THE IMPACT OF ACT 170
TAX CONSEQUENCES OF THE CHOICE OF BUSINESS ENTITY

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A client wants to start a business, but in what form should the business be conducted?

The 4 basic options:

- Sole Proprietorship
- Partnership (General, Limited, and Limited Liability)
- Subchapter S Corporation
- C Corporation

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Primary considerations driving choice of entity…

#1 TAX

#2 LIABILITY

HIGHEST EFFECTIVE TAX RATES

	Federal	Pennsylvania
Corporate	**21%**	**9.99%**
Individual	**37%**	**3.07%**
Capital Gains/Dividends (15% or less for single filers Earning < $415,650 or $469,950 for joint filers)	**20%**	**3.07%**

Don't forget about the 3.8% net investment income tax when an individual taxpayer's "modified" AGI exceeds $200,000 ($250,000 for joint filers)

Always consider the Self-Employment Tax

15.3% (can deduct employer portion)

- 12.4% Social Security
- 2.9% Medicare
- $132,900 cap for 2019
  - 2.9% Medicare portion uncapped

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Review tax considerations at 4 stages . . .

FORMATION

OPERATIONS

DISTRIBUTIONS

DISPOSITION

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SOLE PROPRIETORSHIP

FORMATION Simple. Just start operating (lawfully).

★ Single-member LLC defaults to disregarded entity status and treated as sole proprietorship for tax purposes.

OPERATIONS 1 Level of Tax.

Revenue
− Expenses
Net Income (on Schedule C)

➡ 15.3% self-employment tax applies

➡ Losing $$$? net loss can offset active income

DISTRIBUTIONS N/A

DISPOSITION No separate entity, so it's an asset sale.

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SOLE PROPRIETORSHIP

Pros	***Cons***
Easy to form	Self-employment tax
Maximum control	Asset sale only
1 level of tax	✶Liability exposure✶ (consider SMLLC!)
Losses are useable	

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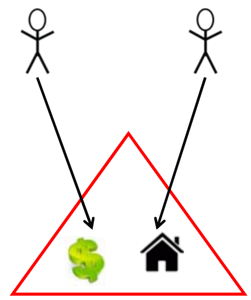
PARTNERSHIP FORMATION

<u>Consequences to Partner</u>:

No gain or loss (generally) to partner upon contribution of property in exchange for partnership interest (§721).

- Capital interest in exchange for services (§83; Reg. 1.721-1(b)). Profits interest exception (Rev. Proc. 2001-43).
- Caution: deemed assumption of liabilities in excess of basis (§§731(a), 752(b)).



Partner's basis = cash + basis of property contributed (§722).

- Potential adjustment for liability allocation (§733).
- Holding period of interest includes holding period of contributed property (§1223).

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PARTNERSHIP FORMATION

<u>Consequences to Partnership</u>:

No gain or loss (generally) to partnership upon contribution of property in exchange for partnership interest (§721).

Partnership's basis in property contributed = basis in hands of contributing partner (§723).

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PARTNERSHIP FORMATION

No tax imposed at partnership level (information reporting only)

Partners decide allocation of Income and Loss amongst partners

- ★ Caution: Substantial Economic Effect
- ★ 15.3% self-employment tax applies to distributable share

Losses can offset partner's income subject to passive activity loss and at-risk rules.

Partner's basis in partnership interest adjusted:

Increase	Decrease
share of income/gains	share of losses
tax-exempt income	distributions
contributions	non-deductible expenses
share of debt	

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PARTNERSHIP FORMATION

Passive Activity Loss Restriction:

Allocable share of losses to partner that does not "materially participate" is treated as passive activity loss ("PAL") (§469)

- PAL can only offset passive activity income
- PAL exceeding passive activity income is suspended for future use and becomes available when interest in partnership is sold

At-Risk Rule:

Partner's ability to use allocable loss share limited to amount "at risk"

What's the amount at risk?

- Cash contributed
- Adjusted basis of property contributed
- Loans by a partner to the partnership
- Partnership debt for which partner is personally liable

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PARTNERSHIP FORMATION

Distributions treated as return of capital up to partner's outside basis (thereafter capital gain)(§ 731).

Generally, no gain to partner or partnership upon distribution of money or appreciated property (*c.f.* marketable securities).

Partner's basis in property received is generally partnership's adjusted basis (§732(a)(2)).

- Limitation: reduce partner's outside basis by (i) cash received in same transaction, then (ii) adjusted basis of property received.
- Compensation to partner for services to partnership ("guaranteed payments") are also subject to 15.3% self-employment tax.

