Tax Cuts and Jobs Act

How Will Changes Impact Your Business?

U.S. CHAMBER OF COMMERCE

RSM

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Introduction

The sweeping changes to tax laws enacted in 2017 continue to have business owners and managers scratching their heads and asking, “How will this impact me?”

While much remains to be seen as the Internal Revenue Service (IRS) formulates rules and guidance, several important clarifications have already been issued, giving businesses an opportunity to figure out just where they fit into the new tax regime and how it will affect their overall tax outlook. In some cases, the changes in tax rules may be significant enough for some owners to consider reorganizing the structure of their businesses from a pass-through entity to a C corporation, or vice versa.

This kind of decision needs to be considered in detail, with special attention given to the strategy, future, operations, market, cash flow, capital needs and other specific aspects that vary greatly from one business to another. Even without moving to a new form of organization, business owners and shareholders need to understand the impact of the new tax law in order to maximize operational efficiency moving forward.

The headlines of the 2017 Tax Cuts and Jobs Act were all about lower tax rates for businesses, specifically the cut of the graduated tax rate on C corporations from a high of 35 percent to a flat 21 percent, along with a 20 percent deduction available to qualified pass-through businesses, including S corporations, limited liability corporations, partnerships, and sole proprietors. However, a plethora of details affecting past, current, and future taxes are contained in the hundreds of pages of guidance now being issued – ranging from the deductibility of fringe benefits to limits on executive compensation.

Changes for Pass-Through Entities

Sole proprietorships, S corporations, limited liability companies (LLCs), and partnerships are categorized as pass-through businesses because, as the name suggests, profits generated by these entities are allocated directly to the businesses owners, whereupon those profits are taxed as part of the owners' income tax returns.

Reduced personal income tax rates

Pass-through entities have become increasingly popular because, among other things, the pass-through structure avoids the double taxation that occurs in C corporations, in which the corporation pays taxes directly on its income, and then shareholders pay tax again on distributions or gains from sales of stock in the corporation. One downside of a pass-through structure is that pass-through owners must pay tax on all business earnings every year, irrespective of whether they receive the corresponding cash from the business, while C corporations owners are not subject to a shareholder level tax if the corporation retains the earnings. This makes staying abreast of year-to-year changes in tax laws essential for owners of pass-through businesses.

The first change for owners of pass-through businesses comes in the form of a reduction in personal income tax rates. Specifically, the top marginal rate dropped from 39.6 percent to 37 percent, along with corresponding reductions in all but the 35 percent bracket. In addition, the income limits on many brackets were increased, which also will reduce tax bills for many filers.

New 20% deduction on pass-through income

The second, and one of the most substantial, changes comes in the form of the newly enacted 20 percent deduction on pass-through income, which, if fully utilized, has the potential to reduce the top marginal rate from 37 percent to 29.6 percent on pass-through income. However, as with any tax break, this new deduction is subject to a long list of limitations.

For those pass-through owners with taxable income of less than $315,000 for joint filers ($157,500 for single filers), the only restriction is that the income must be considered bona fide "trade or business income," and that it not be an attempt to mischaracterize wages. Accordingly, those below this income threshold that meet the bona fide trade or business income requirement will generally be afforded the full 20 percent deduction on qualified income. Businesses and workers will continue to face the same IRS rules regarding employee vs. independent contractor classification. In addition, tax law revisions do not change the requirement that S corporations pay "reasonable compensation" to owners who perform substantial services, which may restrict the ability of personal service businesses organized as S corporations to claim the full benefit.

The unrestricted benefit of the 20 percent deduction phases out – or, more accurately, the various limitations associated with the deduction begin to phase in – as joint taxable income increases from $315,000 to $415,000 (from $157,500 to $207,500 for single filers), with taxpayers above the $415,000 and $207,500 thresholds subject to the full effect of a series of limitations. Specifically, the 20 percent deduction generally may not exceed 50 percent of the owner's allocable share of the business's W-2 wages, or 25 percent of the owner's allocable share of the business's W-2 wages plus 2.5 percent of the owner's allocable share of the acquisition cost of tangible depreciable property. For example, two equal partners in a business generating $1,000,000 of qualified income, paying $300,000 in W-2 wages, and owning no tangible depreciable property, would generally each have a deduction – prior to any limitations – of $100,000 (i.e. 20% x $1,000,000 = $200,000, split equally by the two owners). However, in this case the wage limitation would apply, and each partner's deduction would be limited to 50 percent of his allocable share of the W-2 wages, or $75,000 each. (See illustration 1 on the next page).

The 20% deduction, if fully utilized, has the potential to reduce the top marginal rate from 37% to 29.6% on pass-through income.

How different types of businesses will be affected

Is your taxable income in excess of $157,500 ($315,000 married filing jointly)?

YES → **Are you a "Specified Service Trade or Business"?**

NO → **Your tax deduction is 20% of your qualified business income (QBI)***

Are you a "Specified Service Trade or Business"?

