Choice of entity and addressing entity conversion considerations

The new tax law created substantial changes in corporate, pass-through, and individual tax provisions. In light of these changes, many companies and their owners are now asking whether it makes sense to change their structure from a pass-through to a C corporate entity.

Key provisions of the 2017 tax Act[1]

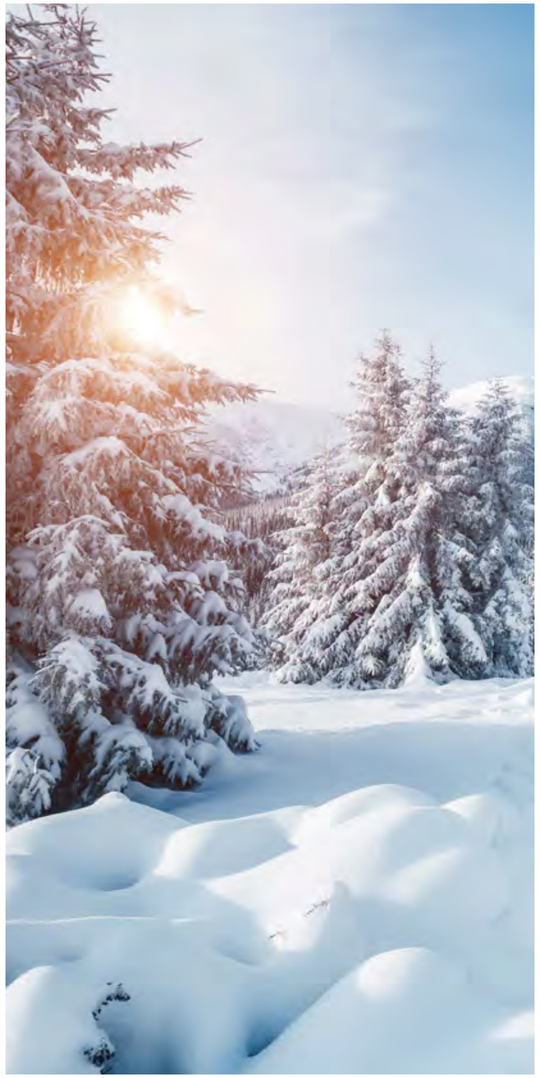
There are numerous factors to consider with a conversion, and it is important to understand all the facts and circumstances of your business, as well as the individual shareholder/ partner situations, before moving forward.

Some of these considerations are listed within this chapter, but we have found that modeling is important to quantify the potential tax implications of a conversion. Moreover, there are a number of qualitative considerations that also should be addressed as part of the analysis.

Federal income tax rate changes

Prior law	
C corporation shareholder	50.47%
Partner/S corporation shareholder	43.40%
New law	
C corporation shareholder	39.80%
Partner/S corporation shareholder (with no pass-through deduction)	40.80%
Partner/S corporation shareholder (with pass-through deduction)	33.40%

- For corporate scenarios, assumes that all after-tax earnings are distributed
- For simplicity, the employment tax rate is assumed to be 3.8% and payroll tax deductions are ignored
- Does not factor in compensation paid
- Does not factor in active vs. passive ownership (assumes either 3.8% employment tax or 3.8% net investment income [NII] tax applies to all income)
- Does not include state tax implications



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[1] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (the Act).

Key provisions to consider

Some of the key provisions that go into the modeling of entity conversion include understanding:

- Key pass-through provisions, such as qualification for and ability to claim the section 199A deduction (pass-through deduction)
- Key individual provisions, such as the owner's effective tax rate structure and the changes to the overall individual tax system, which sunset December 31, 2025
- How those provisions compare to key corporate provisions, including the permanent corporate rate reduction to 21%
- Other key provisions, such as the new international provisions of the Act

These items must be analyzed in conjunction with other considerations, including:

- Amount of annual distributions, now and in the future, which can impact the benefit of a conversion
- Character and timing of income recognized, such as the benefit of keeping long-term capital gain (LTCG) character
- State tax liability generated from the business activity
- Exit strategy alternatives and timing considerations for shareholders and/or partners

