Attractiveness of S Corporations After 2017

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In this article, Crumbley and Hasselback discuss how the Tax Cuts and Jobs Act made significant changes that apply to S corporations, including the new qualified business income deduction. The authors also compare advantages and disadvantages of S corporation and C corporation status.

S corporation owners should reconsider the usefulness of the S election because of the new 21 percent corporate tax rate. An S corporation can have advantages even when individual tax rates are higher than the 21 percent corporate tax rate. Assume that the wage, taxable income, and service limitations do not apply when an S corporation earns $300,000 for the tax year and obtains the full 20 percent deduction. Assume the corporate tax rate is 21 percent, the individual's tax rate is 37 percent, and the dividend tax rate is 23.8 percent. A simplified comparison of a C corporation and an S corporation is shown below.

	C Corporation	S Corporation
Earnings	$300,000	$300,000
Less: corporate tax	-$63,000	$0
Available for distribution	$237,000	$300,000
Less: tax at owner level	-$56,406*	-$88,800**
Available after-tax earnings	**$180,594**	**$211,200**

*$237,000 x 23.8%.

**($300,000 - 60,000) x 37%.

The S corporation generates an extra $30,606 of after-tax earnings ($211,200 - $180,594) compared with a similar C corporation. The C corporation might be able to reduce the disadvantage, however, by paying out its earnings as compensation, rents, or interest expense. Tax at the owner level also can be deferred or avoided by not distributing after-tax earnings. Bear in mind that the S corporation would be required to pay reasonable compensation, which would be taxed by a 15.3 percent payroll tax. To summarize, the maximum C corporation double tax is 39.8 percent (21 percent + (79 percent * 23.8 percent)), and an S corporation would pay 29.6 percent (37 percent * 80 percent), assuming no 15.3 percent payroll tax.

Significant Changes to S Corporations After 2017

Because S corporations are organized under state law, for reasons other than income tax purposes, they are recognized as separate legal entities and generally provide shareholders with limited liability. For federal tax purposes, taxation of an S corporation resembles that of a partnership. Like partnerships, the income, deductions, losses, and tax credits of an S corporation flow through to shareholders annually, regardless of whether distributions (for example, cash) are made to the owners. Thus, under this flow-through concept, income is taxed at the shareholder level at individual rates and not at the corporate level. Payments to S shareholders by the S corporation are distributed tax free to the extent the distributed earnings were previously taxed. Also, C corporation penalty taxes such as the accumulated earnings and personal holding company taxes do not apply to an S corporation. The Tax Cuts and Jobs Act made significant

changes to the treatment of flow-through entities like S corporations.[1]

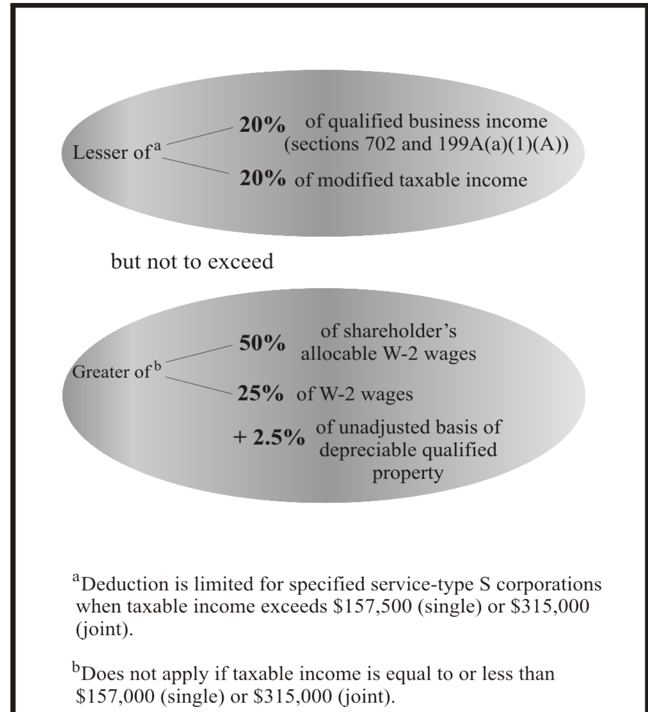
New QBI Deduction (Section 199A)

To bring the taxation of flow-through entities, such as S corporations, closer to the lower C corporation 21 percent rate after 2017, shareholders of some S corporations (and other qualified flow-through entities) may deduct up to 20 percent of qualified business income (QBI) beginning in 2018 through 2025. With the full 20 percent deduction, the passthrough top rate is 29.6 percent (80 percent * 37 percent). The S corporation shareholders can receive the profits tax free, whereas a C corporation shareholder still has a 23.8 percent dividend rate. Thus, the C corporation has a theoretical rate of 39.8 percent (21 percent + (23.8 percent * 79 percent)).

