pass-through deduction would be $80,000 (20% of $400,000). If the business paid no wages, the business would qualify for a deduction of only $50,000 (2.5% of $2 million).
- Example 2: Same facts as Example 1, but $3 million is allocated to the building. The deduction would be limited to $75,000 (2.5% of $3 million).

Section 199A – Examples

- Example 3: Same as facts as Example 1, but assume the business pays $100,000 of W2 wages. The pass-through deduction would now be $75,000, which was calculated by the following method:
  - 50% of W-2 wages (100,000 x .5) = $50,000

  or
  - 2.5% x $ 2 million building base = $50,000
  - 25% x $100,000 of W2 wages = $25,000
  - $50,000 + $25,000 = $75,000

  - Overall limit would be $80,000 (400,000 x 20%), but only $75,000 can be used

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Section 199A – Taxable Income Limit

- Deduction is limited to 20% of excess of taxable income over net capital gain
- Example: $100,000 of QBI, $200,000 of long-term capital gain, and $50,000 of itemized deductions, resulting in taxable income of $250,000
- Before application of limit, deduction is equal to 20% of QBI of $100,000 or $20,000
- Taxable income less net capital gain is $50,000 ($250,000 - $200,000 = $50,000)
- Therefore, the deduction will be reduced under this limit from $20,000 to 20% of $50,000 or $10,000
- Dividends are not subtracted even though they are taxed at capital gain rates

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Section 199A - IRS Proposed Regulations

- On August 8th the Internal Revenue Service (IRS) issued Proposed Regulations to Section 199A
- A public hearing on the Regulations is scheduled for Oct. 16, 2018
- Evidencing the complexity, the Preamble was 104 pages and the six sections were 80 pages

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199A Proposed Regulations - SSTBs

- Specified Service Trade or Business (SSTB)
  - Definition generally tracks the definition of qualified personal service business contained in Internal Revenue Code (IRC) section 448
    - Many fields in health, professional services, performing arts, consulting, athletics disqualified
    - Architecture, engineering, banking, and others qualify
  - Primary question may be, “What is meant by the principal asset of the business being the reputation of its employees or owners?”
  - Regulations address this and appears to be taxpayer friendly
  - Each entity will be required to disclose to its owners whether it is a SSTB

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199A Proposed Regulations - SSTBs

- Regulations provide a de minimis exception for businesses that partly qualify for QBI and are partly SSTB
  - If gross receipts < $25M, 10% of gross receipts can be disqualified and will not be treated as SSTB
  - If gross receipts >$25M, 5% of gross receipts replaces 10% above

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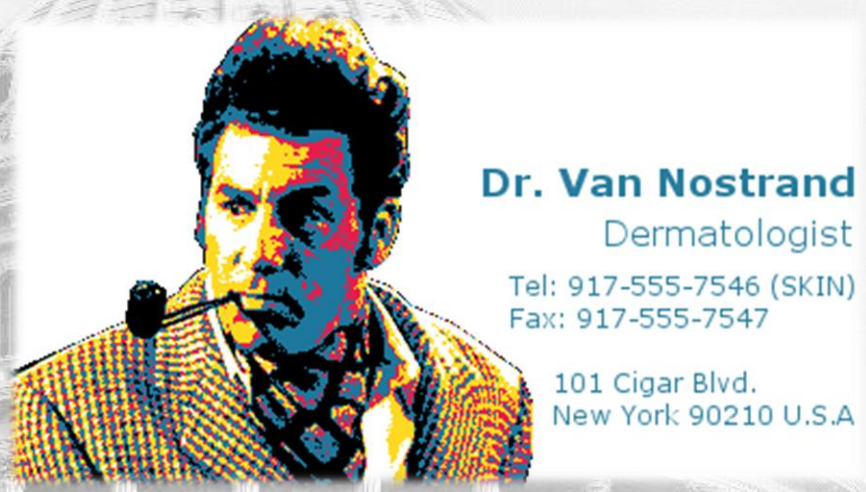
199A Proposed Regulations - SSTBs