YES → **Does your taxable income exceed $207,500 ($415,000 married filing jointly)?**

NO → **Your tax deduction is 20% of your QBI subject to limitations based on wages/assets***

Does your taxable income exceed $207,500 ($415,000 married filing jointly)?

YES → **No QBI deduction**

NO → **You will be allowed a pro-rated tax deduction subject to wage/asset limitations***

** Deduction cannot exceed 20% of taxable income less net capital gain.*

$1 million won't always generate a 20% deduction

Consider these three scenarios where the qualified business income is $1 million. Based on the variables illustrated, the final deduction would be dramatically impacted.

	A	B	C
Qualified Business Income	$1,000,000	$1,000,000	$1,000,000
Share of W-2 Wages	$500,000	$150,000	$300,000
Share of UBIA (unadjusted basis immediately after acquisition)	$600,000	$2,500,000	$1,500,000
Tentative Deduction	$200,000	$200,000	$200,000

Limitations

	A	B	C
A) 50% W-2 Wages	$250,000	$75,000	$150,000
B) 25% W-2 Wages + 2.5% UBIA	$140,000	$100,000	$112,500
Larger A or B	$250,000	$100,000	$150,000
Deduction	$200,000	$100,000	$150,000

What doesn't qualify for the 20 percent deduction?

In addition to the wage and property limitations, income from what are called specified service trades or businesses (SSTBs), will not be eligible for the deduction (again, assuming the taxpayer is over the income threshold discussed previously). The statute defines an SSTB to include "any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners." In addition, an SSTB includes any trade or business involving "the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2))."

While the statutory language provided little detail with respect to what constituted the performance of services in one of the listed fields, the newly issued final regulations have gone a long way to clarify the somewhat ambiguous statutory language.
For instance, the proposed regulations clarify that performance of services in the field of health generally means the provision of medical services by healthcare professionals performing services in that capacity, but that it does not apply to related medical services and suppliers, such as running a health club or spa, providing payment processing services for health professionals, or the research, testing, manufacture, or sales of pharmaceuticals or medical devices. The regulations apply a similar rationale to the services performed in the field of law, in that such services generally include direct provision of legal advice to clients, but not ancillary services, such as legal printing, stenography, or process serving.

Under the regulations, services performed in the fields of performing arts and athletics follow that same line of reasoning, applying to actors and directors but not to motion picture equipment or facilities, and applying to athletes, coaches, and team managers but not to the provision of services that are not "unique to athletic competition", such as videotaping team practices or maintaining athletic facilities or equipment.

> In addition to the wage and property limitations, income from what are called specified service trades or businesses (SSTBs), will be eligible for the deduction only if the taxpayer's income falls below certain income thresholds.

The exclusion of services performed in the field of consulting applies to the "provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems". In addition, the regulations clarify that services performed in the field of consulting also include those generally associated with lobbying – providing advice and counsel regarding advocacy in an attempt to influence decisions made by a government, governmental agency or legislators. However, under the regulations, consulting specifically does not include training or educational work, or consulting that is included with or embedded in the sales of goods or provision of services that are part of a business not otherwise excluded under these rules, as long as the consulting services are not separately billed.

Investment and securities trading activities also are not eligible for the 20 percent deduction. This includes activities such as "investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)) partnership interests, or commodities (as defined in section 475(e)(2))." However, the definition of financial services in the proposed regulations does not include banks, which means shareholders of S corporation banks may be able to take the deduction.

An ambiguous limitation

Perhaps the most discussed, and possibly most ambiguous, limitation in the statute is the exclusion of any trade or business where the principal asset is the reputation or skill of the owner(s) or employee(s). However, despite initial uncertainty, the regulations have defined this very narrowly. Specifically, the regulations state that this test will only apply to businesses or individuals who are paid for the use of an individual's image, likeness, name, signature, voice, trademark, or other associated aspects of the individual's identity, who collect appearance fees or income or who earn money from endorsing products or services.

While the general rule excludes income derived from the performance of these specified services, the regulations do provide a de minimis rule for trades or businesses deriving income from both excluded SSTB operations and qualifying operations.

Specifically, the proposed regulations provide that a trade or business generating otherwise qualified income will not be an SSTB if less than 5 percent of its gross receipts are from SSTB-type activities, or less than 10 percent of its gross receipts if it has gross receipts of $25 million or less for the taxable year.

Active vs. passive investors

The new rules are the same for active to passive investors and do not change how net investment income taxes or self-employment taxes are calculated. Sole proprietors and members of partnerships will continue pay the combined 15.3 percent self-employment tax on their net business income up to $128,400, except for income from rental real estate, which is exempt. S corporation owners will pay FICA taxes on their wages. While passive investors do not face self-employment tax, they will continue to pay the 3.8 percent Net Investment Income Tax that was enacted as part of the Affordable Care Act, which applies to certain types of income of a taxpayer with modified adjusted gross income of more than $200,000 for single filers or $250,000 for joint filers. Obviously, S corporation owners will want to classify themselves as active in order to minimize investment income taxes. LLC members will want to adjust their holdings between manager and investor class shares, in order to accomplish a similar result.

