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Choice of Entity After 2017 Tax Reform: Avoiding Tax Pitfalls in Operations, Ownership Changes, Exit Strategies

Capital vs. Profits Interest, Allowable Deductions, Distributions, Exclusions, and Other Planning Considerations

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JUST WHEN YOU THOUGHT YOU HAD IT FIGURED OUT: Revisiting choice of Entity and Structuring M&A Transactions in Light of Recent Tax Law Changes

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INITIAL CONSIDERATIONS IN CHOICE OF ENTITY – ARE LLCS STILL ALL THEY ARE CRACKED UP TO BE?

Limited Liability Companies

- State Law Considerations.
  - LLCs can be structured to be manager-managed in order to provide a corporation-like governance structure (i.e., have a board of managers, which is similar to a board of directors), or can be structured as member-managed to provide simplified governance for special purpose entities. Note that for an LLC, another entity may serve as a manager, whereas for a corporation, an entity cannot serve as a director.
  - LLCs provide better charging order protection than state law corporations because in most cases the creditor becomes an "unadmitted assignee" and is not considered a normal voting member of the LLC.

- Federal Income Tax Considerations
  - An LLC can be taxed in one of four different ways for federal income tax purposes
    - Disregarded Entity
    - Partnership
    - C Corporation
    - S Corporation

Corporations

- State Law Considerations
  - Corporations on the other hand are much more rigid and formal. In contrast to LLCs and LPs, the governance of corporations is bound more so to state law than by contract.
  - While a LLC may be managed by its members, a corporation is required to have a board of directors. As noted above, another entity cannot serve as a director of a corporation. Furthermore, changes to the capitalization of a corporation involve making public filings to amend the corporations organizational documents, while changing the capital structure of an LLC can be accomplished without a public filing (as such changes can be accomplished via internal company documents).

- In addition, corporations do not provide the same level of protection in the event of a charging order. Unlike LLCs, a creditor who obtains a charging order against the stock of a corporation not only obtains the right to receive dividends, but also receives the right to vote those shares. Therefore, shareholders and directors alike could find themselves having to deal with creditors inserting themselves into the governance of their corporations. Note that this concern can be alleviated (but not eliminated) by having this issue addressed in a buy-sell agreement.

- Federal Income Tax Considerations. A Corporation may only be taxed in one of two ways for federal income tax purposes. A state law corporation is, by default, taxed as a C corporation. The corporation may elect to be taxed as a subchapter S corporation by filing IRS Form 2553.

Limited Partnerships

- State Law Considerations
  - LPs have many of the liability protections that LLCs have, including similar charging order benefits.
  - However, as with corporations, their structure and governance is more complicated. LPs are required to have a general partner, which typically is another entity. Therefore, owners of LPs generally have to deal with governance and compliance matters for two separate entities.
  - Limited partners must be careful not to actively engage in the business of the LP or they risk being reclassified as a general partner.

- Federal Tax Considerations
  - An LP
  - Partnership
  - Disregarded Entity
  - C Corporation
  - S Corporation

As noted above, limited partners must be careful not to actively engage in the business of the LP or they risk being reclassified as a general partner. The presence of the Net Investment Income Tax ("NIIT") presents some interesting challenges here. A limited partner that materially participates in an LP's business may escape the NIIT, but then be reclassified as a general partner. This is a situation where state entity law and federal tax law can have varying interests.

General Partnerships

- State Law Considerations
  - General partnerships offer no liability protection. Therefore, general partnerships and their partners should ensure that they have adequate insurance coverage to protect them against liability.
  - Partners in a general partnership should also consider using other types of entities with liability protection to help shield themselves from general partnership liabilities.

- Tax Considerations
  - As with LP's, general partnerships can be taxed one of four different ways for federal income tax purposes: disregarded entity, partnership, C corporation or S corporation.
  - GPs are not subject to Texas franchise tax if all partners are individuals.

LLC Members and Self-Employment Tax – the Castigliola Case

One issue that has clouded the use of LLCs for many years is whether or not a member of an LLC is considered to be a limited partner for purposes of the self-employment tax. This pertains to LLCs that are treated as partnerships for federal income tax purposes.

One important takeaway is that the Tax Court in *Castigliola* held that the meaning of "limited partner" for purposes of § 1402(a)(13) had to be determined based on Congressional intent, and not based on state law designations. Therefore, it is conceivable that a limited partner of an LP could be subject to self-employment tax on his or her share of partnership income if he or she participates in the control of the partnership.