- A plan to spin off administrative and non-professional service functions from SSTBs ("crack and pack"), was derailed by the IRS which said the entities would be combined for purposes of 199A
  - Any business that provides 80% or more of its property or services to an SSTB
  - 50% or more common ownership
  - Any business that provides less than 80% will not be treated as an SSTB, however any income earned or services provided to the SSTB is ineligible

199A Proposed Regulations - SSTBs

- Example: Dr. Martin Van Nostrand is a doctor who owns his own dermatology practice
- Dr. Van Nostrand also owns his office building 100% and his dermatology practice is his only tenant
- Rent is $100K a year
- All rents are SSTB rents and ineligible for 20% deduction



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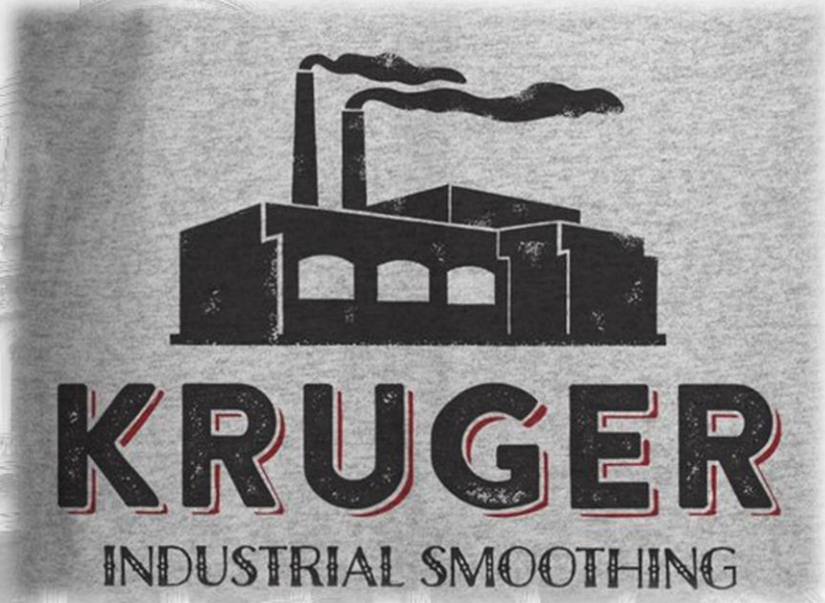
199A Proposed Regulations - SSTBs

- Example, same as above, except Kruger Industrial Smoothing becomes a tenant
  - Rent is $24,000 a year
  - All rents still considered SSTB rents and ineligible ($100,000 / $124,000 = 81%)
  - Rent is $50,000 a year
  - $100K of rents still SSTB, however 50K of rents now eligible for 20% deduction



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Section 199A - Aggregation

- Aggregation of commonly controlled businesses was an unknown before regulations were issued
- Does not follow the rules of Section 469, meaning a new set of rules
- Election is done at the individual level
- Aggregation election must be attached to tax return each year
- Must combine QBI, wages, and basis of qualified property
- Once elected, election cannot be revoked but can be modified to remove previously aggregated businesses or add new businesses if aggregation requirements are met
- IRS may disaggregate if statement is not attached

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Section 199A – Aggregation Requirements

- The same persons must directly or indirectly own 50% or more of each business in order to aggregate (attribution rules apply)
- The test above is met for the majority of the tax year
- The businesses being aggregated share the same tax year
- The businesses may not be SSTBs
- Aggregated businesses must satisfy two of the following:
  - Similar products/services
  - Shared facilities or centralized business elements
  - Businesses are operated/relied upon one of the aggregated businesses

Section 199A – Aggregation Example

- George owns 100% of Vandelay Industries, a manufacturer taxed as an S corp.
- George owns 50% of Costanza & Son, an S corp that sells computers, and his father, Frank, owns 50%
- Both entities lease office space from an LLC that is owned 95% by Frank, 5% by George
- What if Frank owned 100% of the LLC?