Other considerations

In addition to the reduced individual rates and new deduction for pass-through income, pass-through owners will now face a new limitation on allowable business losses. Moving forward, a business owner will be limited to a $500,000 trade or business loss ($250,000 for individual filers) in any year. Losses in excess of those amounts will be treated as a net operating loss and carried forward to the next tax year and subject to the applicable net operating loss (NOL) limitations.

Consult a tax advisor

Business owners should be sure to consult their tax advisers on these and other details of the new Tax Cuts and Jobs Act. Questions include:

- **Will my business qualify for the 20 percent deduction?**
- **How do these changes impact my allowable deductions?**
- **Do I need to change my business structure?**
- **How might these changes affect a sale of the business?**

Many people have the initial, knee-jerk reaction that, if the C corporation rate now is 21 percent and my pass-through rate is either 29.6 percent or 37 percent, clearly I must go to C corporation status. But there are other factors that play into that. The analysis for those who are considering a change is much, much more involved than simply comparing the marginal or effective rates that they'll pay in any particular year.

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C Corporation Changes

As the most common corporate form in the United States today, C corporations present a number of advantages and disadvantages for shareholders and owners. The defining characteristic is that C corporations are taxed on their profits and that any dividends or other gains passed to shareholders is taxable at that individual's personal tax rate. This double taxation of profits is a defining characteristic. Nonetheless, organizing a business as a C corporation offers several benefits.

Benefits of C corporations

One benefit is that this form of incorporation insulates directors, shareholders, employees, and managers of the corporation from any personal liability for the business, so that legal obligations of the company remain with the company, and are not assumed by the individual owners. C corporations also allow for seamless changes in management and ownership, and the businesses can have a large number of shareholders. C corporations also have unlimited ability to deduct state and local taxes, while individuals are limited to deducting $10,000.

The ability to offer public stock allows C corporations to raise large amounts of capital to fund operations and expansions. In addition, C corporations usually have lower tax rates than do individuals.

> With these changes, you now have to think about what's the nature of your income? Is it going to be actual earnings, reinvested earnings or intangibles such as goodwill, and when do you expect to get out of the business? If you anticipate that you're going to be the next Google or something like that where people will buy you out for 100 times earnings, that's when a partnership now becomes more valuable.
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> **Don Susswein, Principal, Washington National Tax, RSM US LLP**

Downsides, besides the taxation question, include registering with the Securities and Exchange Commission, establishing a board of directors, required annual meetings, and additional paperwork and filing requirements, including legally required financial reporting. Finally, corporate losses stay with the corporation and are not deductible by the owners and shareholders, unlike with an S corporation.

Reduced income tax rates

The biggest change in the 2018 tax laws is that the tax rate for C corporations has been reduced from 35 percent to a flat 21 percent.

Previously, $1,000 in profits was taxable at 35 percent to the corporation, and any dividends passed to shareholders were taxed at a reduced rate of 20 percent, resulting in an effective 48 percent tax rate. Under the new law, the same $1,000 is taxed at 21 percent on the corporate level before dividends are taxed at 20 percent, resulting in a 36.8 percent effective tax rate. The result is that a shareholder now nets $63.20 after taxes on each $100 of dividends paid, a gain of $11.20 over previous rates, which netted the shareholder $52 on the same $100 dividend.

The new tax rate does not lower taxes for corporations with low levels of profit, which had been taxed at 15 percent on a graduated scale and now will be taxed at the flat 21 percent rate. A business making $50,000 would face a tax hike, and the advantage of the new rate will not kick in until the business posts a profit of at least $75,000.

No longer subject to corporate alternative minimum tax

C corporations also are no longer subject to the corporate Alternative Minimum Tax (AMT), which had been 20 percent, under a separate set of tax calculations designed to limit or eliminate the extent to which a business could claim certain deductions, credits and other tax benefits. According to IRS data from 2013 (the most recently available), $4.2 billion in corporate AMT was paid that year, primarily in the insurance, finance and mining industries, compared with $293 billion in overall corporate taxes.

This change also affects the ability of C corporations to use the AMT credit, which was earned when a minimum tax paid was carried forward and applied to the business's tax bill when the liability was more than the AMT amount in any one year. Under the new tax law, any unused AMT credit is refundable. For the years 2018 to 2020, the refundable credit is 50 percent of the amount over the minimum tax credit. In 2021, the amount refundable rises to 100 percent of the amount over the minimum tax credit.

