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Entity Choice in the Post-TCJA World: One Year Later

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INTRODUCTION AND BACKGROUND

One year after the enactment of the 2017 tax legislation commonly known as the Tax Cuts and Jobs Act (TCJA), taxpayers continue to reconsider their historic choice of entity for federal income tax purposes.[1] The vast majority of taxpayers reconsidering their entity choice are pass-through entities (S corporations, partnerships, and individuals doing business through disregarded entities), in part as a result of the decrease in the federal corporate income tax rate from 35% to 21%.[2] This article on entity choice in the post-TCJA world briefly summarizes the key considerations for pass-through business taxpayers considering conversion to C corporation status, highlights a few additional unique considerations, and describes practical tips and next steps once the pass-through entity makes the decision to convert—or not to convert—to a C corporation.

KEY CONSIDERATIONS FOR PASS-THROUGH BUSINESS TAYPAYERS

Conversations about potential conversion to C corporation status are occurring with top management, the board of directors, and owners. Considering whether to convert requires decisions about both short- and long-term business goals, growth expectations, owner exit timing, distributions, and estate tax planning.[3]

New Qualified Business Income Deduction

This new deduction allowing pass-through business owners to claim a deduction for up to 20% of their allocable ''qualified business income'' brings the individual income tax rate somewhat closer to the new corporate income tax rate.[4] For an individual paying the new top federal individual income tax rate of 37%, this deduction is equivalent to a marginal income tax rate decrease of 7.4% to 29.6%.[5] However, many pass-through businesses may not qualify for this new deduction, both because of the carve-out for ''specified service trades or businesses'' and because of the wage and property basis limitations. Furthermore, 29.6% is still 8.6% higher than the 21% federal income tax rate for C corporations. For this and other reasons, some pass-through entities have decided to convert to C corporation status entirely or partially.

Future Distributions to Owners

Many pass-through businesses make ''tax distributions'' to their owners to cover the owners' federal and state income tax liabilities for their share of the business income. Generally, partners and S corporation shareholders are not taxed on such distributions (because they have already been taxed on the underlying income). On the other hand, C corporation shareholders are not taxed on their share of C corporation earnings until the earnings are distributed, and therefore tax distributions are unnecessary. Distributions from a C corporation, however, are subject to a second level of taxation at the owner level, generally at a 23.8% federal tax rate.[6] The additional 23.8% federal income tax on dividends from earnings that have already been subject to the 21% entity-level corporate income tax

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[1] Pub. L. No. 115-97.

[2] Compare §11 before and after enactment of the TCJA. All section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

[3] Before executing any of these strategies, taxpayers must consider a number of factors that are beyond the scope of this article.

[4] §199A(a).

[5] 20% x 37% = 7.4%; 37% - 7.4% = 29.6%.

[6] §1(h)(11) (20% highest marginal qualified dividend federal income tax rate) and §1411(a) (3.8% Net Investment Income tax rate).

rate mitigates the benefit of the 21% entity-level corporate income tax rate over the 29.6% to 37% range of effective pass-through business federal income tax rates discussed above. Accordingly, the desired level of future distributions to owners impacts the conversion analysis. Generally, the more earnings a business plans to distribute in the future, the less likely it is to decide to convert to C corporation status. Further, an S corporation that decides to convert should be aware that it may make tax-free distributions of cash before or after conversion depending on the type of conversion and to certain shareholders.[7]

Growth of Reinvested Income Tax Savings

Because C corporation earnings are subject to two layers of tax when distributed, the benefit of the lower C corporation rate increases as the growth rate from reinvestment increases and as the holding period increases.[8] The C corporation also needs time for that growth to compound. Generally, the higher growth rate expectations for the income tax savings and the longer anticipated hold period before a sale, the more likely the pass-through business has been to convert to C corporation status. For many entities, the break-even holding period has been longer than 10 years. For some, it has been greater than 20 years. In fact, an existing C corporation with owners that are considering selling their stock in the next 5–10 years or so might still benefit from conversion to S corporation status.

State Income Taxes

State income taxes and rates can also significantly impact the analysis. For example, many pass-through business owners residing in states such as California and New York may pay state income tax on the pass-through business's taxable income at income tax rates above 10%. Individuals are generally subject to income tax on their entire earnings from a pass-through business in their resident state; however, the same pass-through business taxed as a C corporation may have a significantly lower effective state tax rate, whether because of apportionment or because of ''nowhere'' sales to states where it does not have income tax nexus. Furthermore, state income taxes are generally deductible by corporations, while individuals may only deduct $10,000 of state income taxes per year. On the other hand, in some cases (for example, in states like Florida), state corporate income tax rates are significantly higher than state individual income tax rates.

