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Is Your Business Still the Right Entity Under the New Tax Rule? Part 2

More tips about determining the right corporate, partnership or other structure that's best for your business—and where you are in life.

By Blake Christian, CPA/ MBT

Key Takeaways:

- The legal structure of your business operations can have a significant impact on your annual income tax and estate planning.
- When you and/or your heirs expect to be at or near the maximum income tax rates, you will generally want to leave appreciated and appreciating assets in the taxable estate, rather than transfer them prior to death.
- In general, assets with the potential to appreciate in value should not be placed into an S or C Corporation.

As many of you know, The Tax Act of 2017 created a host of changes and considerations for successful business owners in their families. There are six widely used business operating structure. In **Part 1 {LINK}** of this article we discussed Sole Proprietorships (Schedule C), Limited Liability Companies (LLC) and Limited Partnerships. Here will take a closer look at the other three entities: General Partnerships, Subchapter S Corporations and Subchapter C Corporations.

4) General Partnership

The rules are similar to LLCs and Limited Partnerships discussed above, except that all of the partners will generally have more liability exposure.

The partners are subject to self-employment taxes on most of their allocable K-1 income, other than certain rental real estate/passive/investment/portfolio income. As noted above, Partnerships are eligible for the potential 20 percent deduction against Qualified Business Income.

Estate and Gift Tax – See Limited Partnership discussion in Part 1 {LINK} of this article.

5) S Corporation

An S Corp is generally the least costly and easiest type of entity to set up and operate. Like an LLC, income and losses flow to shareholders, and tax is generally paid at the owner level rather than at the entity level.

One of the biggest tax breaks in this type of structure is that the S Corp shareholders can take a portion of the profits as distributions rather than as W-2 income, and payroll tax savings ranging from a minimum of 2.9 percent to 15.3 percent can be achieved.

Company-level debt does not factor into member tax basis here. Distributions must parallel the S Corp's stock ownership. Shares can only be owned by U.S. resident individuals and certain trusts. S Corps have many restrictive rules and care must be exercised in keeping distributions in the exact proportion as stock ownership. Also, S Corps with excess passive income from rents, royalties and investments can lose their S Corp status. Further, an S Corporation may have no more than 100 members. As noted above, S Corporations are eligible for the potential 20% deduction against Qualified Business Income.

Estate and Gift Tax – Unlike in an LLC, when an S Corp shareholder dies, his or her heirs will only receive a revaluation in the "outside " basis in their corporate shares – not on the underlying S Corp assets. This is also an issue for any potential buyers of the entity. This can create significant income tax problems for your heirs. Furthermore, complexities of retaining S Corp status can occur if an ineligible owner comes into the mix – e.g., an ineligible trust or nonresident alien.

6) C Corporation

C Corps are similar to S Corps with respect to the reasonable cost of formation and operation. The big difference between S Corps and C Corps is that C Corps pay tax at the entity level; however, the 2017 Tax Act dramatically dropped the C Corp rates to a flat 21 percent. C Corp shareholders will still pay taxes on W-2 earnings and certain dividends and other distributions made from the C Corp–making them vulnerable to the highly tax inefficient “double taxation.”

It is important to note that “personal service” businesses such as attorneys, doctors, accountants and consultants can operate as C Corps. Unlike the pre-2018 rules, the 2017 Tax Act will allow Personal Service Corps (PSC) to benefit from the new 21-percent rate on retained taxable income, rather than the maximum individual rate imposed under the old rules.

An unlimited number of shareholders are allowed and the C Corp can generally choose any tax year-end. Most other entities are generally limited to calendar year-ends.

Estate and Gift Tax – Similar to S Corps, a negative characteristic of C Corps is that upon the death of an owner, there is a revaluation of only the stock, not the underlying assets. Lack of restrictions on ownership make C Corps more flexible from an inheritance standpoint.

Conclusion

Congrats on building such a successful and rewarding business enterprise. Make sure you and your advisors evaluate specific facts and changing life circumstances to make sure the goals you have for yourself, your family and your heirs remains on track under the new tax landscape.

About the Author

__Blake Christian, CPA/ MBT__ is a Tax Partner in the Park City and Long Beach offices of California-based Top 50 CPA firm HCVT LLP. Blake has over three decades of experience and specializes in corporate and high net-worth individual income, estate and gift tax planning. Blake is a frequent speaker and author and is a thought leader in best practices for professional service firms.