FEDERAL AND CALIFORNIA CHOICE OF ENTITY CONSIDERATIONS

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OVERVIEW OF PRESENTATION

- What has changed as a result of the TCJA
- What has not changed
- Keeping track of the big picture.

Choice of Entity

- Sole Proprietorships
- General and Limited Partnerships
- C Corporations
- S Corporations
- Limited Liability Companies (LLCs)

Sole Proprietorship

- A disregarded entity: the individual holds all business assets directly, and conducts business in the individual's own name or under a fictitious business name.
- Advantages: No formalities or expense of organizing a legal entity. Complex laws governing corporations (including annual shareholder meetings and corporate minutes), partnerships, and LLCs do not govern sole proprietorships.
- Disadvantages: Owner is fully liable for the debts and liabilities of the sole proprietorship. All capital must either come from the individual owner, or third party debt. An ownership interest in the business can not be sold to others without first reorganizing into a different form of doing business.

General and Limited Partnership

- Generally: Requires at least two owners carrying on a trade or business. General partners have management and control of the partnership, while limited partners are passive investors.
- Tax: The partnership is not subject to income tax. Under the conduit principal, profits and losses "pass through" the partnership to the partners in accordance with the partnership agreement.
- Advantages: Limited liability for limited partners. Only subject to tax at the individual (partner) level. Assets held in the name of the partnership are protected from creditors to some degree.
- Disadvantages: General partners are fully liable for all debts and other liabilities of the partnership.

C Corporations

- Generally: A legal entity organized under state law by filing Articles of Incorporation with the Secretary of State. Corporations have a three-tier system of management that includes shareholders, directors, and officers.
- Advantages: Limited liability for all owners (shareholders), continuity of existence, free transferability of shares, and centralized management. There is no limit on the number of individuals or entities that can be shareholders.
- Disadvantages: Income earned by corporations is potentially subject to double tax. Corporations are tax on the income that they earn, and this income is taxed again when it is distributed to shareholders in the form of a dividend.
  - (Note: the burden of the double tax regime has been reduced by reduction of the Federal corporate tax rate to 21%)

S Corporations

- Generally: A Corporation (or an unincorporated entity that has made an election to be taxed as a corporation) that has made an "S" election for federal income tax purposes.
- Advantages: Provides limited liability for all owners (legally still a corporation). Single layer of tax, meaning all income and loss flow-through the corporation out to the shareholders.
- Disadvantages: A tax of 1.5% imposed at the entity level by California. S-Corporations cannot have more than 100 shareholders and can only have one class of stock. All shareholders must be U.S. individuals who are U.S. citizens or residents. However, note that some trusts (i.e. "Electing Small Business Trusts") can qualify as shareholders.

Limited Liability Company

- Generally: An entity organized under state by filing Articles of Organization with the Secretary of State. Normally Federally files (by default): as a sole proprietorship (if only one (individual) member), partnership (if two or more members), or can elect to be taxed as a corporation.
- Advantages: All members and managers of the LLC have limited liability. LLCs normally avoid double tax (vs. C corporations). Assets owned by the LLC are protected to some degree from the creditors of the individual members. Generally less non-tax formalities than corporations.
- Disadvantage: Subject to California annual tax of $800 plus a fee imposed at graduated amounts beginning at $250,000 of California-based <u>gross</u> income.

LLC Fee Schedule (Based on California-Based Gross *Receipts*)

California Gross Receipts	LLC Annual Fee
$250,000 to $499,999	$900
$500,000 to $999,000	$2,500
$1,000,000 to $4,999,999	$6,000
$5,000,000 +	$11,790

……. Again this is in ADDITION TO the $800 annual LLC **tax**

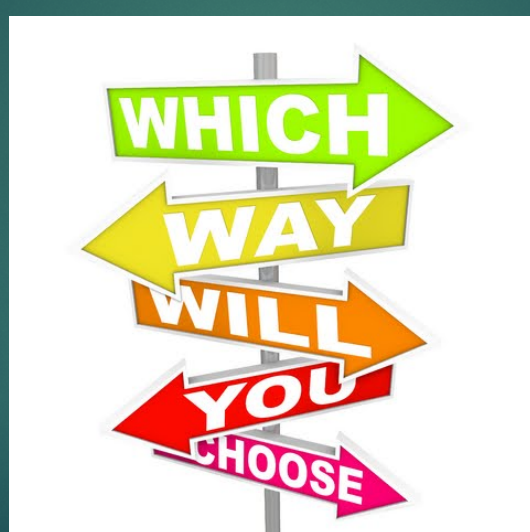
Other Important Tax Issues on *Conversions* of Business Entities

- Various Federal and state income tax rules on when conversations are generally tax-free or taxable (to both the business and/or the owners)
- Federal payroll tax and other tax reporting changes upon change of business entity (usually new FEIN and state tax ID).
- May have potential large state/local non-income tax (i.e., sales/use tax, property, gross receipts tax) issues on a conversation of a pre-existing business entity to another form of business entity (need to be aware of locations in which the business currently has operations and property).