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Section 199A – Reasonable Compensation

- Reasonable Compensation to S Corporation shareholders-employees is not considered QBI
- Should compensation be adjusted to maximize QBI?
- Inequities between an S corporation and sole proprietor exist

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Section 199A – Reasonable Comp Example

- Example – Kramerica Industries is owned 100% by H.E. Pennypacker, a single taxpayer
- Kramerica makes $400,000 taxable income before any shareholder compensation is paid
- Assume all activities qualify for QBI

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Section 199A – Reasonable Comp Example

- If Kramerica is an S corp:
  - Reasonable compensation of $100,000 is paid to Pennypacker on W-2
  - QBI is $300,000, maximum deduction is $300,000 x 20% = $60,000
  - QBI is limited to 50% of wages, or $50,000 ($100,000 x 50%)
- If Kramerica is a sole proprietorship
  - No reasonable compensation exists as wages cannot be paid
  - QBI is $400,000, maximum deduction is $400,000 x 20% = $80,000
  - QBI is limited to 50% of wages, or zero

Section 199A – Reasonable Comp Example

- Assume the same facts, except taxable income is $150,000
- S corp:
  - Reasonable compensation of $100,000 is paid to Pennypacker on W-2
  - QBI is $50,000, maximum deduction is $50,000 x 20% = $10,000
- Sole Proprietorship:
  - No reasonable compensation exists as wages cannot be paid
  - Taxable income is below $157,500, entire amount subject to maximum 20% deduction
  - $150,000 x 20% = $30,000

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Section 199A – Losses, Carryover and Netting

- If all qualified businesses' QBI is less than zero:
  - QBI is zero for the current taxable year
  - Negative amount is treated as negative QBI in the following taxable year
  - Wages and basis of qualified property are not carried to following year
- What if some businesses have QBI and some have a loss?
  - If QBI nets to a positive amount, losses are allocated among all businesses that have positive QBI in proportion to their respective amounts of QBI
  - After this, then W-2 and basis limitations apply
  - W-2 and basis from loss businesses are not included

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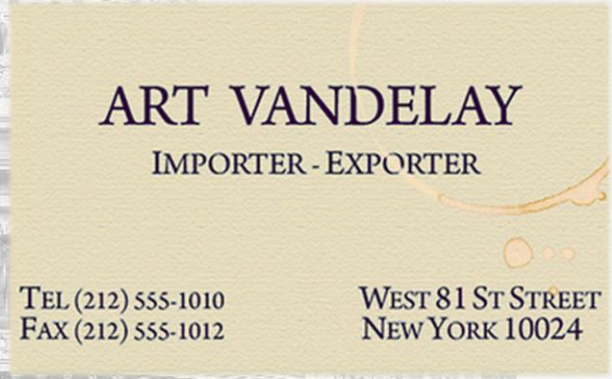
Section 199A – Netting Example

- Example:
  - Art Vandelay, a married taxpayer owns his own architecture firm that has $500,000 of taxable income and has $1M of W-2 wages
  - Mr. Vandelay also owns an importing/exporting company that has a $200,000 loss and $1M of W-2 wages
  - $500,000 x 20% = $100,000 QBI less $200,000 x .2 = $40,000 QBI loss? NO!
  - $500,000 – $200,000 = $300,000 x 20% = $60,000 QBI
  - Wage limitation for $200,000 loss not considered



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Section 199A – Netting Example

- Example:
  - Same as above, except Art Vandelay is also an author with $100,000 of taxable income but $0 wages (sole proprietorship)
  - $200,000 loss from importing/exporting business is allocated proportionately
    - $500,000 + $100,000 = $600,000 taxable income
    - 5/6ths, or approximately $167K, to architecture firm
    - 1/6ths, or approximately $33K, to sole proprietorship
  - $500,000 – $167,000 = $333,000 x 20% = $66,600 QBI
  - $100,000 – $33,000 = $67,000 x 20% = $13,400 QBI; W-2 limitation = 0 QBI

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199A Proposed Regulations - Miscellaneous

