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## Tax Reform – S vs. C Corporate Structure

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- A professional services firm with three distinct business lines
  - Wealth Advisory
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  - Audit, Tax, and Consulting
- More than 5,400 employees
- Offices coast to coast



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# Speaker Introductions

- **Matt Winkelman, CPA, MBT**  
Tax Principal, Minneapolis, MN

Matt has more than 17 years' experience serving the private sector, including businesses in the manufacturing, distribution and service industry. Matt primarily serves as the lead tax advisor for business executives and stakeholders to assist with tax planning and bring seamless capabilities and solutions. He has extensive experience working with clients that are active in mergers and acquisitions, including analysis in acquisition or divestiture scenarios to model and discuss with decision makers.



# Learning Objectives

At the end of this session you will be able to:

- Identify and evaluate benefits and drawbacks of the S and C corporate entity alternatives
- Maximize opportunities using corporate structure under the new tax provisions of the Tax Cuts and Jobs Act





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**CLA exists for one reason: to create opportunities — for our clients, our people, and our communities. We create opportunities when we live the CLA Promise.**





## Prior to Tax Reform: C Corporations

- US C corporations paid some of the highest marginal tax rates in the world with a top rate of 35% on a base of worldwide income
- C corporations that elected S corporation status with net recognized built-in gains paid tax at the corporate level at the highest corporate rate
- Corporate Alternative Minimum Tax (AMT) was computed at the rate of 20% on AMT taxable income in excess of a \$40,000 exemption



## Prior to Tax Reform: C Corporations

- Net Operating Losses were permitted to be carried back for two years and carried over for 20 years to offset taxable income
- Double tax on payment of dividends or exit with a sale of assets with individual shareholder rates at almost 40% steered many privately-held companies away from C corporation status



## S Corporations – An Overview

- Pass-through entity avoided double taxation found in C corps.
- Certain income and deductions retained favorable character for owner tax calculations, i.e, capital gains
- Cash payments to shareholders were generally not taxable to the extent of basis in stock and debt loaned to the S corp.



## The Stampede to C Corps?

- Flat 21% rate effective for years beginning after 2017
- Personal service corporations enjoy the benefit of 21% flat rate
- Alternative Minimum Tax is repealed
- Corporations eligible to deduct state income taxes



# The Stampede to C Corps?

- Highest individual income tax rate decreased from 39.6% to 37.0%
- Even with new deduction for Qualified Business Income (Sec. 199A), pass-through income, individual marginal rates exceed 21% for higher income taxpayers



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**Qualified Business Income  
Deduction - Sec. 199A**



## Sec. 199A: Qualified Business Income Deduction

- Taxpayers other than C corps. are allowed a deduction of up to 20% of Qualified Business Income (QBI). Deduction is taken on individual taxpayers tax return
- Taxpayers must determine the QBI from each qualified trade or business
- QBI is limited for taxpayers with taxable income (before the QBID) greater than threshold amount





## Sec. 199A: Qualified Business Income Deduction

- Deduction is limited to 20% of the excess of
  - Tentative taxable income of the taxpayer, over
  - The sum of net capital gain for the year
    - ◇ Capital gain includes qualified dividends
- Certain service activities do not qualify for Sec. 199A deduction
- Domestic Manufacturing Production Activity Deduction is eliminated





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**Questions and  
Considerations for Entity  
Conversion or Selection**

# Entity Conversion: Questions to Ask

- How much income will be eligible for the 20% QBI deduction?
- Will the shareholder(s) be taking dividends out of the C corporation?
- Are there appreciating assets inside the company?
- What is the expected holding period for the assets?
- Is the company profitable?
- Future capital expenditure needs?
- What is the business income tax liability expected on C vs S?



## Entity Conversion: Questions to Ask

- Is the company selling product or services or some combination of both?
- Would the corporation's stock be eligible for Sec. 1202 status?
- Does the C corporation have current and accumulated earnings & profits?
- What are the levels of owner compensation?
- Resident state and apportioned business income to states?