Other Important Non-Tax Issues on Conversions

- Client can have many business licenses that may (or may not) be able to be transferred if the legal entity changes. Business could be shut down or face large penalties if licenses and right to conduct business are not properly handled.
- Client's contracts (for example: leases and supplier contracts) may (or may not) be assignable to new business entity.
- Worker's compensation insurance, and other insurance policies normally need to transfer to new business entity on a conversion.
- Normally need to transfer title to assets to new business entity following a conversion of business entity
- Not all forms of business entities are available to all types of businesses.
- Many states have business entity conversion rules and required forms.
- For these (as well as other) non-tax issues, it is **critical** that an experienced business attorney be a full part of the analysis of the choice of business entity for the client.

Examples of Analysis of Choice of Entity with the TCJA



Example #1 – Base Facts

Wife Wendy and Spouse Jodie are married and file jointly.

Their anticipated Federal taxable income for 2018 is $293,750 (below the beginning phase-out level of $315,000 for the W-2 (or W-2 + Property) limitations for MFJ filers under Sect. 199A).

Wife Wendy has a retail shoe store that earns $150,000 of QBI (after deducting $50,000 of wages paid to others – in addition to other expenses).

- (For purposes of this example we will assume that there are sufficient assets of the business to not limit the Sect. 199A deduction).

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Example #1 – Additional Notes

Note that while most of the larger (in regards to dollar amount) taxes and similar expenses are included in the following examples, some of the relatively smaller ones (such as FUTA, SUI, SDI, Additional Medicare tax, etc.) have not been included in the calculations.

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Example #1 – Shoe Store Formed as a Sole Proprietorship

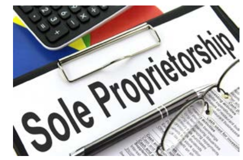
Since the W-2 (or W-2 + property) limitation rule of Sect. 199A does not apply, the couple will get a **$30,000 Federal** 199A deduction ($150,000 of QBI X 20%) if the shoe store is set-up as a *sole proprietorship*.

Summary of *Approx*. **Marginal** Taxes on *Business* Income

Business Entity Level Taxes: N/A

Individual Level (Federal Income Tax): $120,000 net taxable (after 199A deduction) * ≈24% FIT = **$28,800**

Individual Level (Federal SE Tax): $150,000 net taxable * 92.35% subject to SE = $138,525



Soc. Sec. Portion of SE @ $128,400 cap * 12.4% = $15,922
Medicare Portion of SE: $138,525 * 2.9% = $4,017
Total Gross SE Tax (Before Income Tax Deduction on SE) = $19,939
Less Income Tax Deduction Benefit (50% of $19,939 * ≈24%) = ($2,393)

Total Federal SE Tax (Net of Income Tax Deduction Benefit) = **$17,546**

California Income Tax: $150,000 income - $9,969 * 9.3% **= $13,023**

Total Approx. Marginal Tax on Business-Generated Income: **$59,369**

Example #1 – Shoe Store Formed as a C Corporation

Additional Facts:

1) **"Reasonable" wages for Wendy is $60,000.**
2) **Dividend distributions from the corp. is $20,000 (assume distributions are less than E&P and qualify for qualified dividend treatment).**
3) **Uses the cash basis.**

Business-Level Taxes:

Income Tax

Federal: ($90,000 Income - $4,590 in employer's share of Fed. payroll taxes) = $85,410 T.I. * 21% FIT = **$17,936**

California: $85,410 T.I. * 8.84% = **$7,550**

Total Corporate Income Taxes **$25,486**

+

Federal Payroll Tax (On Wendy's Wages): $4,590

= Total Approx. Tax for the Corporation: **$30,076**

Example #1 – Shoe Store Formed as a C Corporation (Cont.)

Personal Income Taxes

$60,000 of wages * 24% Federal marginal rate = $14,400
$60,000 of wages * 9.3% California marginal rate = $5,580

$20,000 of dividends * 15% Federal income tax = $3,000
$20,000 of dividends * 9.3% California income tax = $1,860

Total Personal Income Tax (Approx.) =	**$24,840**
+ Employee share of Federal payroll taxes:	**$4,590**
+Plus Corp. Taxes (See prev. slide) =	**$30,076**

Total (Corp. + Ind.) Taxes as C Corp. = $58,506

Vs.

Sole Prop. Tax Burden of $59,369

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Example #1 – Shoe Store Formed as an S Corporation

Since the W-2 (or W-2 + property) limitation rule of Sect. 199A does not apply, the couple will get a **$17,082 Federal** 199A deduction ($85,410 of QBI X 20%) if the shoe store is set-up as an S corporation.