- NOLs from years before 2018 will not be considered in QBI
- Wages paid by Professional Employer Organizations (PEO) will qualify as wages for 199A as long as they were paid to employees of the taxpayer for employment by the taxpayer
- Section 1231 gains and losses treated as capital gains are not considered in QBI
  - This has a large consequence to businesses selling their assets
- Unadjusted basis of qualified property subject to 2.5% is determined before any bonus depreciation or 179 deductions
- Sales of partnership interests recharacterized as ordinary income are eligible for QBI
- Changes in accounting methods requiring positive or negative adjustments in the year made are treated as from the trade or business

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Section 199A – Planning Opportunities

- Switch from W-2 employee to 1099 Independent Contractor (IC)
  - Loss of employee benefits (e.g., health insurance, 401K, etc.)
  - IC must pay all self-employment taxes
  - Employer may prefer paying W-2 employees to “max out” on its pass-through deduction
  - Need to revisit employee vs. IC classification criteria
- Revisit reasonable compensation for shareholders
  - Too high of wages = more income tax at ordinary rates
  - Too low of wages = unreasonable compensation
- Aggregation
  - Method of aggregation important!
  - Don’t be short sighted with aggregation in year 1

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Entity Selection

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Entity Selection - C vs. S Corporation

- As a result of the new lower tax rate, should taxpayers reconsider their choice of entity?
  - With the reduced C Corporation tax rate of 21%, C Corporation structure seems most beneficial on the surface
  - Owners of qualifying pass-through entities receive a new Business Income Deduction of up to 20% of income
- However, there are some important questions to consider:
  - How often will the company distribute profits?
  - Do the shareholders expect a certain level of cash distributions year-to-year?
  - Will the corporation qualify as a Personal Holding Company (PHC)?
  - Could the corporation be subject to the Accumulated Earnings Tax?
  - Is there a plan in place for the future of the company?
  - What happens to sole proprietors?

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Entity Selection – Effective Rates

	C Corporation	Pass-through
Income Tax Rate	21%	29.6% (effective)*
Dividend/Exit Tax Rate	20% + 3.8% = 23.8%	0%
Aggregate Tax Rate	39.8%	29.6%
State/Local Tax Deductibility	100%	Property taxes deductible, SALT income taxes not deductible

- * = Assumes no 3.8% tax applicable and full use of 20% pass-through deduction (Highest individual rate of 37% * 80% = 29.6% highest individual rate)
- Does not take states into consideration

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Entity Selection – Profit Distributions

- Shareholder A receives $20,000 per year as a tax-free distribution from his S Corporation
- If the entity converts to a C Corporation, the tax implication increases above 21% as the funds will be taxed at the shareholder level as well

	Pass-through	C Corporation
Distribution (Dividend)	$20,000	$20,000
Tax*	$-0-	$ 4,760
Net Cash to Shareholder	$20,000	$15,240

*20% dividend rate + 3.8% NIIT rate

- Entities that reinvest funds and do not regularly distribute profits benefit the most

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Entity Selection – S to C Conversion Distributions

- Post Termination Transition Period (PTTP) – the period beginning on the day following the termination of the S election and ending on the later of (1) one year after the termination date, or (2) the due date for filing the final S Corporation return (including extensions)
  - The PTTP allows the C Corporation to make tax-free distributions of money to the extent of (1) the Accumulated Adjustments Account (AAA) from the time spent as an S Corporation, and (2) the shareholder's basis in corporation stock under IRC Sec. 1371(e)(1).
  - Traditionally, if the company cannot distribute all AAA during the PTTP, remaining AAA essentially disappears.
- P.L. 115-97 provides that certain S Corporations can treat distributions following the PTTP as proportionately paid from AAA and from Accumulated E&P.
  - Only applies to S Corporations that revoke S Corporation status within 2 years of enactment of P.L. 115-97, and share ownership on date of revocation must be identical to that on the date of the law's enactment (December 22, 2017)
- An S Corporation may elect to make all distributions during the PTTP out of E&P rather than AAA.