Net Operating Loss Carryforwards

NOLs generally carried forward indefinitely. Another factor of corporate tax planning that changes in the new Tax Act is the set of rules governing net operating loss carryforward, or NOL carryover. This is created whenever a business ends its year with more operating expenses than revenue on its tax return, resulting in a net operating loss. This loss can be used to offset taxable income in future years — the carryforward aspect — as an asset that reduces the business's total tax liability. Under the new tax rules, the NOL carryover and carryback change, and a new limitation is added on NOL utilization.

Carryback and carryforward

Previously, most NOLs were eligible for a two-year carryback and a 20-year carryforward. If not otherwise limited under IRS rules, they could fully offset the taxable income of the taxpayer. By carrying back the loss against the previous two years and applying it against taxable income from those years, a business could generate an immediate tax rebate. Or the business could skip that option and apply the loss against future taxable income for the next 20 years, after which the value of the NOL carryforwards was canceled.

The Tax Cuts and Jobs Act repeals the two-year carryback period and grants an indefinite carryforward for losses generated in taxable years ending after December 31, 2017. However, any NOL deductions will be limited to 80 percent of the business's taxable income.

Exceptions for farming and insurance

Exceptions to the new rules exist for farming and insurance businesses. Farmers, who had been allowed to carry back NOLs for five years, are now limited to two years, and get the same indefinite limit for carryforwards. Property and casualty insurance companies can continue to carry back losses for two years and forward for 20 years, as under the previous rules. In addition, the 80 percent limit on applying the loss to taxable income does not apply to losses for farmers or property and casualty insurers.

Owners and managers for other businesses should be aware that a previous option for raising cash in an unprofitable year is gone. Highly cyclical businesses that may have relied on the option of receiving a tax rebate in any year that generated a net operating loss will no longer be able to access that cash resource.

The elimination of almost all NOL carrybacks means more carryforwards, so corporations should be wary of rules that can limit the use of those NOL carryforwards. Shifts in stock ownership can result in triggering an IRC Section 382 ownership change that could severely limit the ability to utilize the NOL carryforwards in future tax years. The limitation is initially based upon the value of the corporation multiplied by the long-term tax-exempt rate, but numerous adjustments could further restrict the limit or on the flip side provide a significantly larger limitation. Understanding the impact of such a change is essential to any corporate owner or potential purchaser as the result will significantly impact the value of the corporation's future tax shield provided through the NOLs.

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The elimination of NOL carrybacks has received significant attention. But the new 80 percent limitation, where NOLs generated starting in 2018 can only offset 80 percent of a taxpayer's current year income, will also affect many taxpayers. In sum, losses generated starting in 2018 have become less valuable.

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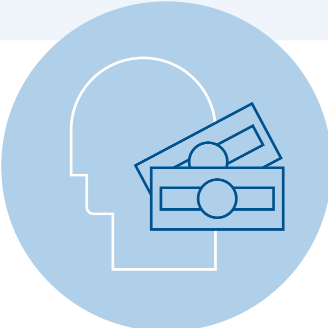

Executive Compensation

On executive compensation, the tax law changes the deduction limitation of $1 million in compensation for certain public company executives and broadens the definition of which executives are subject to that limitation. Previously, corporations could deduct more than the $1 million limitation by using qualified performance-based compensation, including commissions, stock options, and other performance-based arrangements. Now that limit applies to all compensation, subject to a transition rule that will exempt some payments.

Compensation in excess of $1 million to executives of publicly held corporation is not deductible

For publicly traded companies, the reduction of the corporate tax rate eliminates some of the tax advantage that came with performance-based bonuses, commissions and stock options for the CEO, CFO, and the three highest-paid employees. It may prompt employers to reconsider how compensation is structured going forward.

Companies will have more flexibility in designing executive compensation programs, such as adjusting actual awards based on performance, without needing to meet the previous rules to qualify for the deduction. Companies also may want to redesign compensation plans with extended vesting periods in order to stay within the $1 million deduction limit, while avoiding deferred compensation rules for payments received after leaving the company.

An exemption to the $1 million limit is allowed for written, binding contracts that were in existence as of November 2, 2017, as long as material modifications are not made to those plans, but this transition rule is challenging in determining what is and is not subject to it.

The law also redefines who is subject to the tax. Certain entities with publicly-traded debt and foreign entities with American depository receipts are now subject to the deduction limitation. Previously, the limit applied to compensation paid to the CEO and the company's three highest-paid executives on the last day of the fiscal year not including the CFO. The law now applies to all CEOs and CFOs serving during the fiscal year, as well as the three highest-paid executives and all executives who have been covered at any time after December 31, 2016. Those executives will be covered even after they leave the company.

Changes to Foreign Income and Earnings

The very complicated rules on foreign income and earnings for U.S. partnerships, corporations, estates, and certain trusts organized in the United States (as well as for individuals) are changed substantially under the tax reform act. The United States' "worldwide" approach in taxing income is now replaced by a hybrid that adds many features of a "territorial" approach.