Summary of Approx. **Marginal** Taxes on Business Income
Business Entity Level (Federal): **$4,590** (in employer's share of FICA taxes on Wendy's wages)
Business Entity Level (California): $85,410 T.I. * 1.5% Cal. Tax = **$1,281 S corp. tax**

Individual Level (Federal Income Tax – K-1): $68,328 net taxable (after 199A deduction) * 24% FIT = **$16,399**
+ Individual Level (Federal Income Tax – W-2): $60,000 of wages * 24% Federal marginal rate = **$14,400**
+ Employee's share of Federal FICA taxes: **$4,590**

+ California Personal Income Tax: $85,410 K-1 income + $60,000 wages = 145,410 * 9.3% **= $13,523**

Total Approx. Individual Tax on Business-Generated Income: $48,912
+ Business level taxes: $5,871

= Total combined (entity + individual) marginal taxes on business income: $54,783

(Compared with $58,506 as C Corp. and $59,369 as sole proprietor)

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Example #2 – Base Facts (Sammy Accountant)

- ✓ Sammy Accountant files as single.
- ✓ He anticipates having, as his sole source of income in 2018, an accounting practice with taxable income of $240,000.
- ✓ He expects to have $222,000 of taxable income in 2018.
- ✓ Since accounting services are a "specified service" under Sect. 199A and his 2018 income exceeds the $207,500 full phase-out the Sect. 199A for specified services, no 199A deduction will be applicable for 2018.

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Example #2 – Sammy Accountant's Firm Formed as a Sole Proprietorship

With no Sect. 199A deduction available:

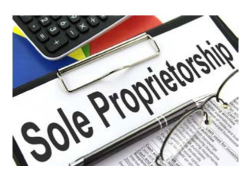
Summary of Approx. Marginal Taxes on Business Income
Business Entity Level: N/A

Individual Level (Federal Income Tax): $222,000 taxable income * (appl. 2018 single tax rates) = **$53,390**

Individual Level (Federal SE Tax): $240,000 net taxable * 92.35% subject to SE = $221,640

Soc. Sec. Portion of SE @ $128,400 cap * 12.4% = $15,922
Medicare Portion of SE: $240,000 * 2.9% = $6,960
Total Gross SE Tax (Before Income Tax Deduction) = $22,882
Less Income Tax Deduction Benefit (50% of $22,882 * 35%) = ($4,004)

Total Federal SE Tax (Net of Income Tax Deduction Benefit) = **$18,878**



California Income Tax: ≈$224,000 income * Appl. CA. rates **= ≈ $18,189**

Total Approx. Tax on Business-Generated Income: $90,457

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Example #2 – Sammy's Firm Formed as a C Corporation

Additional Facts:

1) **"Reasonable" wages for Sammy is $150,000.**
2) **Dividend distributions from the corp. is $30,000** **(assume distributions are less than E&P and qualify for qualified dividend treatment).**
3) **Uses the cash basis.**

Business-Level Taxes:

Income Tax

Federal: ($90,000 (after deducted gross wages) - $6,885 in employer's share of Fed. payroll taxes) = $83,115 T.I. * 21% FIT = **$17,454**

California: $83,115 * 8.84% = **$7,347**

Total Corporate Income Taxes **$24,801**

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Federal Payroll Tax (On Sammy's Wages): $6,885

= Total Approx. Tax for the Corporation: **$31,686**

Example #2 – Accounting Firm as a C Corporation (Cont.)

Approx. Personal Income Taxes (Attributable to Business-Sourced Income)

$150,000 of wages * Appl. 2018 Federal rates = ≈$30,290
$150,000 of wages * Appl. 2018 California rates = ≈$11,307

$30,000 of dividends * 15% Federal income tax = $4,500
$30,000 of dividends * 9.3% California income tax = $2,790

Total Personal Income Tax (Approx.) =	**$48,887**
+ Employee share of Federal FICA taxes:	**$6,885**
+Plus Corp. Taxes (See prev. slide) =	**$31,686**

Total (Combined) Taxes as C Corp. = $87,458

Vs.

Sole Prop. Tax Burden of $90,457

Example #2 – Accounting Firm Formed as an S Corporation

Summary of *Approx*. Marginal Taxes on Business Income
Business Entity Level (Federal): **$6,885** (in employer's share of Federal payroll taxes on Sammy's wages)
Business Entity Level (California): $83,115 T.I. * 1.5% Cal. Tax = **$1,247 S corp. tax**

Individual Level (Federal Income Tax – W-2): $150,000 of wages * 2018 Appl. Federal rates = **$30,290**
+ Individual Level (Federal Income Tax – K-1): $83,115 * ≈32% FIT = **$26,597**
+ Employee's share of Federal payroll taxes: **$6,885**

+ Approx. California Personal Income Tax: $83,115 K-1 income + $150,000 wages = $233,115 * 2018 Appl. CA rates **= $19,036**

Total Approx. Individual Tax on Business-Generated Income: $82,808
+ Business level taxes: $8,132

= Total approx. taxes on business activity: $90,940

(Compared with $90,457 as a sole proprietorship and $87,458 as a C Corp.)