# Entity Conversion: Cash from Operations

- Will the shareholder be taking dividends from the C corporation?
  - Impact of double tax minimized if all or some cash stays in the entity
  - Indefinite deferral of all dividends may lead to assessment of accumulated earnings tax on C corporation
  - Owner compensation is deductible by the C corporation while dividends are not



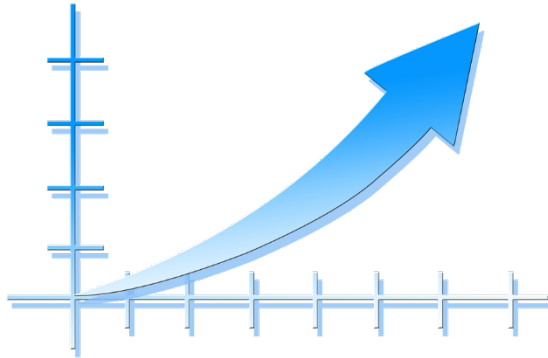
# Entity Conversion: Cash from Operations

- In lieu of dividend payments, consider other cash payments to owners, such as rent, guarantee fees, loans
  - Must be at arm's length rates



# Entity Conversion: Shareholder's tax Rates

- Determining the shareholders marginal rate
  - Qualified Business Income eligible
  - State tax impacts





## Entity Conversion: Appreciating Assets

- Many deals are structured as asset sales
- Flat 21% tax rate applies to both capital and ordinary income in a C corp.
- Preferential capital gains rates generally available in S corp.
- Planning for sale to third party should look at additional tax cost of sale of assets rather than stock



# Entity Conversion: Timeline for Exit Strategy

- What is the expected holding period for the assets?
- Longer term exit may be affected by possible future changes to the tax laws



# Entity Conversion: Timeline for Exit Strategy

- Potential structure of exit transaction affects planning
  - Sale to third party,
  - Internal sale to employees, possibly with an ESOP
  - Gifting
  - Hold until death (step up in basis)
  - State taxes



## Entity Conversion: Profitable or Loss Company?

- If company is generating operating losses, benefit may not be realized in the same subsequent periods for S or C corps.
- S Corp – “excess business losses” are not allowed in a taxable year and become part of the individual taxpayer’s Net Operating Losses in subsequent taxable years



# Entity Conversion: Profitable or Loss Company?

- Aggregate losses for taxpayer trade or businesses over aggregate gross income or gain plus a threshold of \$500,000 (Married Filing Joint)
- C corp. – Net Operating Losses (NOL) limited to 80% of current year business income
  - NOL Carrybacks are now disallowed
  - NOL Carryforwards do not expire



## Entity Conversion: Product or Service Revenue?

- Sec 199A deduction is not available for specified service company with revenues greater than the threshold
- Awaiting guidance on eligible nonservice business
- Planning opportunity: May want to create separate line of business or separate legal entity for two lines of business to take deduction



# Entity Conversion: Sec. 1202 Exclusion

- Gain on the sale of qualified small business stock issued after September 27, 2010 is eligible for a 100% exclusion





# Entity Conversion: Sec. 1202 Exclusion

- Exclusion applies to C corporation stock
  - Five year holding period
  - Gain exclusion limited to greater of \$10MM or 10x basis
  - Applies to non-corp. shareholders of qualified small business stock
- Favorable to C corporations in situations where buyer will acquire qualified small business stock or assets and a liquidation transaction



## Entity Conversion: Earnings & Profits

- Presence of C corp. earnings and profits impacts taxability of cash distributions to shareholders
- Conversion to S does not eliminate E&P
  - Distributions from S corporation with E&P in excess of S corporation AAA may be treated as dividends



## Entity Conversion: Owner Compensation

- Owner compensation planning historically focused on maximizing deductible compensation for C corporation shareholder/employees while avoiding a possible re-characterization as dividend income
- Compensation for S corporation shareholder/employees was minimized as a means of reducing employment taxes



# Entity Conversion: Other Items for Consideration

- Limitations on business interest
- Deducting state income taxes
- At-risk rules
- Passive activity losses



# Entity Conversion: Business Interest Expense Limitation

- Deduction for business interest expense limited to the sum of:
  - 30% of adjusted taxable income
  - Business interest income; and
  - Floor plan financing interest
- Limitation applies at entity level
- Limitation N/A if avg. annual gross receipts  $\leq$  \$ 25M



