IMPACT OF NEW FEDERAL TAX LAW ON CHOICE OF BUSINESS ENTITY

Rob Wollfarth
Shareholder
201 St. Charles Avenue, Suite 3600
New Orleans, Louisiana
504.566.8623
rwollfarth@bakerdonelson.com

Introduction of Topics

A. Effect of the revised Federal income tax rates

B. Effect of the new 20% deduction for owners of pass-through entities

C. Impact of the derivative effects on State and local taxes

D. Effect of new limits on individual business losses

Federal Income Tax Rates:
Basic Entity Choice

pass-through entity

(sole proprietorship, partnership, an LLC taxed as a partnership, or an S corporation)

v.

a C corporation

Federal Income Tax Rates:
Individual Rates v. C Corp Rates Before Rate Changes

TAXABLE INCOME	CORPORATION	INDIVIDUAL	HIGHER RATE?
$0 - $18,650	15%	10%	CORPORATION
$18,650 - $50,000	15%	10%-15%	CORPORATION
$50,001 - $75,000	25%	15%	CORPORATION
$75,001 - $75,900	34%	15%	CORPORATION
$75,901 - $100,000	34%	25%	CORPORATION
$100,001 - $153,100	39%	25%	CORPORATION
$153,101 - $233,350	39%	28%	CORPORATION
$233,351 - $335,000	39%	33%	CORPORATION
$335,001 - $416,700	34%	33%	CORPORATION
$416,701 - $470,700	34%	35%	INDIVIDUAL
$**470,701** - $10,000,000 $10,000,001 - $15,000,000 $15,000,001 - $18,333,333 Over $18,333,333	34% 35% 38% 35%	39.6%	INDIVIDUAL (over $418,400 for singles)

Federal Income Tax Rates:
Considering Distributions Before Rate Changes

- **Highest income tax rate on taxable income of pass-through businesses:**

43.4% =

39.6% (highest individual marginal income tax rate)
+
3.8% (Medicare tax)

- **Highest income tax rate on taxable income of C corporation businesses:**

50.47% =

35% (highest corporate marginal income tax rate) x corporation's taxable income
+
65% of corporation's taxable income x 23.8% (highest rate on qualified dividends (20%) plus Medicare tax (3.8%))

Federal Income Tax Rates:
Individual Rates v. C Corp Rates After Rate Changes

TAXABLE INCOME	CORPORATION	INDIVIDUAL	HIGHER RATE?
$0 - $19,050	21%	10%	CORPORATION
$19,051 - $77,400	21%	12%	CORPORATION
$77,401 - $165,000	21%	22%	INDIVIDUAL ($38,700 FOR SINGLES)
$165,0001 - $315,000	21%	24%	INDIVIDUAL
$315,001 - $400,000	21%	32%	INDIVIDUAL
$400,001 - $600,000	21%	35%	INDIVIDUAL
Over $600,000	21%	37%	INDIVIDUAL

Federal Income Tax Rates:
Considering Distributions After Rate Changes

- **Highest income tax rate on taxable income of pass-through businesses:**

40.8% =

37% (highest individual marginal income tax rate)
+
3.8% (Medicare tax)

- **Highest income tax rate on taxable income of C corporation businesses:**

39.8% =

21% (flat corporate income tax rate) x corporation's taxable income
+
79% of corporation's taxable income x 23.8% (highest rate on qualified dividends (20%) plus Medicare tax (3.8%))

Federal Income Tax Rates:
Other Things to Consider After Rate Changes

- With 20% deduction for pass-through business income, effective individual rates will not exceed 29.6%.

- Both lower individual rates and 20% deduction for pass-through business income is set to expire at the end of 2025.

- The new law eliminates the corporate alternative minimum tax which may result in lowering effective corporate rate to below 21%.

- Wages paid by a C corporation to its owners will be subject to owner's individual income tax rates plus unemployment tax.

New 20% Deduction for Pass-Through Entity Owners: Introduction

- Did not exist before new tax law was adopted.
- Applies to owners of any entity other than a C corporation.
- Deduction equals up to 20% of entity's qualified trade or business income.
- Bottom line effect: lowers maximum individual income tax rate to 29.6%.