Key provisions of the 2017 tax Act
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Key provisions to consider

Key pass-through provisions

- Section 199A deduction 20% qualified business income (QBI), real estate investment trust dividends, PTP income (pass-through deduction)
- Carried interest
- Repeal of section 708(b)(1)(B) related to technical terminations
- Effectively connected income on the sale of a partnership interest

Key individual provisions

- Maximum individual rate of 37%
- Limitation on excess business losses
- Increased alternative minimum tax (AMT) exemption
- Personal exemption phaseout repealed
- Limitation on itemized deductions repealed
- Deduction of up to $10K ($5K MFS) for the aggregate of nonbusiness: (1) state and local property taxes, and (2) state and local income taxes or sales tax

Key corporate provisions

- 21% corporate rate
- Section 162(m) executive compensation
- Corporate AMT repealed
- Change in indirect foreign tax credits

Other key provisions

- New international provisions
  - Global Intangible Low-Taxed Income (GILTI), Base Erosion and Anti-Abuse Tax (BEAT), Foreign-Derived Intangible Income (FDII)
- Section 199 repealed
- 100% bonus depreciation
- Interest limitation of 30% adjustable tax income (ATI)
- State tax implications for entity choice

Sample considerations for analyzing a conversion from pass-through to C corporation

- Annual distributions—now and into the future
- Qualification for section 199A deduction
  - US-sourced vs. non-US-sourced income
  - QBI
- Character of income recognized
  - LTCG and qualified dividends
  - Section 212 portfolio deductions
- Owners of the company
- Growth of the business assets vs. growth of cash distributed
- Section 351 considerations
- International considerations
  - Structure
  - Foreign tax credit planning
  - Certain gain recognition provisions such as overall foreign loss recapture and section 367
  - Impact on dual consolidated loss rules
- Potential future changes in tax law
- Carryforward attributes of partners
- Accumulated adjustments account distribution planning for terminated S corporations
- Estate planning
- Implications of section 7519 payments for fiscal year filers
- State tax implications
  - State sourcing and income tax rates
  - Investment partnership rules
  - Compliance costs
  - State tax footprint of the entity
  - State tax footprint of the owners
- Exit strategy considerations
  - Sale of partnership interest
  - Stock vs. asset deal of corporation
  - Holding period upon exit
  - Purchase price considerations

Choice of entity and addressing entity conversion considerations

Modeling your path forward

Modeling is important to quantify the potential tax implications of a conversion. Although the Act resulted in a lower overall corporate rate, converting to C corporation status may not always be the right answer. You will need to consider specific facts and circumstances of the entity and individual shareholders/partners, as well as both federal and state tax implications of each entity form.