- Potential Solutions to the Castigliola Issue:
  - S Corporation Election
  - Management Company
  - S Corporation Partner
  - Tiered Partnership

New Treas. Reg. §301.7701-2T(c)(2)(iv)(C)(2) – The IRS Continues the Onslaught

- This new temporary regulation provides that an individual cannot be an employee of a disregarded entity that is wholly-owned by the individual, and a partner cannot be an employee of a disregarded entity that is wholly-owned by the partnership. This means that partners who also serve as business managers of operating partnerships cannot treat their compensation as wage income. Note that under Rev. Rul. 69-184, a partnership cannot treat management as employees (dual status partners) with respect to compensation paid to them through regular partnership payroll.

- The new temporary regulation is generally effective as of August 1, 2016. Expires May 3, 2019. The temporary regulation may not be adopted.
- How to get around this?
  - Tiered Partnership. Many private equity funds are employing this strategy. Essentially, partners with management functions form a partnership (or more than one partnership) to hold their equity interests in the operating partnership. Investors hold their interests directly. Note that the IRS has requested comments on tiered partnerships.

- Subsidiary Employee Leasing Company. The partnership could form a subsidiary C corporation which serves as an employee leasing company which employs management. Note that this option is similar to having a separate management company (which was discussed above).
- Think about your employee benefit plans
  - Definition of compensation
  - Control group issues

Structuring Considerations – Net Investment Income Tax

- The NIIT may also have an effect on what type of entity a business owner may choose. The NIIT is a 3.8% tax on the lesser of a taxpayer's net investment income or the taxpayer's modified adjusted gross income over the threshold amount.
- Net investment income is generally tied to passive income, including portfolio income and income from passive activities.
- For C corporation shareholders, this means that dividends paid by their C corporations are subject to the NIIT, as is the sale of their stock.

- For partnerships and S corporations, the question becomes whether or not the partner/shareholder at issue materially participates. When considering ownership structures, especially in the context of succession and estate planning, special care should be given to the participation of partners/shareholders, and in the case of trusts, participation of such trusts' trustees. Consideration should be given to appointing an officer of the partnership/S corporation as the trustee as a possible way to establish material participation for the trust.

Series LLCs

- Many states have enacted changes to permit series LLCs. Series LLCs are a unique type of LLC in which the certificate of formation (or similar state formation document, depending on the state of formation) specifically allows for unlimited segregation of membership interests, assets, and operations into independent series. Each series operates like a separate entity with a unique name, bank account, and separate books and records. A series LLC may have different members and managers in each series. The rights and obligations of these members and managers differ from series to series. Each series may enter into contracts, sue or be sued, and hold title to real and personal property.

- Treasury has issued proposed regulations indicating that each series of a series LLC is treated as a separate entity for federal income tax purposes. Therefore, there is no difference between a series LLC and separate LLCs for federal income tax purposes.
- In Texas, the comptroller will treat series LLC's as a single taxpayer.
- Given these risks, it may be more prudent for clients to continue to use separate LLCs in order to ensure adequate liability protection until more case law is developed to sort these issues out.

TAX CLASSIFICATION – WHAT IS OLD IS NEW AGAIN?

Introduction

- Generally, there are four tax classifications under which an entity can fall for federal income tax purpose:
    - C Corporation
    - S Corporation
    - Partnership
    - Disregarded Entity

- Prior to the enactment of the Tax Cuts and Jobs Act of 2017 (the "2017 Act"), most small to medium business shied away from C corporation status due to the high corporate level tax rate and the exposure to a second level of taxation on dividends from the C corporation. Instead, most businesses classified their legal entities as either S corporations or Partnerships for federal income tax purposes.
- S corporations and Partnerships are considered "pass-through" entities because unlike C corporations, their income passes through the entity and onto the individual owners' personal income tax returns. This eliminates the double taxation issue inherent in C corporation structures.

- There are some key differences between partnerships and S corporations.
  - Partnerships provide the most flexibility with respect to ownership, allocation and transaction planning. Partners may, in most cases, receive distributions of partnership property without any immediate tax due, and partnership agreements can provide for disproportionate or unique allocations and distributions amongst the partners (subject to certain limitations). Partnerships may be owned by trusts, foreign persons, S corporations and C corporations in addition to individuals and other partnerships. However, as discussed above, partners of partnerships may be subject to self-employment tax on their share of partnership income. Further, although estate and company succession planning concerns are not the focus of this presentation,

Partnerships present more flexibility and options in this regard. For example, a family limited partnership can be an owner of a Partnership, but not of an S corporation.

