LLC OR CORP -
AFTER THE PROPOSED SECTION 199A REGULATIONS -
CASE STUDIES

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This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.

This outline was completed on November 29, 2018 and does not reflect developments after that date.

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1. THE BOTTOM LINE

The primary choice of entity issues for U.S. taxpayers doing business in the U.S. are:

(a) Protection from liability

(b) Avoiding a double tax on profits from the operation or sale of the business, and

(c) Whether the owners plan to use Section 1202 when they eventually sell the business.

Other tax issues are of secondary importance.

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[1] The authors acknowledge the insightful comments of Jason Flashberg, CPA on another version of this outline.

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2. TYPES OF ENTITIES

In California, the alternative for-profit business entities are:

⇒ a sole proprietorship

⇒ a general partnership

⇒ a limited partnership

⇒ a registered limited liability partnership (an "LLP," only for accountants, architects, lawyers, land surveyors and civil, electrical and mechanical engineers)

⇒ a limited liability company (including a single-member LLC or a series LLC organized under the laws of another state) (may be *manager*-managed or *member*-managed)

⇒ a regular corporation (taxed as a C corporation, an S corporation or a QSub), or

⇒ a professional corporation (taxed as a C corporation or an S corporation, rarely as a QSub).

Other states have series LLCs, business trusts, limited liability limited partnerships and professional LLCs.

See *Exhibit A* (Alternate Legal Forms of Doing Business in California).

This outline does not discuss *social purpose* corporations (formerly "flexible purpose" corporations) or *benefit* corporations, which can be formed under California law, or limited profit limited liability company ("L3Cs"), which cannot be formed under California law.[2]

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[2] For more info about these entities, see the outline *Benefit Corporations, Flexible Purpose Corporations and L3Cs* on www.staleylaw.com.

3. THE SECTION 199A DEDUCTION

In any discussion of an appropriate entity for a business, there are three elephants in the room:

The Section 1202 exclusion, an modified in 2010,

The Section 199A deduction, added by the 2017 TCJA, and

The reduction in the maximum federal income tax rate for C corporations from a maximum rate of 35% to a flat rate of 21%, effected by the 2017 TCJA.

3.1 **Purpose**:

3.1(a) To align the reduction in the federal tax rate on the income of flow-through entities and sole proprietorships with the reduction in the effective federal tax rate on C corporation income taxed and the new 21% flat rate and then distributed to the shareholders as qualified dividends.

3.1(b) For pass-throughs that get the deduction, the effective federal tax rate is 30% for shareholders active in the business and not subject to the net investment income tax ("**NIIT**") or 33% for inactive shareholders whose income is subject to the NIIT.

3.1(c) For a C corporation that distributes its income to its shareholders, the effective federal tax rate is 40%.[3]

3.2 **Overview**

3.2(a) For 2018 to 2025 a taxpayer who is not a corporation gets a deduction equal to 20% of the taxable income from flow-through businesses and sole proprietorships

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[3] The corresponding effective tax rates for combined California and federal taxes are 44%, 48% and 55%. See *Exhibit A* (Comparison of Income Distributed by a C Corporation or Flowing Through a Pass-Through Entity - Summary - Effective combined federal and CA tax rates on corporate income - after 2017 federal tax act - at highest tax rates).

◊ The taxpayer does not need to itemize deductions to use the deduction.

◊ The deduction does not apply to capital gain, interest income or dividend income.

◊ The deduction cannot create a loss.

3.2(b) The 20% deduction is determined by computing the deduction for each business and aggregating the results.

◊ But if the aggregate base amount is negative for a year, the loss is treated as a loss from a non-corporate business for the next year.

3.2(c) If the taxpayer's taxable income is less than $157,500 ($315,000 for a joint return), then the entire 20% deduction is available, without regard to the type of business.

◊ If the taxpayer's taxable income is more than $157,500 ($315,000 for a joint return), then the deduction phases out over the next $50,000 of taxable income ($100,000 for joint returns) for a "specified trade or business".

3.2(d) If the taxpayer *is* in a "specified service trade or business," then that's all he can get. So his maximum Section 199A deduction is $31,500 (or $63,000 for a joint return).[4]

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[4] A specified service trade or business is any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. I.R.C.