New 20% Deduction for Pass-Through Entity Owners: Persons Eligible for New 20% Deduction

- Owners of entities other than C corporations such as:
  - partnerships
  - LLCs taxed as partnerships
  - S corporations
  - sole proprietorships
  - real estate investment trusts

New 20% Deduction for Pass-Through Entity Owners: Business Types that Qualify for New 20% Deduction

- Any trade or business that is not merely an investment activity

- *Except* that any trade or business **INVOLVING** any of the following do not qualify:

  - health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services;

  - the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities; or

  - **CATCH-ALL**: where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners.

New 20% Deduction for Pass-Through Entity Owners: Planning Around Business Types

- Isolate service-type activities in a separate entity so as not to taint the activities that clearly qualify for the deduction.

New 20% Deduction for Pass-Through Entity Owners: Exceptions to Prohibition on Service Businesses

- **For married owners of service business filing jointly:**
  - 100% of service business income can be used to calculate deduction if taxable income ≤ $315,000
  - only a % of service business income can be used to calculate deduction if
    $315,000 < taxable income < $415,000
    - **<u>FORMULA</u>**: % = 100% *minus* [(Taxable Income *minus* $315,000) *divided by* $100,000]
- **For single owners of service business:**
  - 100% of service business income can be used to calculate deduction if taxable income ≤ $157,500
  - only a % of service business income can be used to calculate deduction if
    $157,500 < taxable income < $207,500
    - **<u>FORMULA</u>**: % = 100% *minus* [(Taxable Income *minus* $157,500) *divided by* $50,000]

New 20% Deduction for Pass-Through Entity Owners: Types of Income Counted Toward Deduction

- Only income earned in U.S.

- With respect to each qualified trade or business, it is the net amount of income, gain, deduction, and loss.

New 20% Deduction for Pass-Through Entity Owners: Types of Income *Not* Counted Toward Deduction

- The following types of income ***do not*** qualify:
  - investment-type income such as dividends, investment interest income, short-term & long-term capital gains, commodities gains, foreign currency gains, and similar items;
  - interest;
  - capital gains from sale of property;
  - **reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business;**
  - **guaranteed payments paid to owner of entity taxed as a partnership for services rendered with respect to the trade or business**;
  - **amounts paid by an entity taxed as a partnership to a partner who is acting outside his or her capacity as a partner for services rendered to the trade or business**;
  - qualified REIT dividends,
  - qualified cooperative dividends, and
  - qualified publicly-traded partnership income.

New 20% Deduction for Pass-Through Entity Owners: Calculating the Deduction – Step 1

- Determine for each qualified business owned how much qualified business income you have been allocated on your Schedule K-1.

- If the sum of the qualified business income from all qualified businesses is a loss, then there is no deduction and the loss is carried forward to the next tax year.

- If the sum of the qualified business income from all qualified businesses is income, then a deduction will be allowed.

New 20% Deduction for Pass-Through Entity Owners: Calculating the Deduction – Step 2

- Determine your taxable income.

- If you are married filing jointly
  - If taxable income ≤ $315,000 then deduction = 20% of qualified business income from all qualified businesses

- If you are single
  - If taxable income ≤ $157,500 then deduction = 20% of qualified business income from all qualified businesses

New 20% Deduction for Pass-Through Entity Owners: Calculating the Deduction – Step 3

- If taxable income > $315,000 (> $157,500 for singles), then you must calculate an alternate deduction amount for each qualified business equal to the *greater of* the following:

  – 50% of W-2 Wages

  or

  – 25% of W-2 Wages *plus* 2.5% of Unadjusted Basis of Qualified Property.

New 20% Deduction for Pass-Through Entity Owners: Planning Around Wage Limitations

- Maximize wages paid to owners. The statute does not exclude wages paid to shareholders from these formulas.

- Ensure that the business that will qualify for the deduction is also the business that is paying the wages and owning the depreciable property, which includes real estate.