- S corporation shareholders may not be subject to self-employment tax on their share of S corporation income so long as shareholders who receive compensation from the S corporation receive salaried compensation that is "reasonable". However, S corporations have several disadvantages including:
  - Limitations on the number and types of shareholders;
  - All allocations and distributions must be made pro-rata to the shareholders; and
  - Distributions of property held by an S corporation results in a deemed sale of the property being distributed and gain recognition for the S corporation and the shareholders.

- The 2017 Act has introduced some new tax changes which have caused many business owners to reconsider their tax structures. The first is a significant reduction in the C corporation tax rate. The rate has been reduced from 35% to 21%, which made the effective tax rate for C corporation shareholders much closer to those who owned pass-through entities.

The second change was the enactment of § 199A, which provided owners of pass-through entities a deduction for combined qualified business income.

Finally, the 2017 Act provides for the suspension of the deduction of investment advisor fees.

C Corporations – Same Old C Corporation, Better Rate

- The reduction in the C corporation tax rate has attracted the attention of many clients and business advisors. Under the 2017 Act, the corporate tax rate was reduced to 21% and the corporate alternative minimum tax was repealed. On paper, a 21% rate seems like a good deal. However, there are a few things to consider.
  - Dividends are still taxable and still result in double taxation of income. Therefore, clients who regularly take distributions from their business may not be in a better position, effective tax rate wise, by converting to a C corporation versus retaining their existing pass-through structure, especially if the client can take advantage of the tax benefits provided by § 199A.

- The receipt of any proceeds from the sale of a C corporations' assets (whether actual or deemed) would also be subject to dividend taxation in addition to the corporate level tax.
- C corporations which retain earnings and do not make dividends could be subject to the accumulated earnings tax on their retained earnings.
- The dividends received deduction has been reduced.
- Inflexibility with respect to distributions of assets due to deemed sale treatment.

- Given these restrictions and the availability of § 199A benefits, C corporations may not be a good fit for many clients.

- However, C corporations may be useful in certain circumstances. This determination has become even more dependent on the facts and circumstances of each situation. The primary case is where a business plans to invest heavily in growth, whether that is through R&D or acquisitions. It may make sense in that instance to obtain (or retain) C corporation status in order to limit the amount of tax generated on its profits, while they are being reinvested into product development or growth. The owners can later convert to S corporation status to obtain pass-through benefits after long-term growth is achieved. Note that converting disregarded entities and partnerships into C corporations is generally tax free. An S corporation that wishes to revoke its election may do so, but cannot re-elect S status for five years.

- Tech Startups –Partnership or C Corporation?
  - Traditionally, C corporations have been the go-to choice for many entrepreneurs looking to raise capital for new startup ventures. This is due to the flexibility with respect to how equity can be issued by a C corporation. For instance, a C corporation can have multiple classes of common and preferred shares, which may receive certain dividend preferences. Generally, each round of financing is issued in a different series or class of stock.
  - In addition, many startups prefer to, or are forced to, issue convertible debt at the initial stages of financing. This is typically because startups do not have a credit history to secure a traditional loan from a traditional lender. This also permits early investors from having to determine a startup's value early, permitting valuations to occur when the startup has more operational experience. The holders benefit because they generally have the ability to convert at a preferred price during the first major round of funding (series A).

- While this flexibility is certainly desirable for many startup owners and investors, there are draw backs. For instance, owners of C corporations cannot take advantage of losses generated by the C corporation (subject to the various loss limitation rules). C corporations are also subject to the net operating loss ("NOL") limitations discussed below. Furthermore, C corporations don't have the flexibility in making special allocations of items of income, deduction or loss. Thus, structuring startups as partnerships could be advantageous for early investors and founders from a tax perspective.

- It is possible that if a startup is structured as a tax partnership initially, it will at some point convert to a C corporation. There are some issues to keep in mind. First, if the partnership has liabilities in excess of its assets, the conversion could trigger gain to the partners. Second, the conversion from a partnership to a C corporation is not considered a disposition for purposes of triggering any suspended losses due to the passive activity loss rules, since the partners are not selling their interests in a taxable transaction.
- As a result, a partner with suspended losses may have to continue to carry those losses until such time as the partner can use them to offset against passive income. If the partnership were to liquidate as the result of a bankruptcy or failure of the business, the passive losses could be triggered so long as the partner receives cash only (and not assets used in the passive activity). If a corporation holds NOLs at the time of its liquidation, those NOLs terminate upon liquidation of the corporation.