(footnote continued on next page)

3.2(e) If the taxpayer *is not* in a "specified service trade or business," then the 20% deduction can cover bigger dollar amounts.

◊ The enhanced limit is based on the wages of the business for the year and the unadjusted basis of depreciable assets that are used in the business and for which the "useful life" has not expired.

◊ For a business with a large payroll (Form W-2 wages) and/or that makes major investments in equipment or buildings, the full 20% may be available.

◊ For a business with a lower payroll and smaller equipment or building purchases, less than the whole 20% might be available if the taxpayer has taxable income over the $157,500/$315,000 threshold.

3.2(f) The Section 199A deduction does not apply to compensation or guaranteed payments paid by the business to the taxpayer.

◊ While the **wages paid by an S corporation** to its shareholder *will not* qualify for the Section 199A deduction, the wages paid to a shareholder *will* increase the wage base for the wage limits, possibly increasing the amount of the deduction.

- Because **guaranteed payments** are not wages, those payments do not have this benefit.

(footnote continued from previous page)

§ 199A(d)(2). The proposed regs published in August provide useful guidance. Prop. Treas. Reg. § 1.199A-5 (2018).

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The partners will deduct, the guarantee payments. But for the recipient the payments will be ordinary income, not subject to the deduction. Also, the guaranteed payments will not increase the wage base for the deduction by the other partners.

- Some recipients of guaranteed payments might be willing to have the **first profits** allocated to them instead of guaranteed payments. This will increase their risk, but allow the deduction to apply.

◊ The concept of unreasonably low compensation might be applied to S corporations to disallow some of the Section 199A deduction.

◊ So a loan-out corporation might not make sense for someone who could otherwise use Section 199A as a sole proprietorship.[5]

3.2(g) The Section 199A 20% deduction does not reduce the stock basis, the S corporation's "accumulated adjustments account" or a partner's basis in the partnership interest (under Section 704(d)).

3.2(h) The Section 199A deduction is not an AMT preference.

3.2(i) The deduction applies to an S corporation's income from publicly traded partnerships (which is useful to avoid excess passive receipts penalties).

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[5] But can a loan-out corporation ever use the Section 199A deduction if the shareholder's taxable income exceeds the limits and the principal asset of the business is the reputation or skill of the shareholder?

3.2(j) Section 199A is a horribly complex statute. It was the subject of intense political negotiations. Sadly, it bears the scars from all the political compromises. The proposed regulations issued in August, 2018 provide some clarity.

3.3 Section 199A and Choice of Entity

3.3(a) For business owners in a "specified trade or business" or a business that is not labor- or capital-intensive, the 20% Section 199A deduction for S corps and unincorporated businesses will not be available – even if the business generates high profits.

3.3(b) For them an S corporation, LLC or sole proprietorship will save a few percentage points over a C corporation in year-to-year income.[6]

3.3(c) The exception is the *inactive* shareholder of an S corporation at *high federal and California tax rates* who *cannot* use the Section 199A deduction. That shareholder will pay somewhat more tax with S corporation than with the double tax on a C corporation's distributed profits.[7] The effective tax rate for a partnership or sole proprietorship is a bit less than the C corporation effective rate for this taxpayer.

3.3(d) Because one of the limitations on the Section 199A deduction is the taxable income of the taxpayer, business own-

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[6] See *Exhibit A* (Comparison of Income Distributed by a C Corporation or Flowing Through a Pass-Through Entity - Summary - Effective combined federal and CA tax rates on corporate income - after 2017 federal tax act - at highest tax rates).

[7] See *Exhibit A* (Comparison of Income Distributed by a C Corporation or Flowing Through a Pass-Through Entity - Summary - Effective combined federal and CA tax rates on corporate income - after 2017 federal tax act - at highest tax rates).

ers might have an additional incentive to use contributions to qualified plans that provide benefits to the owners.

◊ To the extent that the amounts contributed to the plans are deducible, the taxable income of the owner is reduced.

3.3(e) If the business will be sold for a multiple of its annual cash flow, the low federal long-term capital gains rate on the sale of goodwill is the giant benefit of pass-through (or sole proprietor) status.[8]

◊ And the 100% gain exclusion of Section 1202 is the giant benefit of C corporation status.