This section 199A deduction is not a deduction for or deduction from adjusted gross income. Instead, arguably the deduction is from taxable income. However, it is really a between-the-line deduction, so the deduction does not affect AGI or limitations based on AGI. The deduction will be shown on page 2 of Form 1040. Also, it does not reduce self-employment income. Apparently, the deduction must be computed for each separate business owned by the individual. The new deduction is available to both itemizers and non-itemizers. The IRS will likely develop a form like Form 8903, "Domestic Production Activities Deduction," because of the similarities in application and purpose between section 199 and new section 199A.

Many states use AGI as the starting point for determining the tax bases for individuals. Because of conformity issues, shareholders must be aware of the different starting points.

The QBI deduction is based on the following formula:



[a]Deduction is limited for specified service-type S corporations when taxable income exceeds $157,500 (single) or $315,000 (joint).

[b]Does not apply if taxable income is equal to or less than $157,000 (single) or $315,000 (joint).

If an individual is a member of a qualified cooperative, there is an additional QBI deduction of the lesser of either (1) 20 percent of qualified cooperative dividends or (2) taxable income less net capital gain.

There are some important limits on the QBI deduction, so high-income shareholders cannot convert wages and other compensation for personal services into income eligible for this new deduction. The deduction is the smaller of (1) 20 percent of QBI or (2) modified taxable income reduced by net capital gains.[2] In computing the 20 percent deduction, taxable income is computed without considering the section 199A deduction. Taxable income includes all sources of income (for example, nonbusiness income), including a spouse's income, which may reduce or eliminate the 20 percent deduction. Also, even if the shareholder is below the taxable income threshold ($315,000 for taxpayers filing a joint return, and $157,500 for single filers), large capital gains for

[1]Qualified passthrough entities are sole proprietorships (Schedule C), S corporations, partnerships, limited liability companies not taxed as corporations, rental property reported on Schedule E, farm businesses reported on Schedule F, and real estate investment trust investors.

[2]Section 199A(a).

the year may limit the deduction. QBI does not include any service-related income paid by the S corporation, including reasonable compensation paid to the S corporation employee shareholders.[3]

Example 1: Sally owns 30 percent of an S corporation that pays her $50,000 of wages and allocates to her $90,000 of S corporation income. Her QBI from the S corporation is only the $90,000 of income; the $50,000 of wages does not count.

QBI is the net amount of domestic qualified items of income, gains, deductions, and losses in the determination of taxable income for the S shareholder's qualified businesses. For qualified business loss in one year, the loss can be carried over to the next year to reduce QBI (but not below zero). Any QBI deduction allowed in the next tax year is reduced (but not below zero) by 20 percent of any carryover qualified business loss. Further, QBI does not include some investment-type gains, deductions, or losses (for example, short- and long-term gains and losses, dividends, and interest). Income, gains, deductions, and losses are treated as qualified items only if they are effectively connected to the conduct of a trade or business within the United States.

Example 2: Laura owns 50 percent of an S corporation. In 2018 the S corporation allocates a $100,000 loss to Laura. Because Laura materially participates in the S corporation, she can use the $100,000 loss in full to offset her husband's $200,000 of wages. In 2019 the S corporation allocates $200,000 of income to Laura. While Laura would generally start the process of determining her section 199A deduction by taking 20 percent of $200,000, section 199A(b)(6) provides that in determining Laura's QBI deduction for 2019, the $200,000 of income must be reduced by the $100,000 of loss (negative QBI) from 2018. Thus, while Laura will still include the full $200,000 of S corporation income in her taxable income in 2019, her deduction will be limited to $20,000 (20 percent * $100,000) rather than $40,000 (20 percent * $200,000).

A W-2 wages limitation is the greater of either (1) 50 percent of wages paid by the S corporation or (2) the sum of 25 percent of the W-2 wages plus 2.5 percent of the unadjusted basis (determined immediately after purchase) of all depreciable qualified property.[4] Qualified property is tangible property subject to depreciation under section 168. Thus, an S corporation with little or no wages can generate a QBI deduction using depreciable tangible assets. Because land is not a depreciable asset, its basis can't increase the amount of QBI.