## Entity Conversion: Other Items for Consideration

- Starting in 2018, an individual's itemized deduction for state or local taxes is limited to \$10,000
  - Includes real property taxes, personal property tax, state and local and foreign income taxes and general sales taxes
- Limitation does not apply to taxes paid in connection with a Sec. 162 trade or business or Sec. 212 investment property
- States conformity to the Tax Cuts and Jobs Act



# Changing the Entity: Terminating the S Election

- Terminate S status by voluntarily revoking election
- Requires consent of shareholders who hold more than 50% of the number of issued and outstanding shares
- Files statement with IRS Service Center where S election was filed





# Changing the Entity: Terminating the S Election

- Election made during the tax year and before the 15<sup>th</sup> day of the third month is generally effective for the entire year
  - Can specify future effective date in election
- After the 15<sup>th</sup> day of the third month, change is generally effective first day of the next year
  - Can specify a midyear effective date in the revocation



# Changing the Entity: Terminating the S Election

- Revocation of S status effective on other than the first day of the year requires two short year returns to be filed – one as S and second as C
- S short period ends on date before terminating event; C short period begins on the date terminating event occurs



# Changing the Entity: Terminating the S Election

- Items of income, loss and deduction are allocated to the S and C short periods on a pro-rata method or specific accounting method



# Conversion to C Corporations: Considerations

- Rate changes in future years
- Availability of the cash method of accounting to C corporations
- Revocation of S status and re-election period (five year wait period)
- Accumulated Earnings Tax
- Financial Statement Reporting as a C corp



# Conversion to S Corporations: Considerations

- Built-in Gains Tax
- Excess net passive income tax
- LIFO recapture tax
- Shareholder eligibility
- Number of shareholder restrictions
- Single class of stock required



# Comparing S Corps. and Partnerships as C Corp. Alternative

Conversion from partnership to C corp. is treated as a tax free incorporation if Sec. 351 applies and the partnership's liabilities do not exceed the basis of its assets.

Conversion from C corp. to partnership status is treated as a liquidation which generally results in gain recognition for both the corporation and the shareholders.



# Example 1: S vs C Corp

Assumptions: *Business is profitable, pays tax*  
*All cash paid out in dividends*  
*Sec. 199A at maximum rate*  
*Shareholder is in highest bracket*

		<u>Combined C corp taxation</u>		Shareholder
		1120	1040	<u>S corp</u>
				1040
Net Income		\$ 1.00		\$ 1.00
Corporate Tax Rate	21%	\$ (0.21)		
Net Cash Available for Distributions		\$ 0.79		
Cash Paid to Shareholder			\$ 0.79	\$ 1.00
Less Tax for Dividends	23.8%		\$ (0.19)	
Less highest 1040 rate,	37%			
Sec 199A rate at	20%			\$ (0.296) QBID
Net After-Tax Cash			\$ 0.60	\$ 0.70
Difference in net after-tax cash				<b>\$ 0.10</b>
Effective Tax Rate:			39.8%	29.6%

# Example 2: S vs C corp

## Assumptions:

*Business is profitable, pays tax*  
*50% cash paid out in dividends*  
*Sec. 199A at maximum rate*  
*Shareholder is in the highest bracket*

		<u>Combined C corp taxation</u>		<u>S corp tax</u>
		1120	1040	1040
Net Income		\$ 1.00		\$ 1.00
Corporate Tax Rate	21%	\$ (0.21)		
Net Cash Available for Distributions		\$ 0.79		
Cash Paid to Shareholder			\$ 0.40	\$ 1.00
Cash Retained		\$ 0.40		\$ -
Less Tax for Dividends	23.8%		\$ (0.09)	
Less Marginal Rate for individual tax	37%			
Assumes Sec 199A rate at	20%			\$ (0.296)
Net After-Tax Cash			\$ 0.70	\$ 0.70
Difference in net after-tax cash			\$ (0.01)	
Effective Tax Rate:			30%	30%



# Entity Conversion: Look Before You Leap





## Questions?

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