Entity conversion modeling process

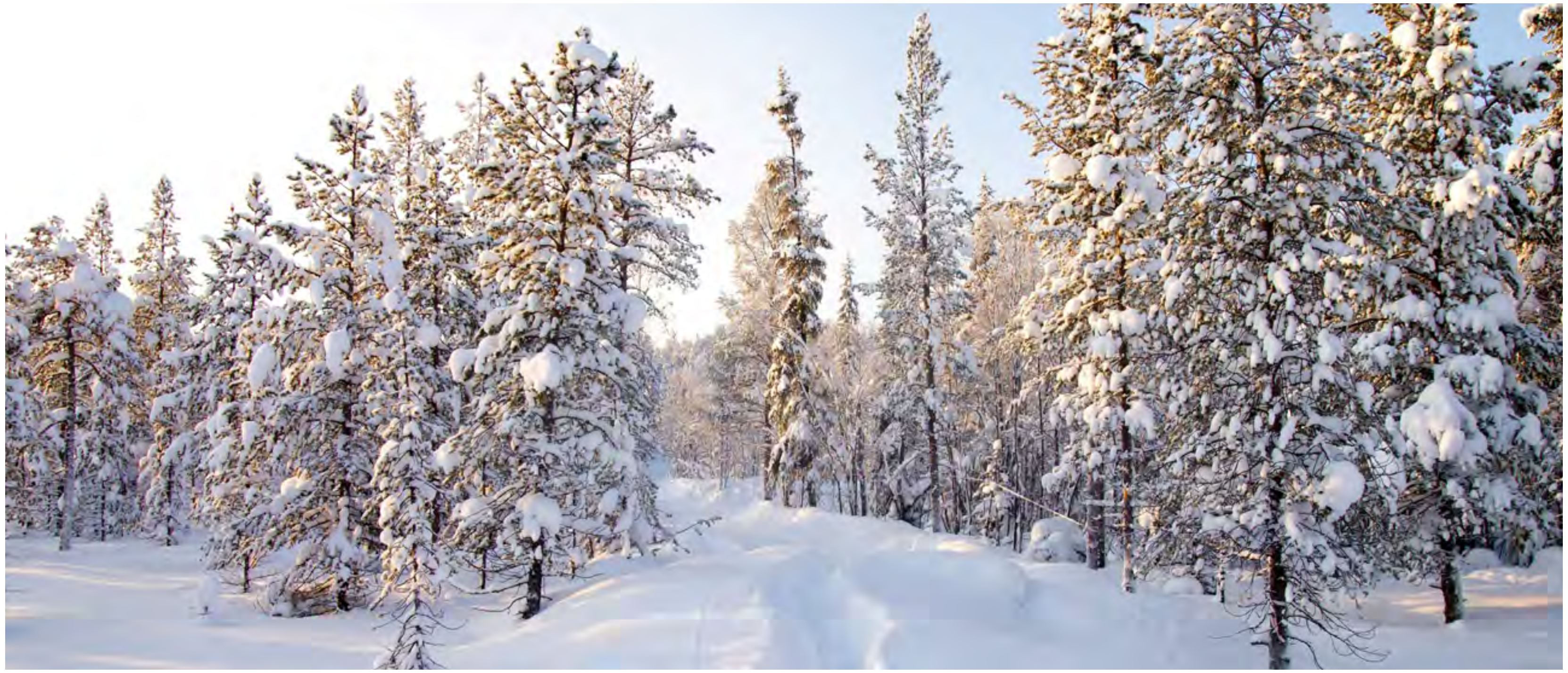
		Federal	State	Other
Step 1	**Analyze** Strategic considerations	• Qualification of section 199A deduction • Business interest expense limitation • Character of income • Portfolio deductions • Fiscal vs. calendar year • Active vs. passive • Excess business losses	• State tax footprint for entity • Residency of owners • Individual state tax considerations • Number of state tax filings/administration • Change in apportionment methodology	• Distributions—current and future • Exit strategy/timing • Form of exit and impact on sales price • Growth of assets in the business • Projected growth of business • International considerations • Estate planning
Step 2	**Model** Understanding the impact of converting	• Annual after-tax cash flow • Individual federal taxes paid • Entity-level federal taxes paid • Self-employment/NII tax considerations • Foreign tax credits	• State taxes paid at entity level • Individual state taxes paid to nonresident states • Individual credits for taxes paid to other states • Individual state taxes paid to resident state	• Time value of money considerations • After-tax cash following an exit • ASC 740 implications
Step 3	**Execute** Putting your plan into action	• Conversion to a C corporation—Prepare and execute the steps to effectuate a conversion considering the federal, state, and international requirements • Retain existing structure—Address strategic planning opportunities identified within steps 1 and 2 of the modeling process		

Services for the path forward

We invite you to look again at the important issues at hand and consider Deloitte's additional tax reform services as you move forward on the path ahead.

Additional tax reform services

- Tax accounting and provision assistance, ASC 740
- E&P and tax basis analyses; separate state analysis may be required
- Technology and systems updates
- Strategic compensation and benefits reviews
- Global mobility cost analysis and program design planning
- Value chain alignment
- Tax compliance services
- Private wealth planning assistance



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