Estate Tax Planning

Generally, many estate tax planning considerations, such as Grantor Retained Annuity Trusts (GRATs) or Intentionally Defective Irrevocable Trusts (IDITs), rely in part on distributions from the business to transfer owner wealth. Because C corporation distributions can be subject to a second level of tax, conversion of a pass-through to a C corporation may decrease the effectiveness of estate tax planning with respect to the business. In general, pass-through businesses owned by individuals whose wealth is below the estate tax exemption amount or who have largely accomplished their estate tax planning goals have considered converting their pass-through entity to a C corporation. Other owners have decided to keep a portion of their business in pass-through status to allow for more efficient estate tax planning after conversion of the remaining portion to C corporation status.

Potential for Change

Many people have questioned whether the current tax rates will remain the same over the next few years. Even if no changes are made, many provisions of the TCJA, including the qualified business income deduction and 37% top federal income tax rate for individuals, expire after 2025. Taxpayers should consider the possible future income tax rates changes. Further, many entities that decided to convert to C corporation status have purposely structured into situations where they can convert partially or wholly back to pass-through status again if things change. For example, instead of converting a partnership directly to a C corporation, the partners might contribute their partnerships interests to different C corporation holding companies at least one of which is eligible to elect S corporation status if later desired.

ADDITIONAL UNIQUE CONSIDERATIONS

While one or any combination of the above key considerations may drive a pass-through entity's decision to convert to C corporation status, in some cases a single additional consideration unique to the particular business can drastically influence the decision. Such considerations may arise due to the nature of the business, specific business or operational practices, or industry-specific tax incentives, among other reasons. Below are some examples.

Qualified Small Business Stock

Converting to C corporation status may be more favorable for owners still eligible for and able to qualify the C corporation stock they receive as ''qualified small business stock.''[9] The requirements to qualify the stock are stringent, but, if eligible, a portion or all of the shareholder's realized gain upon the sale of the qualified small business stock is permanently excluded from taxable income of the shareholder (lim-

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[7] *See generally* §1368, §1371(e), §1371(f).

[8] A C corporation must also carefully consider application of the ''accumulated earnings tax'' with respect to retained earnings. *See* §531, et. seq.

[9] §1202(c).

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ited to a certain lifetime threshold).[10] One of the significant requirements is that the exclusion is available only for stock issued from a C corporation. Thus, an S corporation conversion to a C corporation may not qualify for the exclusion upon disposition of the stock. Even if owner exit events are planned as soon as the mid-term (e.g., 5–10 years), the owners' ability to treat the C corporation stock as qualified small business stock can weigh heavily toward conversion of a pass-through entity to C corporation status.

Significant Tax Depreciation Recapture or Other Ordinary Income on Sale

Generally, the seller of stock or a partnership interest may be eligible for the preferential long-term capital gain federal income tax rates if the equity was held for greater than one year.[11] However, in the case of a partnership interest (but not C corporation stock), gain may be recharacterized as ordinary to the extent of the selling partner's "share" of ordinary income items (often called "hot assets"). These ordinary income items include depreciation recapture and appreciated inventory.[12] These provisions are sometimes a surprise to partners selling their partnership interests.

ESOP Ownership

Some pass-throughs are partially or wholly owned by an Employee Stock Ownership Plan (ESOP). The unrelated business income rules apply to all ESOPs, except S corporation ESOP shareholders on income and gain from the pass-through entity. Pass-through entities in this structure may be less likely to convert to C corporation status. Existing C corporations may be more likely to consider converting to this structure. However, only the sale of stock to a C corporation qualifies for gain deferral under certain conditions.