New 20% Deduction for Pass-Through Entity Owners: Calculating the Deduction – Step 4

- **For married business owners filing jointly:**
  - if $315,000 < taxable income < $415,000
    - if 20% deduction ≤ alternate deduction amount, take 20% deduction
    - if 20% deduction > alternate deduction amount, take 20% deduction reduced by the following:
      - 20% deduction *minus* [(Excess) *multiplied by* (TAXABLE INCOME - $315,000)/100,000)]
  - if taxable income ≥ $415,000
    - if 20% deduction ≤ alternate deduction amount, take 20% deduction
    - if 20% deduction > alternate deduction amount, take alternate deduction amount

- **For single business owners:**
  - if $157,500 < taxable income < $257,500
    - if 20% deduction ≤ alternate deduction amount, take 20% deduction
    - if 20% deduction > alternate deduction amount, take 20% deduction reduced by the following:
      - 20% deduction *minus* [(Excess) *multiplied by* (TAXABLE INCOME - $157,500)/50,000)]
  - if taxable income ≥ $257,500
    - if 20% deduction ≤ alternate deduction amount, take 20% deduction
    - if 20% deduction > alternate deduction amount, take alternate deduction amount

New 20% Deduction for Pass-Through Entity Owners:
Calculating the Deduction – Step 5

- Reduce taxable income by amount of any net capital gains.
- Multiply result by 20%.
- Deduction may not exceed this amount.

New 20% Deduction for Pass-Through Entity Owners: Deduction Calculation Chart

A = 20% OF QUALIFIED BUSINESS INCOME
B = *THE GREATER OF*
[50% OF W-2 WAGES] *OR* [25% OF W-2 WAGES + 2.5% OF UNADJUSTED BASIS OF QUALIFIED PROPERTY]

MARRIED FILING JOINTLY		
TAXABLE INCOME	**COMPARISON A v. B**	**DEDUCTIBLE AMOUNT**
≤ $315,000	CALCULATION OF B NOT REQUIRED	A
> $315,000 AND < $415,000	A ≤ B	A
> $315,000 AND < $415,000	A > B	A – [(A-B) X (TAXABLE INCOME - $315,000)/100,000)]
≥ $415,000	A ≤ B	A
≥ $415,000	A > B	B
ALL OTHERS		
≤ $157,500	CALCULATION OF B NOT REQUIRED	A
$157,500 AND < $207,500	A ≤ B	A
> $157,500 AND < $207,500	A > B	A – [(A-B) X (TAXABLE INCOME – $157,500)/50,000)]
≥ $207,500	A ≤ B	A
≥ $207,500	A > B	B

New 20% Deduction for Pass-Through Entity Owners:
Bottom Line Impact on Effective Income Tax Rates

- The full 20% deduction for pass-through income will reduce the effective highest marginal income tax rate for income earned by sole proprietors and owners of pass-through entities from 37% to 33.4%:

[37% (highest individual marginal income tax rate) - (20% x 37%)] + 3.8% (Medicare tax).

- This is lower than the highest income tax rate of 39.8% on taxable income of C corporation businesses distributing after tax earnings.

Impact of New Federal Tax Law on Choice of Entity:
Factors that Favor C Corporation

- Factors that favor choosing C corporation:

  - the business will retain a large portion of its earnings
  - the owners will not qualify for the 20% deduction
  - the owners will be subject to the 3.8% Medicare tax

- If these factors are present, individual faces marginal income tax rate of 40.8% while the C corporation is taxed at 21% on its retained earnings.

Impact of New Federal Tax Law on Choice of Entity:
Factors that Favor Pass-Through Entity

- Factors that favor choosing the pass-through entity:
  - the business will distribute most of its earnings
  - the owners will qualify for the 20% deduction
  - the owners will not be subject to the 3.8% Medicare tax
- If these factors are present, individual owners of pass-through entities face a marginal income tax rate of only 29.6% while dividends from the C corporation are subject to an effective rate of 39.8%.

Impact of Derivative Effects on State and Local Taxes

- The effect of the 20% Federal deduction on State income tax may be a factor in the choice of entity analysis depending on whether the State begins its computation of taxable income with Federal adjusted gross income or taxable income or some other variation.

- Depending on how the state individual income tax rate compares to the State corporate income tax rate, the $10,000 cap on an individual's ability to deduct State and local taxes may also impact choice of entity.