◊ So from a planning standpoint, we arrive at the fork in the road when the entity is organized.

4. CASE STUDIES

4.1 Start-up

4.1(a) Will go through several capital raises, have venture capital, with an exit strategy of going public or exchanging its stock for stock of a public company (or soon-to-be-public company)

4.1(b) LLC? Can't go public or have an easy tax-free stock swap

4.1(c) S corp? Eligible shareholder rules too restrictive and one-class-of-stock rule too restrictive.

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[8] See *Exhibit A* (Comparison of Income Distributed by a C Corporation or Flowing Through a Pass-Through Entity - Summary - Effective combined federal and CA tax rates on corporate income - after 2017 federal tax act - at highest tax rates).

4.1(d) C corp with possible Section 1202 exclusion.

4.2 **Joe's Plumbing**

4.2(a) Everyone calls Joe because he's such a good plumber and does so much advertising. Joe has a contractor's license.

4.2(b) An LLC? The rules allowing a contractor to use an LLC are too restrictive.

4.2(c) A C corporation? The company will never go public and Joe will pay a high effective tax rate to get the profits out of the company.

4.2(d) An S corporation? None of the S corporation rules are too restrictive for Joe.

- ◊ Can Joe use the 20% Section 199A deduction? Or is the business a "specified trade or business" because it relies on Joe's personal reputation?

- ◊ Probably, because Joe is not licensing his likeness or making personal appearances like a celebrity.[9]

4.3 **Gina's Creations**

4.3(a) Gina makes costumes for movies. Can she use the Section 199A deduction?

4.3(b) She "participates in the creation of performing arts."[10]

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[9] Prop. Treas. Reg. § 1.199A-5(b)(2)(xiv), -5(b)(3) Examples 7 and 8. (2018).

[10] Prop. Treas. Reg. § 1.199A-5(b)(2)(vi) (2018).

4.3(c) But do her services "require skills unique to the creation of the performing arts"?[11]

4.3(d) Or are her services more like "the maintenance and operation of equipment or facilities for use in the performing arts"?[12] Probably, because making clothes does not "require skills not unique to the performing arts." Does that cover making period costumes? Monster costumes? Space alien costumes?

4.4 **Surfing Law**

4.4(a) Brian, Carl and Dennis really like surfing, so they become lawyers and practice surfing law in Manhattan Beach. The have a staff of 15 and several associates. They know that practicing law is a specified trade or business. They feel like maybe they should be doing something else, but they can't put it into words. Their accountant Murray suggests separating the law practice from the admin side so that the admin side, as a separate entity owned by Brian, Carl and Dennis can get the Section 199A deduction. If that works, they might pump up the fees that the law firm pays to the admin side. Does it work?

4.4(b) No, it doesn't, under the proposed regs, because the admin entity will provide more than 80% of its services to a law firm, and at least 50% of the admin entity is owned by the partners in the law firm.[13]

1111 *Id.*

1212 *Id.*

13 Prop. Treas. Reg. § 1.199A-5(c)(2) (2018).

4.4(c) Providing admin services to other law firms won't change this, because the other law firms are specified trades or businesses, too.

4.4(d) The employees of the firm who become independent contractors and still provide services to the firm are still treated as employees of the firm for purposes of the rule that the Section 199A deduction does not apply to services as an employee.[14] Same result if the employee incorporates.

4.5 FLP

4.5(a) FLP is an LLC organized by Mom and Dad to hold several parcels of commercial real estate. The parcels were inherited by Mom and Dad and were developed in the 1960s and 1970s. There are buildings on the parcels and the parcels are rented to tenants on triple net leases. The properties were placed in service by Mom and Dade from the early 1970s to 2016. After a year or so, Mom and Dad give interests in the LLC to their children. The FLP has no payroll. Does FLP get the Section 199A deduction?

4.5(b) The FLP is not a corporation, so it's income is eligible for the Section 199A deduction.[15]

4.5(c) Is the business of renting commercial real property a specified trade or business? No. "The performance of services of investing and investment management does not include directly managing real property." It does not involve receiving fees for providing services or advice.[16]

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[14] Prop. Treas. Reg. § 1.199A-5(d)(3) (2018).

