Congressional Tax Reform Update

October 19, 2017

To our Clients and Friends:

As the Trump Administration begins to present its goals for tax reform, various planning considerations will come to the forefront. As presented, proposed tax reform is expected to significantly reduce the tax rates imposed on C corporations' taxable income. Such a reduction in rates could give closely held businesses a reason to consider converting their passthrough-entity structures (S corporations, LLC's and partnerships), which are taxed at the owner level, to C corporations.

Changing from a passthrough to a C corporation is typically uncomplicated, generally requiring revocation of an S election or, for a limited liability company (LLC) or other entity taxed as a partnership, filing Form 8832, *Entity Classification Election.* In most cases, this is a tax-free transaction, although care must be taken when converting an entity taxed as a partnership, as the relief of liabilities may exceed the owners' adjusted tax basis in the entity, which would result in a taxable event. In cases like this, taxpayers will need to fully analyze both the potential benefits and pitfalls of changing the form of entity taxation, because conversion back to a passthrough structure could carry a significant tax cost.

Taxing a company as a C corporation has traditionally offered a short-term benefit when the entity earns a modest amount of income and the low C corporation tax brackets save significant tax over the marginal cost of including the income on the owner's personal tax return.

> ***Example:*** A company has taxable income before owner's compensation of $300,000 and pays the owner a $200,000 salary. The $100,000 of the company's net income remaining after owner's compensation would be taxed at a blended rate of roughly 22% to the C corporation. In the passthrough-entity regime, the same $100,000 would most likely be taxed at the owner's individual marginal rate, which can be substantially higher than 22%.

Further costs could potentially include self-employment tax on partners and accelerated phase-out's from the increase in the owner's adjusted gross income. Beyond that, there may be added state tax benefits or costs, depending on the states where the company conducts business.

There may also be a compliance benefit when using a C corporation instead of a passthrough entity in cases where the company has nexus in several states and has several owners. This is especially true where the passthrough entity's circumstances will not allow composite filing. Additional tax filings multiply quickly in the passthrough-entity environment, versus the "one and done" filing for C corporations. A simple example would be a family-owned business that has taxable operations in 15 states and, due to its specific circumstances, cannot file composite returns in 10 of the 15 states. Further, assume that the business has multiple generations of owners, totaling 10 individual taxpayers. Under these circumstances, the state filing requirements could entail 105 or more separate returns (five state composite returns, plus 10 separate individual returns for each of 10 owners). In the C corporation environment, this is most likely reduced to 15 separate filings.

The downside of converting to a C corporation is primarily the double tax that ultimately will be paid on a liquidation of the C corporation or sale of its assets followed by a distribution of the net sales proceeds to its owners. Sec. 1202 (which allows a partial exclusion of gain from the sale of certain small business stock), if applicable, could help to mitigate this added expense in certain circumstances.

Appropriate planning may include the use of multiple entities. For example, assets such as real estate, machinery, intellectual property, or business goodwill and other intangibles may be housed in a passthrough entity to provide for a single tax on their sale. Income assets, such as receivables or inventory, could be owned by a C corporation that conducts the actual business and pays rents and royalties to the passthrough entity as a cost of operations. There may be very little taxable gain on the sale of full-basis receivables and inventories in disposition, but the business can benefit from lower tax rates and more deductible fringe benefits while in operation. In these situations, where a business is operated through multiple related entities, the taxpayer should be particularly aware of the need to have arm's-length pricing of goods and services between the related entities.

Planning options could include providing for a business operating as a passthrough entity to forming a wholly-owned C corporation subsidiary with its income assets. Rules established under the Code would need to be followed to ensure tax-free incorporation. Leases and licensing agreements between the parent and subsidiary would need to be written. Payroll tax filings, workers compensation and unemployment tax experience ratings might need to be shifted to the subsidiary, as well. .

Also, the product liability exposure, insurance coverage and qualifications to do business in various states, etc. would need to be addressed. Once established, however, the business could benefit from the current income tax treatment of C corporations, combined with the long-term benefit of a passthrough entity, because the value assets remain in the passthrough entity holding company.

Taxpayers with Qualifying Subchapter S Subsidiary (QSUB) elections in place may consider a revocation of the election. In such cases, particular care will need to be take to avoid running afoul of issues related to C corporation earnings and profits and potential taxation of its distributions.

In summary, tax reform, if enacted, could make C corporations much more attractive in closely held business settings than they have been in the past 30 years. We will continue to follow Congress' actions on tax reform and keep you advised as planning opportunities arise.

Very truly yours,

Miller*Searles* LLC

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