Effect of New Limits on Individual Business Losses

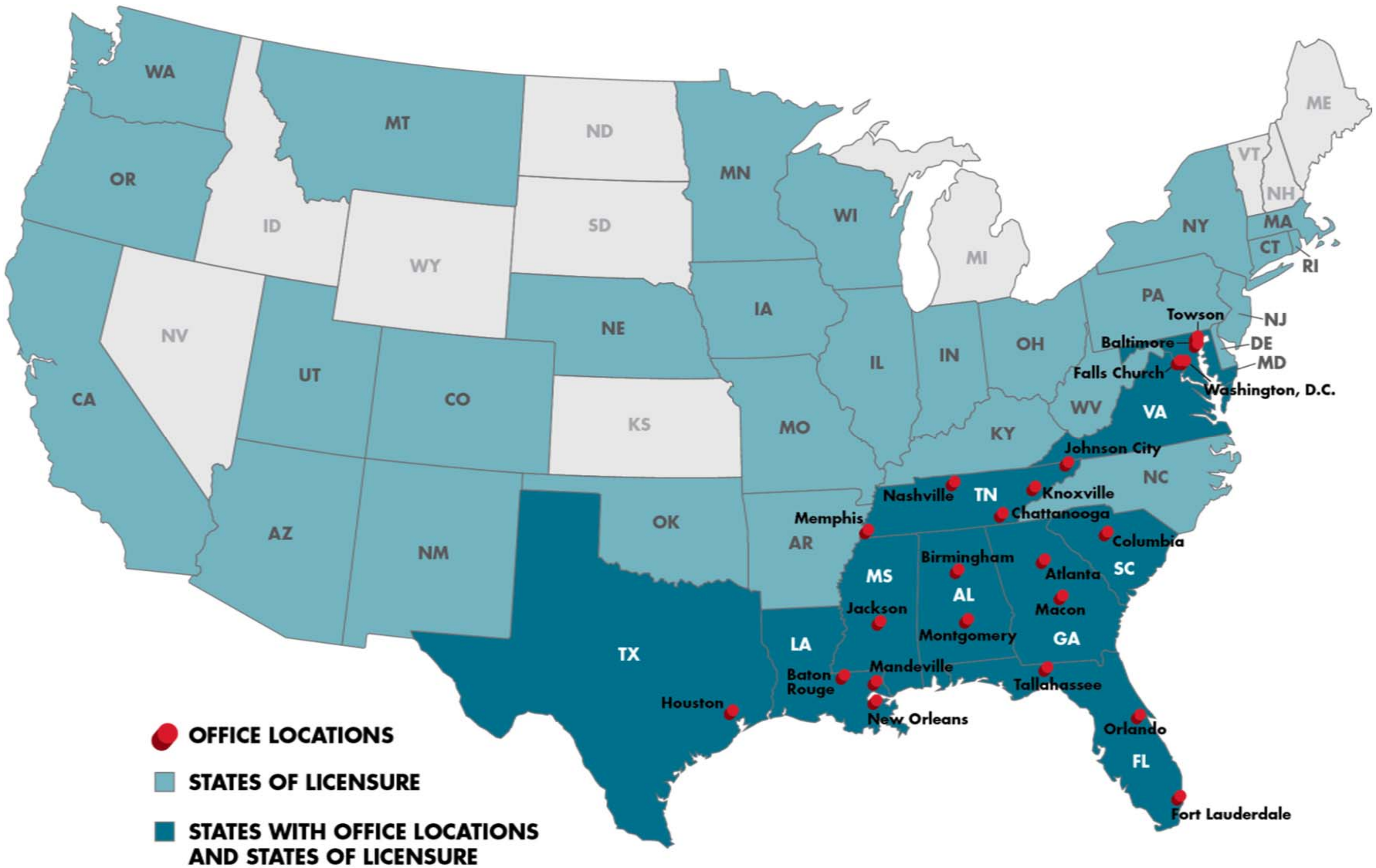
- Before the Act, business losses recognized by individuals could reduce nonbusiness income (such as interest, dividends and capital gains) without limitation.

- Beginning in 2018, through the 2025 tax year, taxpayers can only deduct up to $500,000 (for married filing joint taxpayers) or $250,000 (for singles) of these losses against nonbusiness income.

- Amounts above the threshold are considered “excess business losses” and carried forward and treated as part of the taxpayer’s NOL carryforward in subsequent taxable years.

Footprint Maps

Footprint Maps continued



Questions?