§ 199A – Pass Through Entity Owners Catch a Break

- Introduction.
  - In enacting § 199A, Congress realized that it needed to provide some benefit to owners of pass-through entities, given that the majority of business are structured as pass-through entities for federal income tax purposes. Section 199A provides a deduction below for an individual's "combined qualified business income amount“.
  - An individual's "combined qualified business income amount" is the sum of the "deductible amounts" for each "qualified trade or business" carried on by a taxpayer, plus 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

- A "deductible amount" is the lesser of: (i) 20% of the taxpayer's qualified business income with respect to the qualified trade or business, or (ii) the greater of: (A) 50% of the W-2 wages with respect to the qualified trade or business, or (B) the sum of 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.
- A "qualified trade or business" is any trade or business other than a "specified service trade or business" or the business of performing services.
  - Specified service trades or businesses are generally trades or businesses involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.

- Planning Considerations. Advisors should consider the following when evaluating whether a taxpayer may benefit from § 199A or when developing a reorganization plan to take advantage of § 199A:
    - Whether the taxpayer is engaged in a specified services trade or business.
    - Whether the qualified trade or business is an active trade or business.
    - Whether the qualified trade or business has sufficient W-2 wages or depreciable property to permit the taxpayer to receive a deduction.
    - How income flows through a taxpayer’s pass-through entity structure.

Suspension of the Deduction for Investment Advisor Fees

- Prior to the enactment of the 2017 Act, investment advisor fees were deductible under § 212. However, the 2017 Act suspended the deductions for miscellaneous itemized deductions under § 67, which is where the deduction for § 212 expenses fell under for individuals.
- In the context of family limited partnerships, this could mean partners of a family limited partnership may not be able to deduct these fee expenses, including management fees that may fall under the § 212 umbrella.

- Many advisors have begun restructuring their fee arrangements to be commission based. In family limited partnership situations, advisors may want to examine the fee arrangements to see if commission-like fees can be implemented, especially in family limited partnerships that hold third party managed investments.

ACQUISITION PLANNING – RIDING THE ASSET ACQUISITION WAVE

Buyer and Seller Considerations in Asset Acquisitions

- Stock Acquisition as Asset Acquisitions
- Section 1031 Like-Kind Exchanges
- Patents, Inventions, Certain Models or Designs, and Secret Formulas or Processes are no longer Capital Assets
- Purchase Price Allocation – Sellers
- Purchase Price Allocation – Buyers
- Cyclical Businesses
- Sale of Personal Goodwill
- Limitation on NOLs and Interest Deductions

Other Considerations

- New Partnership Audit Rules
- Special Allocations of Partnership Items
- Use of Incentive Shares and other Phantom Equity
- New Holding Period for Carried Interests and Partnership Assets
- New Pilot Program for Letter Rulings regarding Spin-offs
- Qualified Small Business Stock
- Puerto Rico – Tax Benefits for Taxpayers Willing to Move to the Island

OPPORTUNITY ZONES

- Introduction
  - Opportunity Zones are a new take on what were once known as empowerment zones. With the enactment of the 2017 Act, many investment companies have been marketing opportunity zones to would-be investors large and small.
  - At a high level, an investment in gains from the sale or disposition of property into a "qualified opportunity fund" provide the taxpayer with significant gain deferral and potential reduction depending on the length of time the gains remain in the opportunity fund.
  - While many third parties have set up large opportunity funds to invest in opportunity zones, there is the potential for individual taxpayers to set up private opportunity funds to invest in opportunity zones.

- Tax Benefit
  - As mentioned above, investments in a qualified opportunity fund provide a taxpayer with gain deferral and potential gain reduction.
  - In order to qualify, a taxpayer must invest an amount which does not exceed the gain realized from the sale of property into a qualified opportunity fund within 180 days from the date of the sale or exchange. Transactions must be closed prior to December 31, 2026 in order to qualify. Gain from the sale of property to a related party does not qualify for deferral.
  - Gain is deferred until the earlier of the date on which the investment is sold or December 31, 2026. The amount of gain that is recognized is the lesser of the fair market value of the opportunity fund investment on the date of the gain recognition or the amount of gain originally deferred, over the taxpayer's basis in the opportunity fund investment.

