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

(General, Limited, and Limited 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)

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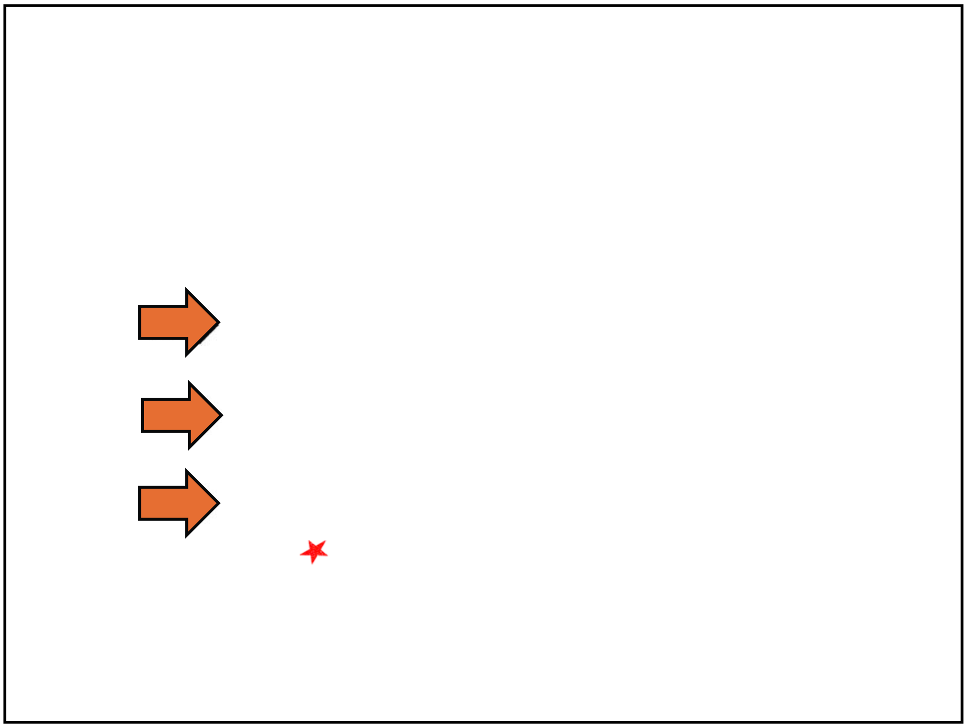