[15] I.R.C. § 199A(a).

[16] Prop. Treas. Reg. § 1.199A-5(b)(2)(xi) (2018).

4.5(d) The deduction is available for the lesser of 20% of the income from the properties or "2.5% of the unadjusted basis immediately after acquisition of all qualified property."[17]

◊ "Qualified property" is tangible property subject to depreciation.[18] So the building might be qualified property, but the land is not.

◊ For non-residential real property, the applicable recovery period is 39 years.[19] So the basis of buildings placed in service before 1979 would not count towards the 2.5% limit. The cost of building placed in service after that date would be included.[20] If a cost segregation study had been done, the basis allocated to assets placed in service more than ten years ago with applicable recovery periods of less than ten years would be excluded from the 2.5%.[21]

◊ The gift of the LLC interest from parent to children does not appear to have any Section 199A effect.

4.6 **Widget Company**

4.6(a) The promoters of a new company to manufacture widgets ask if they should use an S corp, C corp or LLC.

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17 I.R.C. § 199A(b)(2)(B)(ii).

18 I.R.C. § 199A(b)(6)(A).

19 I.R.C. § 168(c).

20 I.R.C. § 199A(b)(6)(B).

21 *Id.*

4.6(b) If they can use Section 1202 to escape gain on the sale of the stock (or the gain on the liquidating distributions if the C corporation sells its asset), that might be attractive. But they will have a higher effective tax rate on operations, and there can be no certainty that all of the requirement of Section 1202 will be satisfied when the business is sold.

4.6(c) If the business can use Section 199A, it probably makes sense to use an LLC, because there is no requirement to pay wages (that are not subject to the deduction).

4.6(d) If the business cannot use Section 199A, it might make sense to use an S corp to avoid the 2.9% Medicare tax. However, using an S corporation risks becoming a C corporation, paying higher taxes on operating income and on the sale of the shares or assets (if Section 1202 does not apply). So the LLC might be attractive anyway.

4.6(e) If the promoters plan to take Widget Company public or to swap shares with a IPO candidate or a public company in a tax-free transaction, they will need to be a corporation. At some point the capital needs of the business will dictate whether it can stay an S corporation (with one class of shares and only humans and certain trusts as shareholders) or whether the corporation must become a C corporation.

[End of Outline.]