Percentage Depletion

For pass-throughs that own upstream oil and gas wells, the percentage depletion rules for U.S. taxpayers, and in particular, the 1,000 barrel of oil equivalents (BOEs) per day limitation, can weigh against converting to C corporation status.[13] First, it is important to note that percentage depletion can be claimed in excess of tax basis in the oil and gas well, resulting in a potential permanent tax benefit.[14] However, a taxpayer is limited by a 1,000 BOEs per day limitation on percentage depletion. Thus, while each owner of a pass-through oil and gas business may have a separate 1,000 BOEs per day limitation on percentage depletion, a C corporation has a single 1,000 BOEs per limitation.[15] Take for example an equal partnership with 20 partners—that partnership's partners could potentially claim percentage depletion on up to 20,000 BOEs per day, while the same business held in a C corporation could only claim 1,000 BOEs per day. This consideration could weigh against an upstream oil and gas partnership converting to C corporation status.

Charitable Contributions

Another consideration that could weigh heavily against a pass-through converting to C corporation status is significant charitable contributions planned by the business. Following the TCJA, individual owners of a pass-through business can deduct charitable contributions up to 60% of their adjusted gross income depending on the type of gift and charitable donee.[16] On the other hand, C corporations can continue to deduct charitable contributions up to only 10% of their taxable income.[17] While amounts donated in excess of such limitations may be carried forward to utilize in future years where charitable contributions do not exceed such limitations, a business that intends to make significant charitable contributions on an annual basis may see its carryforwards expired unused.[18] Thus, if annual charitable contributions in excess of 10% are expected, this consideration could weigh against converting a pass-through business to C corporation status.

PRACTICAL TIPS AND NEXT STEPS ONCE THE DECISION IS MADE NOT TO CONVERT

Whether or not a pass-through business makes the decision to convert to C corporation status, this initial analysis is just the beginning of the tax planning and analysis that should be considered following enactment of the TJCA. Companies that ultimately decide not to convert may benefit from the analysis, including from the increased clarity and understanding of what top management, boards of directors, and owners expect for the future of the business. Numerous other federal, international, and state taxation considerations exist, but are beyond the scope of this article.

New Qualified Business Income Deduction

For pass-through businesses that decide not to convert, analyzing the availability of the new qualified business income deduction for the owners previously discussed could be a key tax planning initiative of the business. Although the recently released regulations

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[10] §1202(a).

[11] §1222(3).

[12] §751(a).

[13] See generally §613A for additional details on percentage tax depletion for oil and gas wells.

[14] *See, e.g.,* §613A(c)(4).

[15] §613A(c)(7)(D).

[16] §170(b)(1)(G).

[17] §170(b)(2)(A).

[18] *See* §170(d).

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impose various anti-abuse rules that could limit or deny the deduction in some fact patterns, pass-throughs facing specified services businesses or wage and property limitations may wish to consider other forms of restructuring.[19] Some examples may include moving employees to businesses otherwise limited by wages, restructuring debt into preferred equity interests, and restructuring guaranteed payments into wages. For pass-through entities with multiple businesses or tiers of partnership investments, careful consideration also should be given to the possibility of aggregating those businesses at the owner level.[20]

Estate Tax Planning

If estate tax planning is one of the key reasons the pass-through business decided not to convert, tax and finance leaders following conversion analysis may have gained the vision necessary to assist the business with estate tax planning for its owners. This can be crucial to the business because often estates look to the business for funding when it comes time for them to pay the estate tax bill. As discussed above, GRATs and IDITs can be effective estate tax planning tools for pass-through businesses. GRATs and IDITs are trust-based transactions that generally freeze the current value of a business at today's value for the individual's taxable estate and moves some or all future appreciation to the beneficiaries of the trust outside of the taxable estate. They both can be effective wealth transfer strategies for pass-through entity owners that provide tax distributions, because the tax distributions effectively count as part of the pass-through's appreciation in value within the trust and move more of the business to the beneficiaries. Apart from GRATs and IDITs, the TJCA also increased the lifetime exemption from the estate tax to approximately $10 million for an individual and $20 million for a married couple, so owners should consider additional lifetime giving before the business appreciates further.[21] Note that the Treasury and the IRS have indicated that the gifts made under the above exemptions will not be retroactively taxed if the exemptions are decreased again.