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Entity Selection – Personal Holding Company

- Pass-through entities are not subject to Personal Holding Company (PHC) rules
- Closely held C corporations must be careful to avoid PHC status
  - If income is not distributed and the corporation is subject to the Personal Holding Company tax, a 20% tax will be imposed on the undistributed PHC income (IRC Sec. 541)
  - Must meet two objective tests for PHC status:
    - Income – at least 60% of the corporation's adjusted ordinary gross income is PHC income (Sec. 542(a)(1))
    - Ownership – More than 50% of the value of the corporation's outstanding stock is owned (directly or indirectly) by five or fewer individuals on any day during the last half of the corporation's tax year (Sec. 542(a)(2))

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Entity Selection – Accumulated Earnings Tax

- Accumulated Earnings Tax – A tax penalty assessed by the IRS when a C Corporation retains earnings above an amount which the IRS determines is reasonable.
  - 20% of accumulated taxable income
  - Intended to discourage the accumulation of earnings to allow shareholders to avoid paying income taxes on dividends.
- What is "reasonable"?
  - $250,000 or less is considered reasonable
  - Amounts in excess of $250,000
    - Specific, definite, and feasible plans for use of the cash
    - Amount necessary to redeem corporation's stock
- Lack of regular withdrawals can indicate absence of a bona fide business purpose for accumulating earnings

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Entity Selection – Example 1

- Facts:
  - Married taxpayer
  - $300,000 gross income
  - Assumed 5% state/local combined rate
  - QBI qualified activity
    - Taxable income less than $315,000 (MFJ)
  - Owner is only employee, owner wages are the only expense
  - Assumes $10,000 SALT deduction limit has been met on Schedule A of 1040

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Entity Selection – Example 1

	Schedule C	S Corporation
Gross Income (A)	$300,000	$300,000
Owner Wages (B)	$-0-	($100,000)
Net Income (C = A-B)	$300,000	$200,000
Qualified Business Income Deduction (D = C * 20%)	($60,000)	($40,000)
Self-Employment Tax (E = C * 15.3%)	$ 24,622	$-0-
Deductible Portion of Self-Employment Tax (F = 0.5 * E)	($12,311)	$-0-
Taxable Income (G = A-D-F)	$227,689	$260,000
Federal Tax	$43,224	$50,979
State/Local Tax (G * 5%)	$11,384 (Not Deductible)	$13,000 (Deductible)

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Entity Selection – Example 2

- Same facts as Example 1, except:
  - $500,000 gross income
  - QBI qualified activity
    - Section 199A deduction is limited to 50% of the W-2 wages

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Entity Selection – Example 2

	Schedule C	S Corporation
Gross Income (A)	$500,000	$500,000
Owner Wages (B)	$-0-	($100,000)
Net Income (C = A-B)	$500,000	$400,000
Qualified Business Income Deduction (D = C * 20%)	$-0-	($50,000)
Self-Employment Tax (E = C * 15.3%)	$30,422	$-0-
Deductible Portion of Self-Employment Tax (F = 0.5 * E)	($15,211)	$-0-
Taxable Income (G = A-D-F)	$484,789	$450,000
Federal Tax	$121,055	$108,879
State/Local Tax (G * 5%)	$24,239 (Not Deductible)	$22,500 (Deductible)

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Entity Selection – Other Considerations

- Potential for future changes to the tax law could reverse logic
- Moving from S to C Corporation eliminates basis adjustments to shareholder's stock
- If the company is sold during the C Corporation years or within 5 years of re-electing S status, it is very likely that the tax cost of the sale would eliminate any benefits of lower tax rates
  - S Corporation is subject to Built-In Gains Tax for 5 years after conversion from C Corporation
- Easy to move into C Corporation status, but difficult to move out
  - S Corporation re-election can be made after 5-taxable year wait
- Most effective strategy is a 10-year plan considering transition to C Corporation and back to S Corporation
- One size does not fit all

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Tax Reform 2.0

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Protecting Family and Small Business Cuts Act of 2018

- Bill created to make permanent many of the individual tax changes from the TCJA:
  - Change in individual tax rates
  - Increased standard deduction and elimination of personal exemptions
  - Increased child tax credit
  - Elimination of 2% AGI floor deductions and $10,000 limitation on the state, local, and real estate tax deduction
  - Section 199A deduction
- Bill also extends certain provisions:
  - 7.5% AGI floor for medical expense deduction through 2020 (back to 10% in 2019 under TCJA)
  - Estate exemption of $11.2 million per individual (expires in 2025 under TCJA)