Partial territorial approach toward certain foreign earnings

Until now, U.S businesses with foreign earnings paid the corporate tax rate of 35 percent on all their worldwide earnings, minus any tax already paid in other countries. Companies could defer taxation by reinvesting foreign earnings in their foreign operations, with the exception of passive income, such as dividends, royalties, interest, and others, to discourage keeping financial assets overseas indefinitely. As a result, companies with substantial overseas earnings had an incentive to shift their legal headquarters to a foreign country in tax inversions or simply keep as much foreign income as possible out of the United States. Because this system differed from how foreign earnings are handled in most other developed countries, which is generally to not tax already-taxed foreign earnings, U.S.-headquartered businesses felt they operated at a competitive disadvantage by paying higher taxes on overseas income in many cases.

Under the new law, dividends paid by a foreign corporation to a U.S. corporation that owns at least 10 percent of the foreign business are exempt from U.S. taxes, by way of a deduction for dividends received (DRD). The U.S. firm must have owned the overseas company for at least a year to get the deduction and cannot claim a foreign tax credit or foreign deduction for any taxes on the dividends received. This deduction is available only to C corporations, except for regulated investment companies (RICs) or real estate investment trusts (REITs). There also are new rules governing the sale or exchange of stock in a foreign subsidiary that treats those gains as dividends in certain cases, with the basis of the stock adjusted in relation to the DRD.

However, under the new law, income of a controlled foreign corporation above a 10 percent return on the Qualified Business Asset Investments (QBAI) of the company attributable to its U.S. owner is considered Global Intangible Low Tax Income (GILTI), a new category of foreign income. As a return on intangible rather than hard assets, GILTI income is taxable to a U.S. shareholder even if the controlled foreign corporation makes no cash distributions. U.S corporate shareholders are taxed at 50 percent of the corporate rate, or 10.5 percent of their share of GILTI while individuals are taxed at the rates applicable to ordinary income.

In addition, U.S. corporations receive an 80 percent credit against foreign taxes already paid on GILTI, giving U.S. corporations an 80-cent credit for every dollar of foreign taxes paid. These foreign tax credits cannot be carried forward or back. The intent here is to make U.S. firms consider foreign income tax rates, rather than ignoring any rate that is below the U.S. corporate tax rate, by increasing the total tax (foreign and domestic) when the foreign tax rate is higher relative to other foreign countries, even if it's lower than the U.S. rate.

Another new tax provision on intangible income applies to Foreign Derived Intangible Income (FDII), which is derived by U.S. corporations from sales or services to foreign persons. These FDII earnings are calculated similarly to GILTI income – the amount of FDII generally equals certain of the company's foreign income minus 10 percent of its qualified asset investment. The new law allows companies to deduct 37.5 percent of FDII from their taxable income, resulting in an effective tax rate of 13.125 percent on that income.

To prevent corporations from shifting profits out of the U.S. to avoid tax liability, the new tax rules also include the Base Erosion and Anti-Abuse Tax (BEAT), limited to multinational firms with $500 million or more in gross receipts. The base erosion required to trigger BEAT occurs when payments from corporations based in the U.S. to their related foreign businesses are more than 3 percent of the total deductions taken by the corporation.

The threshold is 2 percent for certain types of financial firms. The BEAT tax rate starts at 5 percent in 2018 and thereafter rises to 10 percent of a defined modified taxable income minus the regular corporate tax. Modified taxable income is the total of base erosion payments to related foreign businesses added back to the corporation's regular taxable income.

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Fundamentally, what has happened is that there has been a sea change in the way foreign earnings are taxed. The U.S. is moving to a participation system that is similar, but not entirely the same, as what much of Europe and much of the rest of the world has been using for a long time.

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Deferred offshore earnings

The new rules also address what happens with the large amounts of offshore earnings that have been deferred by U.S. companies. That money is subject to a complex one-time transition tax that could apply to the estimated $2.6 trillion in foreign profits kept abroad. These foreign earnings and profits are subject to the repatriation tax, based on the foreign corporation's accumulated deferred earnings and profits as of either November 2, 2017, or December 31, 2017.

This money is taxed at one of two rates, depending upon whether earnings are held in cash and cash equivalents (taxed at 15.5 percent) or in illiquid assets (8 percent tax).

This transition tax can be paid in installments over an eight-year period in most cases. The tax must be calculated based on U.S. tax rules and principles, even if the foreign operations have used non-U.S. accounting principles to keep their books. This likely will require companies to make substantial efforts to recalculate foreign earnings based on U.S. tax law.

Limitations on deducting business interest

The tax law changes also place limitations on deducting business interest under a new rule that limits the ability of corporations and many other businesses to deduct interest expense, whether paid or accrued. The net interest expense deduction for most businesses, regardless of form, will be limited to 30 percent of adjusted taxable income. Net interest expense means the interest paid or accrued during a particular tax year, minus any interest income included in gross income for that same year.