An S corporation's W-2 wages are the sum of wages subject to withholding, elective deferrals into a section 401(k)-type vehicle, and deferred compensation paid by the S corporation (including wages paid to S corporation owners). W-2 wages do not include amounts such as payment to an independent contractor or management fees, because they are not shown on a payroll tax return.[5] However, there is no QBI deduction unless there is QBI.

The use of the unadjusted basis of property begins on the date the property is placed in service and ends the later of either (1) 10 years later or (2) on the last day of the last full year in the asset's general modified accelerated cost recovery system (not alternative depreciation system) rules.

Example 3: An S corporation purchases furniture in year 1 with a seven-year tax life for $100,000. Even though fully depreciated before year 10, the furniture remains qualified property through the end of year 10 (if the furniture is still in use generating QBI). So in year 10 the property contributes the full $100,000 to the S corporation's unadjusted basis of property calculation.

The W-2 wages and qualified property limits do not apply if the shareholder's taxable income for the tax year is equal to or less than the threshold amount. The benefit phases out at $207,5000 (single) and $415,000 (joint).

Example 4: Jerry has QBI of $200,000 from an S corporation that paid a total of $40,000 of W-2 wages and that has no qualified property. Jerry's spouse has $70,000 of W-2 income, and Jerry and his spouse have interest income of $20,000. Their total taxable income is $270,000 after itemized deductions.

Jerry's deduction typically would be limited to $20,000, the lesser of:

[3] Section 199A(e)(5)(A).

[4] Section 199A(b)(2)(B)(ii).

[5] Section 199A(b)(4)(c).

1. (1) 20 percent of QBI of $200,000, or $40,000; or
2. (2) the greater of:
   a. 50 percent of W-2 wages of $40,000, or $20,000; or
   b. 25 percent of $40,000 plus 2.5 percent of $0, or $10,000.

While Jerry's deduction would usually be limited to $20,000, because Jerry's taxable income is $290,000 — less than the $315,000 threshold — the wage limitation is disregarded, and Jerry simply takes a deduction equal to 20 percent of QBI, or $40,000.

Example 5: Jorge and April are married and file a joint return, reporting taxable income of $350,000. April has a qualified business that is not a specified service business. In that tax year, QBI from April's business is 75,000, so 20 percent of her QBI is $15,000. April's share of wages paid by the business in the tax year is $20,000, so 50 percent of the W-2 wages from the business is $10,000. For the purposes of this example, assume that no qualified property factors into the calculation. The $15,000 amount is reduced by 35 percent (($350,000 taxable income — $315,000 threshold amount)/$100,000). The benefit phases out between $315,000 and $415,000. Jorge and April take a section 199A deduction of $9,750 (65 percent * $15,000).

A qualified trade or business means any trade or business other than a specified service trade or business and other than the trade or business of being an employee. A qualified S corporation does not include specified service trade or business activity in the fields of health, accounting, law, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, and investment services (excluding architecture and engineering).[6] Basically, any trade or business where the principal asset of that trade or business is the reputation or skill of one or more of its employees is a disqualified S corporation. A disallowance of the deduction for specified service trades or businesses is also phased in above the threshold amount of $315,000 (married) or $157,500 (other shareholders) of taxable income. However, the section 199A deduction may apply to a service-type S corporation if the shareholder's taxable income does not exceed the threshold. This limitation will have a major impact on most partners at major law and CPA firms.

Example 6: Carol's taxable income is $300,000, her share of the income of a consulting S corporation is $200,000, her share of the W-2 wages is $60,000, and her share of the assets of the S corporation is $40,000. Even though Carol is a consultant, she may take the deduction because her taxable income is below $315,000, the start of the phase-out threshold. Thus, Carol can take a deduction of 20 percent of $200,000, or $40,000. Remember, when taxable income is less than $315,000, the specified service trade or business limitation does not apply. Therefore, Carol is entitled to the full $40,000 deduction.

Example 7: Andrew files a single tax return with taxable income of $197,500, of which $124,000 is attributable to a consulting S corporation (that is, a specified service business) after paying wages of $63,000 to employees. Because his taxable income is less than the $207,500 phase-in threshold for specified service businesses, Andrew can claim the section 199A deduction, but only for an applicable percentage of his qualified items of income, gain, deduction, or loss, and the W-2 wages from the consulting business. (Assume no qualified property factors into the calculation.) Andrew has an 80 percent reduction percentage (($197,500 - $157,500)/ $50,000). In determining includable QBI, Andrew considers only 20 percent of $124,000, or $24,800. In determining the includable W-2 wages, Andrew considers only 50 percent of $63,000, or $31,500. Andrew calculates the deduction by taking the lesser of (1) 20 percent of $124,000 ($24,800) or (2) 50 percent of $63,000 ($31,500). Theo can take a section 199A deduction of only $24,80.