- December 31, 2026, is a hard recognition date for gain initially deferred. Therefore, if a taxpayer invests in an opportunity fund in 2024, for example, they will only be able to defer the initial gain for two years. Note that the amount of gain recognized is the lesser of the original gain deferred or the fair market value of the investment. Thus, if the fund has declined in value, the amount of gain triggered may be less than what was originally deferred.
- The taxpayer receives a $0 basis in the opportunity fund equity upon his or her investment in the fun. If the investment is held for 5 years, the basis of the investment is increased by 10% of the amount of gain originally deferred. After 7 years, the basis is further increased by 5% of the gain originally deferred. When the taxpayer is forced to recognize gain on December 31, 2026, the basis of the equity is increased by the amount of gain recognized.

- Once the investment has been held for 10 years, the basis is stepped up to the fair market value of the investment on the date it is sold. Thus, taxpayers can potentially not pay taxes on gain from the sale of their investments in opportunity funds which exceed the amount of gain they originally deferred, so long as they hold the investments for 10 years. If investments are disposed of before the 10 year period, then taxpayers could potentially eliminate up to 15% of the deferred gain, depending on how long the investment is held.

Qualified Opportunity Funds

- A qualified opportunity fund is an investment vehicle which is organized as a corporation or a partnership (for federal income tax purposes) for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund).
- A qualified opportunity fund is required to hold at least 90% of its assets in qualified opportunity zone property. The asset mix is measured on the last day of the first 6-month period of the taxable year of the fund and on the last day of the taxable year of the fund.

- Qualified Opportunity Zone Property. Qualified opportunity zone property is property that is either: (i) qualified opportunity zone stock, (ii) qualified opportunity zone partnership interests, or (iii) qualified opportunity zone business property.
  - Qualified Opportunity Zone Stock. Qualified opportunity zone stock is stock in a domestic corporation which is acquired after December 31, 2017, at its original issue solely for cash, and such domestic corporation was a qualified opportunity zone business at the time the stock was acquired (or formed to be a qualified opportunity zone business) and has been a qualified opportunity zone business during the opportunity fund's holding period.

- Qualified Opportunity Zone Partnership Interest. Qualified opportunity zone partnership interests are partnership interests in a partnership which are acquired from the partnership by the opportunity fund after December 31, 2017, solely for cash, and such partnership was a qualified opportunity zone business at the time the stock was acquired (or formed to be a qualified opportunity zone business) and has been a qualified opportunity zone business during the opportunity fund's holding period.

- Qualified Opportunity Zone Business Property. Qualified opportunity zone business property means tangible property used in a trade or business of the qualified opportunity fund if acquired by purchase (as defined in § 179(d)(2)) by the fund after December 31, 2017, the original use of the property commences with the qualified opportunity fund or the qualified opportunity fund substantially improves the property, and during the qualified opportunity fund's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone. Note that property that is acquired from a related party is not considered to be purchased.

- Substantial improvement means during any 30 month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30 month period in the hands of the qualified opportunity fund.
- *See* Section IV.F. below regarding Rev. Rul. 2018-29 for special rules relating to the substantial improvement of real estate.

- Qualified Opportunity Zone Business. A qualified opportunity zone business is a trade or business which:
  - All of the tangible property owned or leased by the business is qualified opportunity zone business property;
  - At least 50% of a business' total gross income be derived from the active conduct of a qualified business;
  - A substantial portion of the business' intangible property be used in the active conduct of a business;
  - Less than 5% of the average unadjusted basis of qualified business entity's property is attributable to nonqualified financial property (i.e., working capital); and
  - The business is not a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

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CHOICE OF ENTITY AFTER 2017 TAX REFORM: Considerations Relating to Exit

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Factors Relating to Exit

	C Corporation	Pass-Through Entity
Sale of Assets		
• Single tax		√
Sale of Stock of C Corporation vs. Sale of Assets of Pass-Through		
• Rates		
○ Character of income	√	
○ Medicare surtax		√
○ Section 1202 benefits	√	
○ State and local taxes	√	
• Basis		√
• Ease of sale		√
• Higher price		√

Factors Relating to Exit continued

	Corporation	Partnership
Business Combination		
• Tax-free reorganization	√	
Liquidation		
• Distribution of assets in kind		√
• Timing of liquidation after sale of assets		√
Death of Owner		
• Basis step up		√
• Income in respect of a decedent	√	
Bankruptcy		
• Avoid COD income	√	