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PARTNERSHIP FORMATION

Generally capital gain or loss equal to excess of sale proceeds over adjusted basis in partnership interest.

- Portion of gain attributable to "hot assets" (appreciated inventory, unrecognized receivables, and depreciation recapture) treated as ordinary income.
  - ★ Election to adjust asset basis is available (§754)

<u>Withholding Required</u>

<u>Historically</u>, non-US partners were subject to gain/loss on "effectively connected income," which typically caught gain on the disposition of partnership interest.

<u>Now</u>, non-US partners' gain on disposition of partnership interest is subject to tax to extent attributable to assets used in US trade or business and transferee is required to withhold 10% of proceeds if any portion of gain is attributable to US trade or business. (Transferor can certify US status)

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PARTNERSHIP FORMATION

Pros	Cons
1 level of tax	Potential Income allocations w/o cash
Flexible allocations	Self-employment tax (allocable share and guaranteed payments)
Capital gains character retained	✶Potential liability exposure✶ (consider LLC, LLP, LLLP!)
Tax-free distributions	

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S CORPORATION FORMATION

Must Elect S Corporation Treatment (Form 2553)

First qualify as a "small business corporation"

- 100 shareholders or less
- Shareholders limited to U.S. citizen/resident individuals (and certain trusts and estates)
- One class of stock (voting and non-voting allowed)
- Insurance companies, certain financial institutions, and current/former DISCs not allowed

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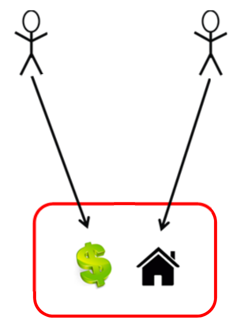
S CORPORATION FORMATION

Contribute assets to corporation:

No gain or loss if transferor(s) contribute property to corporation solely in exchange for stock in such corporation and the transferor(s) have control of the corporation immediately thereafter (§351).



1) **Property** construed broadly
- Not services (§83)
- Liabilities in excess of basis (§357)

2) **Solely in exchange for stock** does not include stock rights or warrants (seeking continued equity interest in assets contributed).

3) **Control immediately thereafter** requires (i) 80% of total combined voting power, and (ii) 80% of all other share classes.
- Avoid pre-planned subsequent transfers of stock

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S CORPORATION FORMATION

Basis in stock received equals basis of property contributed:

(i) decreased by fmv of property and cash received by the shareholder (if any), and
(ii) increased by the amount of gain recognized by the shareholder on the exchange (if any) (§358).

- Holding period of stock received includes time shareholder held property contributed (§1223).

Basis of property received by corporation equals basis of property contributed in the hands of the shareholder plus the amount of gain recognized by the shareholder (if any) on contribution (§362).

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S CORPORATION FORMATION

Income, gain, loss items allocated pro rata only

- Subject to PAL and at-risk rules
- Shareholder cannot transfer losses
- No self-employment tax on allocable share (*c.f.* partnerships)

Shareholder's basis in stock adjusted:

Increase	Decrease
share of income/gains	share of losses
tax-exempt income	distributions
contributions	non-deductible expenses

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S CORPORATION FORMATION

Distributions pro rata only

Ordering rules:

1. **Tax-free return of capital (up to shareholder basis in shares)**
2. **Excess of basis (if any) is capital gain**

Different considerations if there is E&P (former C corporation)

Distributions of appreciated property trigger gain to S Corp to extent fair market value of property exceeds adjusted basis of property (§311). Such gain is allocated to shareholders for tax reporting and basis increase.

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S CORPORATION FORMATION

Selling shareholder will generally recognize capital gain or loss equal to the excess of net proceeds over adjusted basis in S Corp shares (§1001).

- §338(h)(10) election treats buyer as purchasing assets

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S CORPORATION FORMATION

Pros	Cons
No Self-Employment tax (allocable share)	Potential Income allocations w/o cash
§338(h)(10) available	Self-Employment tax (compensation)
No shareholder liability	Limitations (shareholders and stock classes)
	Pro rata allocations only

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S CORPORATION FORMATION

"A corporation is like a lobster pot: it is easy to enter, difficult to live in, and painful to get out of."

\- Boris Bittker (Yale) and James Eustice (NYU)

Involves forming corporate entity and contributing assets. Same considerations as S Corp formation (i.e., §351).

- Remember, no gain or loss if transferor(s) contribute <u>property</u> to corporation <u>solely in exchange for stock</u> in such corporation and the transferor(s) have <u>control</u> of the corporation immediately thereafter (§351).