The adjusted taxable income (ATI) calculation includes several factors, including net operating loss deductions, interest income and expense, among other factors. For 2018 through 2021, the ATI computation would roughly equal the business's earnings before interest, taxes, depreciation, and amortization (EBITDA). After 2021, the ATI definition will not exclude depreciation, amortization and depletion deductions, approximating the business's earnings before interest and taxes (EBIT).

Consult a tax advisor

Business owners will want to consult their tax advisers on these and other details of the new Tax Cuts and Jobs Act. Questions include:

- **How will our business interest deductions change?**
- **What happens to the value of our net operating loss carryforwards?**
- **Which executives are covered by the compensation cap?**
- **Should we reconsider stock-based compensation?**
- **Should we continue to offer benefits that are no longer deductible?**

Choice of Entity

C Corporation or Pass-Through

The newly enacted tax legislation may be the most impactful since the Tax Reform Act of 1986 – affecting both corporate and pass-through entities alike. The substantial reduction in the corporate tax rate has left many pass-through entities questioning whether a conversion to C corporation status might make sense. However, such a change is not as simple as comparing tax rates. Instead, the decision can also be affected by the financial structure of the business, its capital needs now and in the future, whether it retains its earnings or distributes them regularly, and the growth potential, and possible exit strategies of partners or owners.

Tax impacts both near and long term

Since every business and business owner is unique, with different needs, goals, markets, and methods of operation, this choice must be a well-considered. Further, it must incorporate practical concerns for the future – ranging from considering compensation schemes to attract executive talent to projecting the future value of intangible property.

The tax differences between C corporations and pass-through entities are significant, but they generally revolve around the fact that C corporation earnings are subject to double taxation – first at the corporate level, and then again at the shareholder level when earnings are distributed to the owners. Earnings of pass-through entities, on the other hand, are generally only taxed once – at the individual level. This difference is one of the main considerations in selecting the most tax-efficient structure for a business.

The new tax law has caused many to consider whether their current structure is the most efficient.

The new tax law has impacted significantly this analysis, causing many to consider whether their current structure – whether it be pass-through or C corporation – is the most efficient. Specifically, with the enactment of the new tax law, the earnings of a C corporation are now taxed at a flat 21 percent tax rate, with shareholders still paying the second layer of tax due when the earnings are distributed. Pass-throughs also experienced a tax cut as a consequence of the reduction in individual income tax rates and the enactment a new deduction for certain qualified business income. The highest marginal tax rate applied to the owner of a pass-through entity was reduced from 39.6 percent to 37 percent. In addition, owners of certain eligible pass-through entities can take a 20 percent deduction against those earnings, thereby reducing the overall tax rate on a pass-through entity's earnings to an effective 29.6 percent rate.

To see the impact of these changes, consider the case of a business that generates $100 of income, which it distributes to its business owner who is in the top marginal tax bracket:

C corporation: The company first pays corporate level tax of $21 on the $100 of income, leaving $79 available to be distributed to the shareholder. The shareholder then pays tax at a 23.8 percent rate (including the net investment income tax) on the distribution (tax of $18.80), which leaves $60.20 in the shareholder's hands. This translates into an effective tax rate of 39.8 percent.

S corporation that doesn't qualify for the 20 percent deduction: There is no corporate level tax; instead the shareholder pays tax on the income at his marginal tax rate. So he pays tax of $37, leaving $63 for the shareholder. This translates into an effective tax rate of 37 percent.

S corporation that qualifies for the new 20 percent deduction: The $100 of income is again taxed the shareholder level, but the shareholder is able to take a 20 percent deduction. So the shareholder is taxed on $80 at the 37 percent marginal rate. Total tax is $29.60. This results in an effective tax rate of 29.6 percent, with the owner retaining $70.40 after federal tax payments.

Other considerations when reviewing your entity choice

While tax rates and after tax cash are a major factor in entity choice, there are other differences between entities as well, such as the ability of C corporations to have an unlimited number of shareholders, to have foreign shareholders, to issue more than a single class of stock, to make public offerings, to own other corporations, and to deduct fringe benefits provided to shareholder employees. On the other hand, owners of pass-through entities are able to deduct business losses on their individual tax returns (subject to certain limitations) against other income the shareholder may have, an advantage not available to C corporation owners.

Another consideration with respect to choice of entity is the change in the deductibility of business interest. Previously, interest paid by a business was generally completely deductible, in the same way that interest income to a business was fully taxable. Now the law imposes a limitation on deductions for business interest incurred by certain large businesses – defined as any business, regardless of structure, except those with average annual gross receipts of $25 million or less, real estate and farming businesses that elect

Additional resource

A look at the math behind a new deduction that can lower taxes

In this video series, Patti Burquest and Don Susswein, principals in RSM's Washington National Tax office, unpack the potential tax savings from the pass-through provisions in the tax reform package.