Exit Planning

Another reason some pass-throughs may decide not to convert is a planned near-term exit by one or more owners. Numerous tax-free or tax-advantaged exit strategies may be available.[22] If the exit is through an initial public offering (IPO), a so-called ''Up-C'' IPO could be considered. Such pass-throughs should also consider analyzing asset versus equity sale scenarios and the potential additional purchase price paid to or for a pass-through entity for part of the value of the buyer's tax basis step-up.[23]

Compensation Planning

A business in partnership form may consider using profits (carried) interests for equity compensation. Profits (carried) interests generally allow for favorable tax treatment, including that the recipient is not taxed on receipt and may recognize capital gain on sale or redemption.[24] However, an individual cannot be a partner and an employee of the same partnership, so consider restructuring to assist profits (carried) interests recipients who desire to continue to receive a Form W-2 and participate in employee benefit plans limited only to employees.[25] If no restructuring is undertaken, any partners receiving wages and income tax and FICA/Medicare withholding will need to be converted to receiving guaranteed payments and paying their own income taxes and Self Employed Contributions Act (SECA) tax/Net Investment Income tax.

IC-DISC

If the pass-through business engages in exporting, consider establishing an Interest Charge Domestic International Sales Corporation (IC-DISC).[26] Pass-through businesses may pay an IC-DISC a deductible commission based on a percentage of export gross receipts or taxable income.[27] The IC-DISC is tax-exempt, so the commission income is not taxable to the IC-DISC.[28] When the IC-DISC distributes the taxable income to its owners, the distribution may be subject to the qualified dividend tax rates.[29] Accordingly, the tax rate differential between ordinary income and the qualified dividend tax rates may be saved permanently. While this tax rate differential has decreased with the TCJA, the federal income tax rate differential may still be 5.8% to 13.2%, depending on whether the pass-through qualifies for the new qualified business income deduction.[30]

PRACTICAL TIPS AND NEXT STEPS ONCE THE DECISION IS MADE TO CONVERT

For those pass-through businesses that make the decision to convert to C corporation status, there are nu-

[19] T.D. 9847, 84 Fed. Reg. 3015 (Feb. 8, 2019).

[20] *Id.*

[21] Compare §2010 before and after enactment of the TCJA.

[22] *See, e.g.,* §368(a).

[23] *See, e.g.,* §1012(a).

[24] §741.

[25] Rev. Rul. 69-184.

[26] See generally §991-§997 for additional details on IC-DISCs.

[27] §994(a).

[28] §991.

[29] §1(h)(11), §1411(a).

[30] 37% Highest Individual Federal Income Tax Rate - 23.8% Highest Qualified Dividend Federal Income Tax Rate = 13.2%; 29.6% Highest Individual Federal Income Tax Rate for Pass-through Taxable Income Fully Eligible for the New Qualified Business Income Deduction - 23.8% = 5.8%.

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merous additional tax planning considerations as well, both before and after conversion. Several of these considerations are in similar areas to the issues noted above. Numerous other federal, international, and state taxation considerations exist, but are beyond the scope of this article.

Pre- and Post-Conversion Distribution Planning

For S corporation shareholders that desire tax-free distributions, the corporation could make distributions to the extent of the corporation's accumulated adjustment account (AAA) before conversion. Corporations may make pre-conversion distributions in cash or a note (that must constitute debt under general principles of tax law).[31] Further, post-conversion, a C corporation may make tax-free distributions of cash to those shareholders who were shareholders during the period of being an S corporation generally up to a year after conversion.[32] After the first year following conversion, a corporation makes all corporate cash distributions proportionally from AAA (tax-free) and accumulated earnings and profits.[33]

Pre-Conversion Structuring

The entity should also consider how to structure into C corporation status. If an S corporation, the simplest option may be to revoke the S corporation election, which will automatically convert the entity to a C corporation.[34] If a partnership, the simplest option may be to make a check-the-box election to elect C corporation status.[35] However, some taxpayers may elect a hybrid structure, in which part of the business remains outside of the C corporation tax regime. Additionally, if there will be more than one C corporation in the new structure post-conversion, restructuring prior to conversion to enhance the amount of AAA at the parent C corporation should be considered. For example, a ''qualified subchapter S subsidiary'' (Q-Sub) may be converted to a single member limited liability company (SMLLC) disregarded entity prior to its parent S corporation revoking its S election, or two S corporations may be merged together in a tax-free reorganization rather than one being contributed to the other.[36] Lastly, as discussed above, structuring the C corporation conversion in a manner that could allow some or all of the business to convert back to pass-through status may be desirable.

[31] §1368(a), §1368(b)(1).

[32] §1371(e)(1).

[33] §1371(f).

[34] §1362(d).

[35] Reg. §301.7701-3(a).

[36] *See, e.g.,* §368(a).