When computing alternative minimum taxable income, a shareholder calculates QBI without taking into consideration any AMT adjustments or preferences under sections 55-59.[7] QBI is the same as AMT is for regular tax, so the 20 percent deduction is computed the same way.

[6] Section 1202(e)(3)(A).

[7] Section 199(A)(f)(2).

Determination of AMTI starts with taxable income, and the code does not provide a specific addback to AMTI for the 20 percent deduction.

QBI does not include net capital gains.

Example 8: Jason has $100,000 of QBI. Also, he has $200,000 of long-term capital gains, $30,000 of wage income, and $50,000 of itemized deductions, for a taxable income of $280,000.

Jason's deduction is limited to the lesser of (1) 20 percent of QBI of $100,000, or $20,000; or (2) 20 percent of ($280,000 - $200,000), or $16,000.

Thus, Jason's deduction is limited to $16,000. Because Jason has taxable income of $280,000 (including $100,000 of QBI), $200,000 of that taxable income will be taxed at favorable long-term capital gains rates. Thus, there is only $80,000 to be taxed at ordinary rates, meaning the 20 percent deduction should be limited to $80,000 of income ($16,000); after all, you do not want to give a 20 percent deduction against income that is already taxed at a top rate of 23.8 percent.

One major advantage of an S election is the ability to pass through net operating losses directly to the shareholder. However, an NOL does not include the section 199A deduction.[8]

Once the initial stock basis of an S shareholder is determined, various transactions during the life of the corporation affect the shareholder's basis in the stock. The 20 percent deduction has no effect on an S shareholder's basis because the deduction is not listed in section 1367(a).

The corporate-level accumulated adjustments account (AAA) tracks the undistributed earnings of an S corporation that have been previously taxed to shareholders. Distributions from AAAs are tax free. Because an AAA is a corporate-level account, the 20 percent deduction does not affect the AAA.

A shareholder claiming the section 199A deduction may be subject to the 20 percent accuracy-related penalty for a substantial understatement of income tax if the understatement is more than either the greater of (1) $5,000, or (2) 5 percent (not 10 percent) of the tax required to be shown on the return for the tax year.[9]

QBI must be earned in a qualified trade or business.[10] The term "trade or business" is not precisely defined by the tax law, so there are different interpretations of what constitutes a trade or business. The highest standard may be in section 162, under which the business activity must be regular, continuous, and substantial. However, more than 100 years of judicial precedent has not provided clarity for whether a rental activity rises to the level of a section 162 trade or business. The determination depends on many factors, such as the length of the lease, the type of property leased, and whether the lease is gross or triple net.[11] Apparently, an owner does not have to be involved in the business that generated the income to be eligible (for example, it is extended to the owner of the rental property).

Example 9: Sara owns a 50 percent interest in a commercial rental property through an LLC. Sara's share of the rental income is $1.2 million and the company pays no W-2 wages, but the LLC pays a management fee to an S corporation Sara controls. The management company pays W-2 wages, but it also breaks even, passing out no net income to Sara. Sara's share of the total unadjusted basis of the commercial rental property is $8 million.

Sara is entitled to a deduction from taxable income — assuming the rental activities rise to the level of a section 162 business — equal to the lesser of (1) 20 percent of QBI of $1.2 million ($240,000) or (2) 2.5 percent of the unadjusted asset basis of $8 million ($200,000).

Thus, Sara is allowed a $200,000 deduction that was almost zero before the property addition. The $200,000 shareholder-level deduction does not reduce the AAA's or Sara's stock basis.

There are suggestions that trader tax status (TTS) should consider an S corporation for business expenses, and a section 475 election on securities for exemption from the wash sale losses and ordinary loss treatment (tax loss insurance). A TTS S corporation allows employee benefit plan deductions (for example, health insurance and high-deductible retirement plans). The new law is

[8] Section 6662(d)(1)(c).

[9] Section 6662(d)(1)(c).

[10] Section 199A(c).