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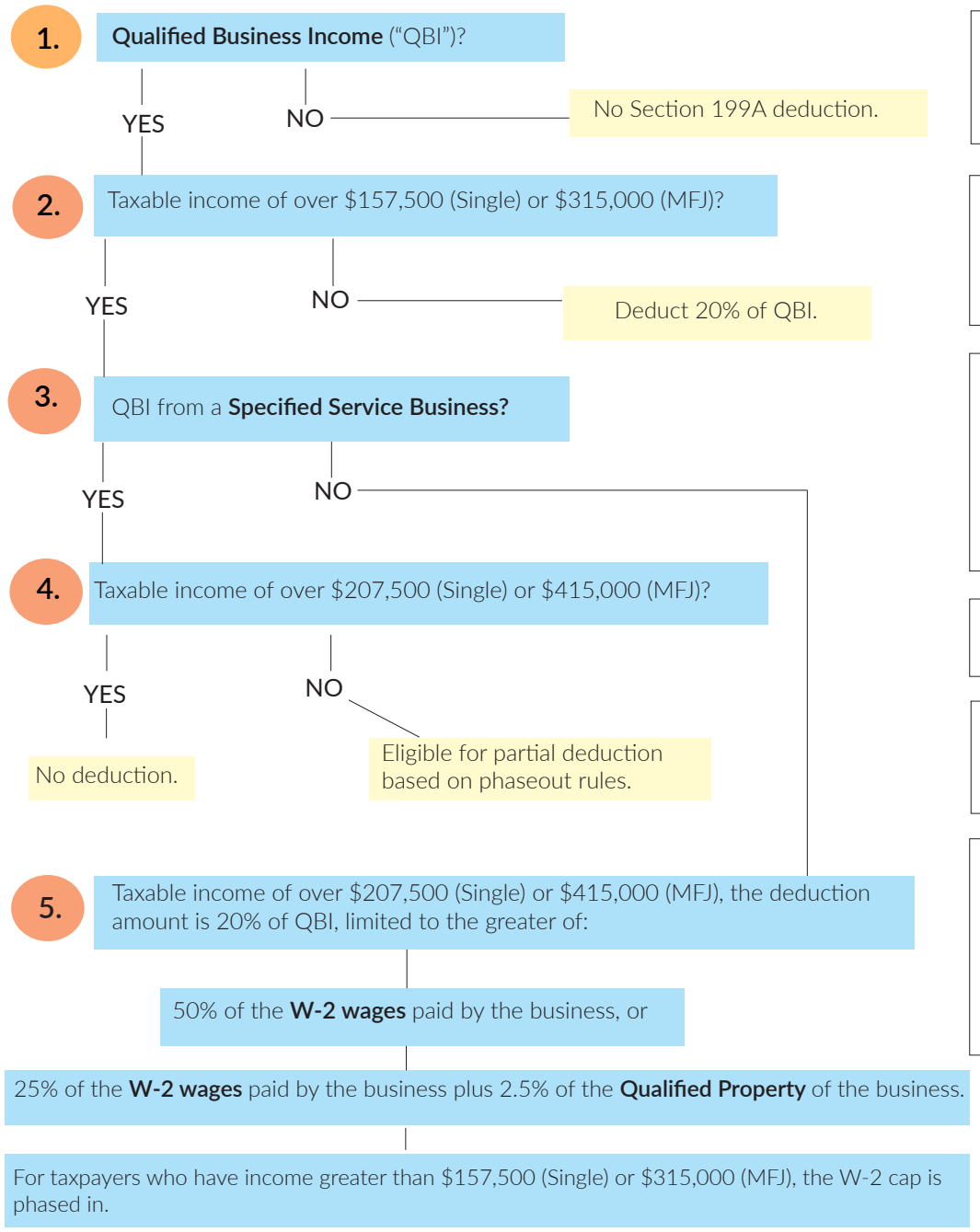
Comparison of Income
Distributed by a C Corporation or Flowing Through a Pass-Through Entity
Summary - Effective combined federal and CA tax rates
on corporate income - after 2017 federal tax act - at highest tax rates

			Shareholder Is NOT Active in the Business	Shareholder IS Active in the Business	Notes
Pass-Through (S corp)	Ordinary income	NO Section 199A deduction	56%	52%	(1)
		WITH Section 199A deduction	48%	44%	(1)
	Long-term capital gain		39%	35%	(1)
C corporation income distributed to shareholder			55%		(2)

Notes

(1)	The difference is the federal 3.8% net investment income tax.
(2)	The federal 3.8% net investment income tax applies whether or not the shareholder is active in the business.

Section 199A



Generally, QBI is the net amount of qualified items of income, gain, deduction and loss for each separate qualified trade or business of the taxpayer. Rental income earned in a trade or business activity, not simply as an investment, is included in QBI.

Qualified items do not include those items considered when determining net capital gain or loss, dividends, and interest income unless it is allocable to the trade or business. Also, to be QBI, any amount must be incurred in connection with the conduct of an active trade or business within the United States.

Specified Service Business includes any trade or business involving the performance of services in accounting, actuarial science, athletics, brokerage services, consulting, financial services, health, law, performing arts, or where the principal asset of such trade or business is the reputation or skill of one or more of its owners or employees. Also included are performance of services consisting of investing or investment management, trading or dealing in securties, partnership interests or commodities.

Engineering and architecture are excluded in the list of specific service businesses. They could still fall under the "reputation or skill exception".

W-2 wages encompass the total wages (subject to wage withholding), elective deferrals, and deferred compensation paid by the qualified trade or business with respect to the employees of the business.

Qualified Property consists of the original cost of any tangible property held by, and available for use in, the business, which is used in the production of QBI and for which the depreciable period has not ended before the close of the taxable year. The depreciable period ends on the later of (a) 10 years after the property is first placed in service or (b) the last day of the last full year in the applicable recovery period that would apply to the property under Section 168.

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