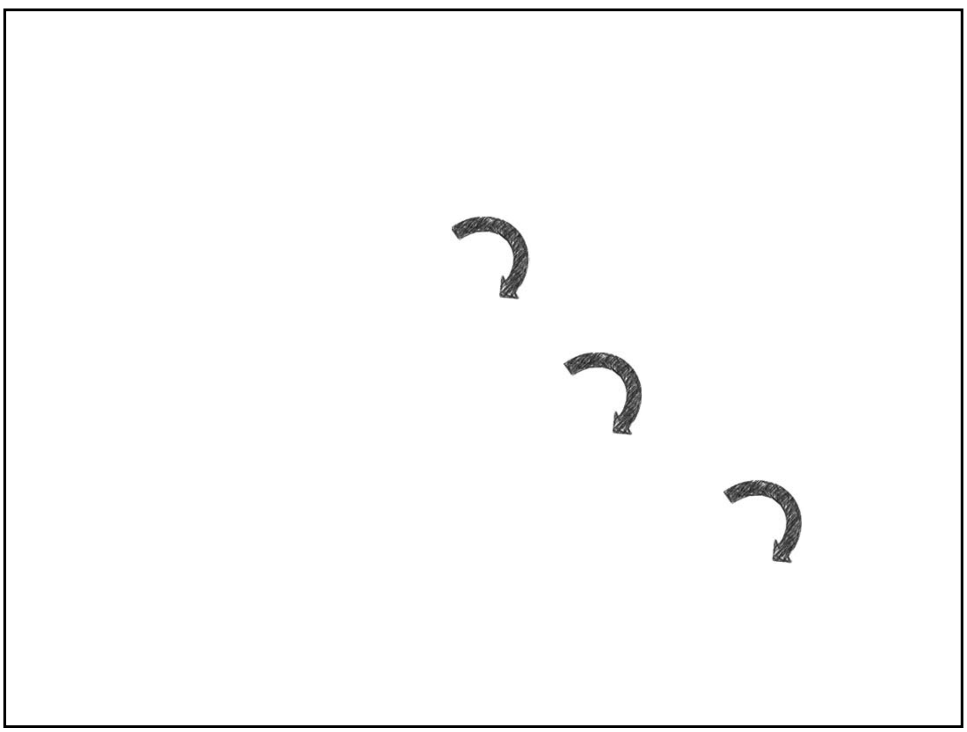

SOLE PROPRIETORSHIP

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15.3% self-employment tax applies

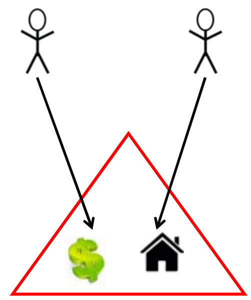
Losing $$$? net loss can offset active income

SOLE PROPRIETORSHIP

(consider SMLLC!)

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).

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).

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	

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.

PARTNERSHIP FORMATION

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PARTNERSHIP FORMATION

Pros

Cons

(allocable share and guaranteed payments)

(consider LLC, LLP, LLLP!)

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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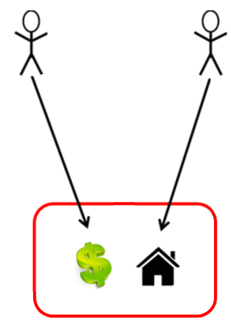
S CORPORATION FORMATION



S CORPORATION FORMATION

K&L GATES

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K&L GATES

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

S CORPORATION FORMATION

Pros

Cons

(compensation)

(shareholders and stock classes)

S CORPORATION FORMATION

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

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	

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

- $315,000 (married filing jointly); 157,500 (otherwise)
- Real property partnerships benefit from basis limitation
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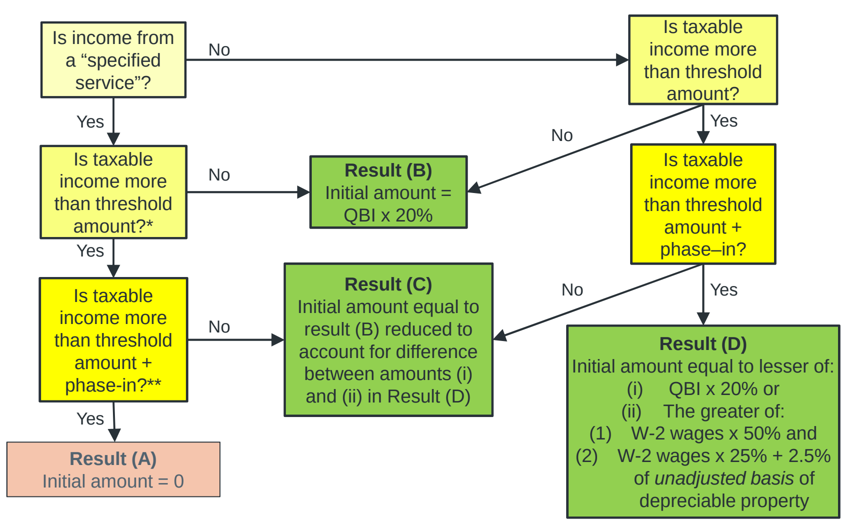
It can get complicated . . .



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Pass-Through Example

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

Assumes §1202 exclusion is not available.

C Corp, S. Corp or LLC
A Comparative Analysis

C Corp, S. Corp or LLC
A Comparative Analysis

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C Corp, S. Corp or LLC

A Comparative Analysis (000s)

(per year over 10-year period)

(to cover tax due
on allocated income)

(per year)

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.

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.

Questions

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