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Is Your Business Still the Right Entity Under the New Tax Rule? Part 1

What you need to know about corporations, partnerships and other structures under which you do business

By Blake Christian, CPA/ MBT

Key Takeaways:

- There are six widely used business operating structures. Each has pros and cons depending on the owner's income and estate planning options.
- Choosing the right legal form for your business is critical for both legal and tax purposes
- The Tax Cuts and Jobs Act of 2017 (2017 Tax Act) made significant changes that should be factored into your entity choice.

As many of you know, The 2017 Tax Act made significant changes to the tax code. Most significantly individual tax rates have dropped and now cap out at 37 percent (vs. prior 39.6 percent). Here are some of the other highlights:

- The C Corp tax rate has decreased from 35 percent to 21 percent
- Flow-thru entities and Sole Proprietors are generally eligible for 20 percent taxable income reduction which results in a maximum tax of 29.6 percent (vs. 37 percent) on up to $315,000 of Qualified Business Income.
- Estate and gift tax rates have decreased from 45 percent to 40 percent (but only on net assets exceeding $11.18 million per spouse for 2018 – nearly doubling the prior exemption). However, most of these provisions will sunset in 2026, making long-term planning even more important – and challenging.

One of the most common questions we get from clients and friends is: “Which legal structure should is best for my new or existing business? My standard answer is: “Well, it depends on your specific facts.”

There are a multitude of legal, tax and operating issues to consider, and one size certainly does not fit all. The general choices for operating a business include the following:

1. Sole Proprietorship – Schedule C

2. Limited Liability Company (LLC)

3. Limited Partnership

4. General Partnership

5. Subchapter S Corporation

6. Subchapter C Corporation

There are also other legal entities that may be worth investigating for certain operations, including trusts, cooperatives and joint ventures in unincorporated form.

Following is a general summary of the pros and cons of the most common forms of operations and how structure may impact income tax and estate tax planning.

1) Sole Proprietorship

This is by far the simplest form of doing business and requires very little in the way of startup costs. While legal liability exposure is highest in this form, owners can still have employees, pay themselves a W-2 and fund various benefits in a Schedule C business. As noted above, Sole Proprietors are eligible for the potential 20% deduction against Qualified Business Income, with limitations phased in once taxable income exceeds $315,000 per taxpayer (not available to certain “specified service businesses”).

Estate and Gift Tax – Upon the death of the owner(s), the legal entities' business and personal assets will transfer to trusts or heirs as outlined in the taxpayer's trust and estate documents. Various minority and marketability discounts available to other legal structures are not available in a Sole Proprietorship.

2) Limited Liability Company (LLC)

LLCs are by far the most popular form of doing business for a variety of reasons, including limited legal liability for other members' bad behavior, as well as flexibility in modifying the tax structure as your business plan evolves. There are various federal elections available to treat the entity in a variety of ways for tax purposes – see IRS Form 8823. The remaining discussion assumes a *Partnership* election is made.

Taxable income and losses (as well as credits) flow through to LLC members (and retain their "ordinary" or "capital" character) and member tax basis is adjusted. In addition, both partner and third-party loans can increase member tax basis. Also, moving assets and members in and out of the LLC is generally easier from a tax perspective than it is for a Corporation. As noted above, LLC's are eligible for the potential 20 percent deduction against qualified business income, with limitations phased in once taxable income exceeds $315,000 per taxpayer (not available to certain "specified service businesses").

Estate and Gift Tax – The most significant estate tax advantage associated with operating as an LLC that's taxed as a Partnership is that upon the death of an LLC member, both the "outside" tax basis in the LLC units inherited and the tax basis in the assets held by the LLC on the date of death will be revalued to their fair market values. This offers a very significant advantage to your heirs when the LLC has increased in value during your lifetime. As discussed later, this "step-up" in basis of the underlying assets of an LLC is not afforded to either S Corporations or C Corporations.

3) Limited Partnership

A Limited Partnership must still have a General Partner (GP). LPs are generally not subject to self-employment tax on their K-1 income as is the case with most

GP and LLC members. As noted above, Partnerships are eligible for the potential 20 percent deduction against Qualified Business Income.

Estate and Gift Tax – The value of the general and limited units will vary much more than the LLC units, based on the specific partnership terms.

Conclusion

An LLC or Limited Partnership generally provides you with the most flexible lifetime and post-mortem planning opportunities for your business. But you and your advisors must fully evaluate your specific facts and options based on the type of business operations you own and your overall estate plan. It is not uncommon for successful owners to have a variety of entities to achieve the most beneficial operational and income/ estate tax results. In Part 2 of this article we will discuss the other three common entity options: General Partnerships, Subchapter S Corporations and Subchapter C Corporations.

About the Author

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