Watch video

While the determination of entity choice may start with an emphasis on tax rates, it is likely to quickly encompass many complex characteristics of the business.

to exempt themselves, and certain regulated utilities. For business subject to this new interest limitation, deductible business interest expense now generally is limited to 30 percent of the business's adjusted taxable income.

This means businesses that are debt-financed will face a very different tax situation than in the past, when interest was fully deductible. This might influence a business that expects to borrow large amounts and cause it to consider structuring as a C corporation in order to raise capital through stock offerings rather than debt. Previously, the tax incentive for businesses favored debt over equity, especially since distributions of earnings aren't deductible to the business. These changes level the playing field slightly.

Thus, while the determination of entity choice may start with an emphasis on tax rates, it is likely to quickly encompass many complex characteristics of the business. There are some very general observations, however, that may prove helpful when initially pondering this issue. If a business is stable, established, and profitable, and is distributing its earnings on to the owners, pass-through structures typically are more favorable. If, however, the business is retaining substantial earnings and reinvesting them in the business, a C corporation structure may prove to be desirable.

Another highly important factor in this analysis relates to the owners' overall succession plans – that is to say, whether (and how) they plan to pass the business on to their heirs, or whether they instead might sell the business. Owners of C corporations who plan to hold the company and then pass it along to their heirs generally will be able to avoid the second layer corporate tax via the step-up in basis their heirs will receive. If, on the other hand, the owners plan to sell the C corporation, particularly through the sale of the company's assets, the second layer of corporate tax would not be avoided – potentially leading to a much higher effective tax rate as a C corporation than would be the case with a pass-through structure, particularly if there is a large amount gain eligible to be taxed at the preferential capital gains rates (a benefit C corporations do not enjoy).

If, after this analysis, an S corporation decides it is beneficial to convert to C corporation status, the business owners have several factors to consider with respect to the actual conversion.

Specifically, there are several tax compliance aspects associated with a conversion. For instance, if a mid-year conversion date is selected, both C and S corporation short period returns will need to be filed, and the shareholders will need to choose a method for allocating income between the two periods. Generally the income is prorated; however, the shareholders can make an election to do an interim closing of the books, potentially adding complexity to the conversion.

Another issue to consider is whether the company has sufficient cash on hand to distribute any previously taxed income of the S corporation during the post-termination transition period – typically a one-year period following the date of conversion. If the previously taxed earnings are not distributed within this period, it becomes more difficult to get those amounts out on a tax free basis.

Consult a tax advisor

Business owners will want to consult their tax advisers on these and other details of the new Tax Cuts and Jobs Act. Questions include:

- **Will changing my corporate structure lower my overall tax obligation?**
- **Should we make changes now or later?**
- **How will another structure affect my exit strategy?**
- **How does my debt to equity mix affect the analysis?**

Employee Benefits and Health Care Changes

Two direct changes for businesses are the loss of the deduction for qualified transportation benefits, as well as the creation of special rules that may apply to an equity purchase program for private companies. Finally, employers might consider whether cash freed up by lower corporate tax rates presents an opportunity to increase compensation, change compensation structure, or fund retirement benefits.

Loss of transportation and moving deductions

Employer-provided qualified transportation expenses for benefits such as parking passes, mass transit passes, vanpool benefits, and reimbursements for bicycle commuting, are no longer deductible to the employer but remain untaxed to employees who receive the benefits. This includes the employer-paid portion of transportation benefits offered through cafeteria-style plans.

The opposite applies to qualified moving expenses and reimbursements. While employers retain the deduction for the cost, individual employees generally lose the ability to deduct their own moving costs and now will have employer-paid or -reimbursed moving expenses included in their gross income.

In both cases, employers will want to balance how these changes affect the cost of providing these benefits, their approaches to providing the benefits and how much the benefits add to the company's ability to recruit and retain employees. Employers may want to eliminate providing relocation services and give employees a bonus or special payment to cover the costs, and may want to consider whether to gross up the payments to offset the tax cost to employees. On commuter benefits, employers that are mandated by the city or state to provide transit passes will see their costs increase.

While the tax act eliminates the individual penalty on taxpayers who do not maintain minimum essential health coverage, it does not strike down the penalties that employers can face if they fail to offer coverage or offer inadequate healthcare coverage and maintains the information reporting requirement for employers.

New retirement plan deductions

For employers, the major issue in retirement plans may well come from the increased cash flow that results from the cuts in corporate tax rates and whether that money can be directed to underfunded pension plans or employee matches in 401(k) and similar retirement plans offered by the business. At the same time, the deduction for those payments will be smaller for C corporations that saw a tax rate drop from 35 percent to 21 percent.