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Family Savings Act of 2018

- Bill focuses on savings related to retirement and education accounts
  - Removes the 70½ age limit on IRA contributions
  - Exempt people with less than $50,000 in their retirement accounts from taking required minimum distributions
  - Allow families to withdraw up to $7,500, penalty-free, from retirement accounts for costs related to a new child
- Creates a new tax-deferred savings account – Universal Savings Account
  - Work similarly to Roth IRAs
  - Contribute up to $2,500 of after-tax income annually
  - No restrictions on when or why withdrawals can be made
  - Investment gain and interest comes out tax-free

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American Innovation Act of 2018

- Allows new businesses to deduct up to $20,000 in start-up expenses in the year they are incurred
- Deductible amount reduced (not below zero) by the amount of the aggregate amount exceeds $120,000
- Remainder amount is amortizable over 180-month period beginning in the month that the active business begins
- Deductible and aggregate amounts subject to inflation adjustments after 2019

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Other Potential Reform 2.0

- President Trump expressed his goal to lower corporate rates to 20% rather than the 21% under the TCJA
- Movement growing to index capital gains for inflation
  - Initial investments in securities would be adjusted for inflation
  - Many investors would see a bump-up in cost basis depending on when securities were purchased
  - Lowers capital gains tax by closing the gap between cost basis and selling price for long-term securities

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Takeaways

- With this new law, buyers will look to buy assets since they can be written off faster or, in some cases, written off immediately
- In high-income states, the capital gains rate is actually going up over the stated rate since state and local taxes are limited to $10,000 as an itemized deduction
- Entity structures need to be reviewed to see if they still make sense. Although the C Corporation rate is now a flat 21%, many other factors will impact the entity type decision

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Takeaways (Cont.)

- With the limitation on interest expenses and deductions, transactions will favor greater equity deals vs. highly leveraged with debt deals
- Due to the higher standard deduction, many taxpayers will not itemize
  - May want to double up on charitable contributions to be over the standard deduction in one year and then taking the standard deduction in the next year
- Most individuals will not have to worry about nor pay Alternative Minimum Tax (AMT)
- QBI Regulations were issued in proposed form and changes may occur in finalization process – maybe.
- Service based businesses above certain income limits do not benefit from the pass-through deduction

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Takeaways (Cont.)

- Private equity hold periods may extend longer. Requires three-year hold period for carried interest to get capital gain rate treatment and the IRS is executing plans for taxpayers trying to work around the period
- The excess business loss limitation will greatly impact taxpayers
- “Zero tax” years will not occur
- Some high income tax rate states (CA, NY & NJ) are trying to recast their individual tax payments as “charitable contributions” to work around the $10,000 tax itemized deduction. The IRS has issued Regulations to squash the tactic.

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Takeaways (Cont.)

- Manufacturing and other asset-heavy businesses seem more tax favorable due to rapid write-off of capital expenditures
- Foreign-owned businesses need to be reviewed in order to maximize offshore held assets. The new law brings very favorable, but complex tax rates
- Potentially different views for estate and gift tax planning – with the large exemptions less will be subject
- Another round of tax changes in 2018 recently was proposed including making the temporary changes permanent among other topics.
- One size does NOT fit all!

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Q & A Session

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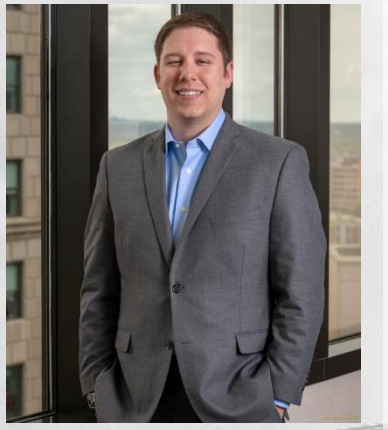

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