C CORPORATION FORMATION

<u>Key differences versus pass-through form</u>:

#1 **Corporation is separate entity distinct from shareholders**

#2 **Corporation is a standalone taxpayer (files tax return and pays tax on net income)**

- Tax Reform reduced max federal rate from 35% to 21%

#3 **Corporate losses remain within corporation (subject to limitations) to offset future positive net income.**

- Partnership and S Corp losses could be utilized immediately
- Corporation has no preferential capital gains rate

C CORPORATION FORMATION

Pro rata distributions only within each class of stock.

<u>Distributions from C Corporation will be treated as</u>:

1) Dividend to extent of E&P
2) If distribution exceeds E&P, treated as tax-free return of shareholder capital to extent of basis
3) If exceeds shareholder basis, treated as capital gain

"Qualified" dividend income taxed at capital gain rate (and subject to net investment income tax of 3.8%)

Distributions of appreciated property to shareholder results in recognition of gain to the corporation to the extent fair market value exceeds adjusted basis of distributed property (§311).

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C CORPORATION FORMATION

Selling shareholder generally will recognize capital gain or loss equal to the excess of the net proceeds received in the sale over the adjusted basis in the shares (§1001).

Sales of "qualifying small business stock" may be afforded complete or partial capital gain exclusion (§1202).

➡ Corporation must be engaged in certain trades or businesses and stock must meet acquisition and holding period requirements.

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C CORPORATION FORMATION

Pros	Cons
Separate Entity (liability protection)	Separate Entity (files and pays own taxes)
No s/h tax on retained income	Double Tax (entity and s/h level)
No ownership restrictions (*c.f.* S Corp)	Entity Gain on distributed property (*c.f.* S Corp)
Multiple classes of stock permitted	No preferential capital gain rate
§1202 exclusion possible	

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The "Super 199A" Deduction (new for 2018)

Pass-through entities (sole proprietorships, S Corps, and partnerships) can qualify for a deduction of up to 20% of "qualified business income" ("QBI")

Disclaimer: provision was enacted hurriedly with Tax Reform and contains ample ambiguities that are just starting to be addressed in recently released final regulations and other guidance.

What is QBI?

- Basically business income less deductions
  Does not include wages, guaranteed payments, or passive income

QBI must be generated by a "trade or business"

- Regulations clarify that §162 standard governs (regular, continuous, and substantial activity)
- Problematic for isolated rental properties????

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Complex Limitations of 199A

Limits only triggered when taxpayer's taxable income exceeds applicable threshold

- $315,000 (married filing jointly); 157,500 (otherwise)

Quantitative Limitation

Limited by formula involving pass-through's W-2 wages and unadjusted basis in depreciable property used in the trade or business

- Real property partnerships benefit from basis limitation

Qualitative Limitation

"Specified Service Trades or Businesses" ("SSTBs") are excluded

- Among the excluded fields are consulting, law, accounting, medical, investment management, and performing arts. Definition is based on §1202, which is ill-defined. New regulations attempt to better define contours of SSTBs.

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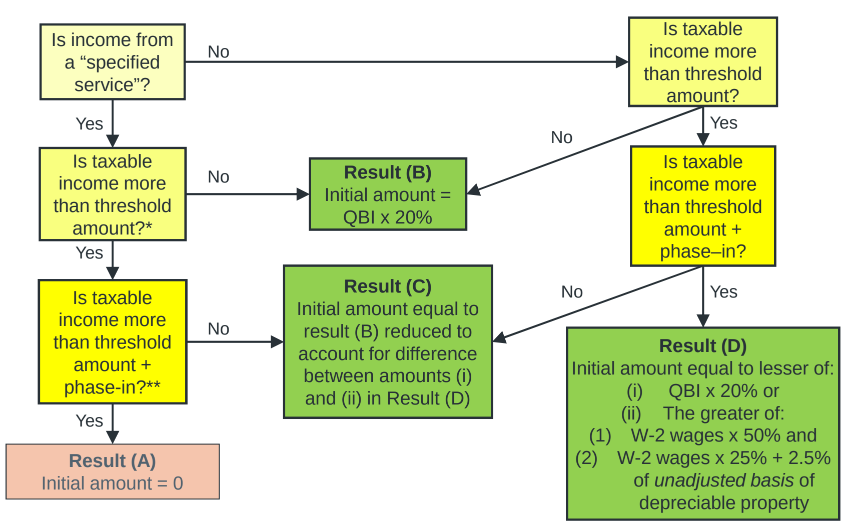
It can get complicated . . .