Additionally, the tax law increases the amount of time employees have to repay loans from retirement plans when they leave the company before the loan balance is considered a taxable distribution. The time frame is increased from a strict 60-day limit to the extended due date of an employee's individual income tax return. For businesses that use an outside administrator to handle their plans, this shouldn't be an issue, but firms that run their own plans will need to make sure that they're in compliance and that they have dutifully informed employees about the changes.

For 2018 and 2019, employers will be able to claim a general business credit for any wages paid to qualifying employees for any period those employees are on family and medical leave. The credit amount is 12.5 percent of the wages paid to these qualifying employees during that leave when the payment is 50 percent of the employee's normal wages. The credit increases by 0.25 percentage point, up to 25 percent, for each point by which the rate of payment is more than 50 percent. Employers can consider a maximum amount of family and medical leave of 12 weeks for any employee during the taxable year.

When it comes to employee fringe benefits, there are a few changes that remove deductions for the cost of offering certain benefits. Employers need to consider whether the levels of employee participation, cost and attractiveness of those benefits for hiring and retention are worth the cost of losing these deductions. Even if these benefits had remained deductible, the value of such a deduction would be reduced for C corporations with the lower tax rate.

Some of these changes expire in 2026. The list includes:

Qualified transportation fringe benefits:
Employers are no longer allowed deductions for the cost of providing qualified transportation fringe benefits to employees, although the benefits are still tax-free to employees, if provided. Employers will need to consider whether to continue providing these benefits and, if they do, how to appropriately account for the cost of providing them to be able to comply with the deduction rules.

Employee achievement awards:
A minor change, in that previous tax rules did not consider employee achievement awards of tangible personal property as income to the employee (within limits). The new tax law clarifies that items such as cash, gift cards other cash equivalents, theater

or sporting tickets, vacation vouchers, and similar awards are not tangible personal property. The limits of $400 per award and $1,600 for all awards to any single employee during the year remain in place.

Meals and entertainment:

Entertainment costs are no longer deductible to businesses as the new tax law eliminated the 50% exception that used to apply (note the 50% exception still applies to meals so it is now important to know what is entertainment and what is a meal). Certain employee-related meal and entertainment expenses received exceptions from the deduction limitations that apply to entertainment or meals, or both, so employers must carefully understand the new rules and these exceptions and, in many cases, change tracking of internal expenses to be able to properly apply these new rules.

When it comes to the actual changes to some plans and structures over time, people are waiting to react to the bigger tax reform pieces and the large business considerations first, and then asking whether they have cash savings after tax reform, and, if so, how much did they benefit and what's the best use of that cash in the business.

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2019 Tax Return Due Dates for Filing 2018 Business Returns

Partnership tax return due date	March 15, 2019
Extended tax return due date for partnerships	September 16, 2019
S corporation tax return due date	March 15, 2019
Extended tax return due date for S corporations	September 16, 2019
C corporation tax return due date	April 15, 2019
Extended tax return due date for C corporations	October 15, 2019
Sole proprietor (Individual) tax return due date	April 15, 2019
Extended tax return due date for sole proprietors and individuals	October 15, 2019

Resources

Sources and Relevant Articles

The Tax Cuts and Jobs Act (the Act): Corporate tax considerations

Tax Options Abound for U.S. Multinationals

Broad new limitation on business interest deductions

New tax law spells big changes for companies' approach to executive compensation

How the 2017 tax overhaul changed Sec. 162(m)

How the Corporate AMT Affects Different Industries

2018 Federal Tax Law Changes Regarding C-Corporations

How Does The New Limitation On Deducting Business Interest Expense Work?

How tax reform affects S and C corporation planning strategies

IRS Sheds Light on New Limit on Business Interest Expense Deductions

Tax reform - Healthcare and employee benefit related changes

Business-Related Meals and Entertainment under Tax Reform

IRS issues proposed transition tax regulations

Additional guidance regarding the new repatriation tax issued by IRS

IRS Issues Guidance on Transition Tax on Foreign Earnings

Checkpoint Special Study on foreign income, foreign persons tax changes

A Hybrid Approach: The Treatment of Foreign Profits under the Tax Cuts and Jobs Act

Net operating losses (NOLs) after the Tax Cuts and Jobs Act

Final pass-through rules help some firms more than others

Professional Services and the New 20% Pass-Thru Deduction

An Overview of Pass-through Businesses in the United States

IRS releases proposed regulations regarding pass through deduction

Final tax bill to make major changes for domestic businesses

Possible tax reform benefit for partnerships, entrepreneurs

New pass-through rules cut taxes for entrepreneurs large and small

Tax reform provides incentive for S corps to re-examine owner comp

Converting from S corp. to C corp.: Select issues for consideration

Tax Cut and Jobs Act changes to section 174 rules

Tax reform results in favorable impact to R&D tax credit election

Tax reform, retirement plans and business ownership

Tax reform - Healthcare and employee benefit related changes

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

The Chamber and RSM appreciate the efforts of Brian O'Connor in drafting this report.

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