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.
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Key provisions of the 2017 tax Act

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

<table>
<thead>
<tr>
<th>Prior law</th>
<th>New law</th>
</tr>
</thead>
<tbody>
<tr>
<td>C corporation shareholder</td>
<td>C corporation shareholder</td>
</tr>
<tr>
<td>50.47%</td>
<td>39.80%</td>
</tr>
<tr>
<td>Partner/S corporation shareholder</td>
<td>Partner/S corporation shareholder (with no pass-through deduction)</td>
</tr>
<tr>
<td>43.40%</td>
<td>40.80%</td>
</tr>
<tr>
<td></td>
<td>Partner/S corporation shareholder (with pass-through deduction)</td>
</tr>
<tr>
<td></td>
<td>39.80%</td>
</tr>
</tbody>
</table>

- 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).
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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
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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
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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

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