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Pass-Through Example

Beth invests $1000 in a new venture, ACME (a partnership formed to design and manufacture portable 3-D printing equipment). ACME generates $100 of income in each of its first 10 years of operations. At the end of year 10, Beth sells ACME for book value.

Initial Book Value	$1000
Net Income (10 years)	$1000
QBI Deduction	(200)
Distributions for Tax (40%)	(320)
Ending Book Value	$1680
Sale Proceeds	$1680
Basis in Equity	(1480)
Gain	$200
Tax (20%)	(40)
Net Proceeds to Beth	**$1640**

Beth's Basis Adjustment	
Beginning	$1000
Income	$ 800
Distribution	(320)
Ending	**$1480**

Assumes net investment income tax (3.8%) does not apply due to passive ownership

C Corporation Example

Beth invests $1000 in a new venture, ACME (a corporation formed to design and manufacture portable 3-D printing equipment). ACME generates $100 of income in each of its first 10 years of operations. At the end of year 10, Beth sells ACME for book value.

Initial Book Value	$1000
Net income (10 years)	$1000
Tax (29%-federal and PA)	(290)
Ending Book Value	$1710
Sale Proceeds	$1710
Basis of shares	(1000)
Gain	$ 710
Tax (20%)	(142)
Net Investment Income Tax (3.8%)	(27)
Net Proceeds to Beth	**$1541**

Assumes §1202 exclusion is not available.

C Corp, S. Corp or LLC
A Comparative Analysis

Qualitative issues to consider:

- Limited liability, character of equity owners, distribution requirements

Quantitative issues to consider:

- Tax efficiency and return on capital

Tax Rate Assumptions:

C Corp (federal/state combined)	**29%**
Individual (federal/state combined)	**40%**
Capital Gains	**26%**
Net Self-Employment Tax	**12.4%** (2.4% after $132,900 cap)

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C Corp, S. Corp or LLC
A Comparative Analysis

Ownership Compensation Assumptions:

- Owners receive a salary (or guaranteed payments in the case of a partnership) in the aggregate amount of $1 million per year.

Operations and Disposition Assumptions:

- ACME commences operations in 2017 with an initial capitalization of $10 million.
- LLC is taxed as a partnership.
- Acme is projected to generate income before taxes of $2 million per year (after deduction for salaries and guaranteed payments).
- The equity of Acme will be sold after year 10 at adjusted book value.

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C Corp, S. Corp or LLC
A Comparative Analysis (000s)

	C Corp	S Corp	LLC
2017 Book Value	$10,000	$10,000	$10,000
Pre-Tax Income (per year over 10-year period)	$ 2,000	$ 2,000	$ 2,000
199A Deduction(1)	--	($ 400)	($ 400)
Taxable Income	$ 2,000	$ 1,600	$ 1,600
Corp Income Tax	($580)(2)	--	--
Tax Distributions (to cover tax due on allocated income)		$ 640(3)	$ 678(4)
Net After Tax (per year)	**$ 1,420**	**$ 1,360**	**$ 1,322**

(1) Assume Qualified Business Income deduction equals 20% of pre-tax income determined in the hands of the individual shareholders/members.
(2) 29% combined corporate tax rate.
(3) 40% combined individual tax rate.
(4) 40% combined individual tax rate plus 2.4% Medicare tax.

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C Corp, S. Corp or LLC
A Comparative Analysis (000s)

	C Corp	S Corp	LLC
Net After Tax (cumulative 10 years)	$14,200	$13,600	$13,220
Value Adjustment Reflects benefit of lower taxes of **(i)** C Corp ($98/year @ 15% ROI) and **(ii)** S Corp ($38/year @ 15% ROI)	$ 1,000	$ 391	--
2027 Net Book Value	$ 25,200	$23,991	$23,220
Upon Sale			
Amount Realized	$25,200	$23,991	$23,220
Original Equity Basis	$10,000	$10,000	$10,000
Adjustments	--	$ 9,600(1)	$ 9,220(1)
Adjusted Basis	$10,000	$19,600	$19,220

(1) S Corp and Partnership bases increased by $16,000 taxable income ($1,600/year) and decreased by cumulative tax distributions.

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C Corp, S. Corp or LLC

A Comparative Analysis (000s)

	C Corp	S Corp	LLC
Taxable Gain	$15,200	$ 4,391	$ 4,000
Tax on Gain(1)	$ 3,952	$ 1,142	$ 1,040
Net to Owner(2)	$ 21,248	$22,849	$22,180

(1) Taxed at individual (combined federal/state) rate of 26%.

(2) Amount realized from sale less taxes.

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Questions

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