Estate Tax Planning

Owners may want to consider making lifetime gifts to utilize their full lifetime gift exemption prior to conversion.[37] One of the reasons driving many pass-throughs to C corporation conversions is an expectation that the business will experience additional growth as a C corporation, so gift transfers before conversion could keep such incremental appreciation in value out of the owners' taxable estates. Shareholders will also need to consider whether to terminate GRATs or IDITs immediately before or after conversion. Planning with existing GRATs or IDITs may benefit from an increased value of the business due to the lower C corporation income tax rate.

Establishment of Accounting and Reporting for Income Taxes

One of the biggest impacts and considerations for the business's tax and finance leaders may be accounting and reporting for income taxes under Accounting Standards Code (ASC) 740. Many pass-through businesses are exempt from this accounting because it only applies to entity-level taxes. However, a C corporation will need to begin recording deferred tax assets and liabilities on its balance sheet, entity level tax expense on its income statement, and other related tax accounts and disclosures throughout the financial statements. Because the business's employees may have limited experience with ASC 740 and C corporation tax returns if the business has historically been a pass-through, the employees may need training and assistance with software selection, preparation, review of accounting for income tax returns, and preparation and filing of income tax returns. Lastly, entities that convert to C corporation status may have additional data needs to meet their new ASC 740 and tax return obligations.

Compensation Planning

If the pass-through business converting to a C corporation has existing equity compensation plans, such as partnership profits (carried) interests, such plans will have to be converted into restricted stock or other comparable equity plans for the C corporation. Similarly, partners previously receiving guaranteed payments for their compensation and remitting income tax and SECA will need to be transitioned to wages and income tax and FICA/Medicare withholding by the C corporation. As employees, such prior partners may also become eligible for additional employee benefit plans.

IC-DISC

While a C corporation owning an IC-DISC might not enjoy the same tax rate differential that a pass-

[37] See generally §2505 for additional details on the lifetime gift exemption.

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through does, an IC-DISC owned brother-sister with the C corporation can still be an attractive option for C corporations planning to make taxable distributions after conversion. Assuming the owners desire cash equal to or greater than the allowable IC-DISC commission, the C corporation could pay the commission to the IC-DISC and claim a deduction at a 21% federal income tax rate.[38] Because the IC-DISC continues to be tax-exempt, the commission income is not taxable to the IC-DISC.[39] When the IC-DISC distributes the commission to its shareholders, the distributions may be taxable at the qualified dividend tax rate of up to 23.8%.[40] However, the shareholders would have been taxable at the same tax rate if the commission income had just been distributed to them directly by the C corporation, but the C corporation would not have received a deduction.[41] Accordingly, the C corporation receives an extra deduction at the 21% federal income tax rate through use of the IC-DISC. Further, the C Corporation's export activity that qualifies for IC-DISC treatment may also be eligible for the newly-enacted benefit for Foreign Derived Intangible Income (FDII).[42] The FDII regime provides a 37.5% deduction for income from qualifying sales or services that may be applied concurrent with the IC-DISC commission. In such situations, the IC-DISC commission will likely be treated as a directly allocable expense in computing the FDII eligible income, so the total export-related benefit is less than the sum of each benefit computed without regard to the other. Even so, where both regimes apply, the total deduction will exceed the amount available under either if computed alone.

[38] §994(a).

[39] §991.

[40] §1(h)(11), §1411(a).

[41] *Id*.

[42] *See* §250.

Tax Accounting Method Changes and Elections Planning

A business converting to a C corporation may want or need to change tax accounting methods and elections. For example, certain C corporations are not allowed to use the overall cash receipts and disbursements (cash) method, so pass-through businesses on the cash method may be forced to convert to the accrual method.[43] Consideration should also be given to tax attributes of the owners such as net operating loss and credit carryforwards before converting. For example, reverse planning to accelerate taxable income or defer tax deductions may be necessary to help owners utilize such tax attributes before the business is converted to C corporation status.

CONCLUSION

There are key considerations common to all pass-throughs considering conversion to C corporation status following enactment of the TCJA. Additional unique considerations can also significantly influence the decision whether or not to convert. This analysis is highly fact intensive, and no two analyses are exactly the same. Even when a pass-through business decides not to convert, the analysis and discussion with top management, the board of directors, and shareholders gives tax and finance leaders the vision necessary to engage in other tax planning. For those pass-throughs that have converted or are planning to convert, using the above analysis results in additional tax planning, both before and after conversion.

[43] *See* §448.

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