[11] Tony Nitti, "Tax Geek Tuesday: Making Sense of the New 20% Qualified Business Income Deduction," *Forbes* (Dec. 26, 2017).

unclear regarding whether section 475(f)[12] income is QBI or a specified service activity. TTS business-related capital gains probably will not be included in QBI.[13]

Revocation of an S Election

Because of the reduction of the C corporation tax rate after 2017, it is expected that some S corporations will terminate their S election and convert to C corporation status. Usually distributions from a C corporation are taxed as dividends to the extent of earnings and profits. However, any distribution of cash by a corporation to former S shareholders during an approximately one-year post-termination period following the voluntary revocation of the S election receives special treatment. Such a distribution is treated as a tax-free recovery of stock basis to the extent it does not exceed the AAA.[14] To take advantage of these post-termination benefits, an S corporation must know the amount of both the AAA and any other adjusted accounts as of the date of the revocation. A shareholder can elect to not have the post-termination transition period rules apply.

Because the S corporation may have used a cash-basis accounting method, the new C corporation may have to convert to an accrual-basis method. During a temporary two-year period starting after December 22, 2017, any section 481 adjustments from this accounting change resulting from the revocation may be taken ratably over a six-year period beginning with the year of change.[15] If the eligible terminated S corporation makes a cash distribution *after* the one-year post-termination year and there is any accumulated E&P, the AAA is allocated to the distribution in the ratio as AAA divided by the total of AAA and accumulated E&P.[16] This rule applies only to shareholders at the time of the termination.

If an S corporation has a qualified subchapter S subsidiary and the S corporation election is terminated, the former QSub is treated as a new corporation acquiring all the assets (and assuming all the liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation. The deemed exchange of S corporation assets for the former QSub stock is determined under the IRC and general principles of tax law. If the parent continues to own at least 80 percent of the stock of the terminated QSub, the incorporation transaction is generally tax free. If the parent is not in control of at least 80 percent of the stock immediately after termination (for example, more than 20 percent stock sale), the deemed stock exchange can be taxable. Such a partial sale would trigger gain or loss on all the QSub assets.[17]

Other Changes

- A large S corporation after 2017 may be subject to the $1 million limitation on commissions and performance-based compensation.
- After 2017, the charitable contributions allowed for the portion of an electing small business trust holding S corporation stock is determined using individual rules and not trust rules.
- A nonresident alien can be a potential current beneficiary of an electing small business trust after 2017, which may allow more estate and gift tax planning.
- If an S corporation is a U.S. shareholder of a specified foreign corporation, each S corporation shareholder may elect to defer paying any net tax liability on its mandatory inclusion until there is a triggering event.
- After 2017, the built-in gains tax and the passive investment income tax will be smaller (21 percent), but the flow-through gain will be larger to be taxed at shareholder-level rates.
- The majority of an S corporation can be passed to beneficiaries, and the owner of the business can retain control of the business.

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[12] A section 475(f) election (mark-to-market election) allows a trader to treat gains and losses from the sales of securities as ordinary gains and losses (except for securities held for investment).

[13] Robert A. Green, "How Traders Can Get the 20% QBI Deduction Under New Law," *Forbes*, (Jan. 12, 2018); and Green, "Traders Should Be Entitled to the Pass-Through Tax Deduction," *Forbes* (Dec. 12, 2017).

[14] Sections 1371(e) and 1377(b).

[15] Section 481(d)(1).

[16] Section 1371(f).

[17] *See* section 1361(b)(3)(C), reg. section 1.1361(b)(1), and Rev. Rul. 2004-85, 2004-2 C.B. 189.

The grantor forms an intentionally defective grant trust, which is irrevocable. Split the stock into voting and nonvoting stock, which does not create a second class of stock, and transfers 99 percent of the nonvoting stock to the trust, which the beneficiaries will inherit. The S corporation shareholder retains the remaining 1 percent voting stock.[18]

- Business losses exceeding business income plus $500,000 (joint returns) are not deductible for the current year. The excess losses are carried forward as part of the shareholder's NOL carryforward. The limitation applies at the shareholder level but after the passive loss rules.[19]

Example 10: Assume an S corporation in 2018 is subject to the section 1375 penalty tax because the net passive income is $240,000, and the excess net passive income is $116,842. With taxable income of $390,000, the lower net passive income is multiplied by 21 percent to determine the section 1375 penalty tax of $24,537 ($116,842 * 21 percent). Before 2018, the tax would have been $40,895 ($116,842 * 35 percent). Section 1366(f)(3) indicates that the penalty tax at the S level reduces the passive investment income items flowing through to the shareholders ($40,895 in 2017 compared with $24,537 in 2018). Thus, the net passive income of $240,000 will be reduced by the $24, 537 net passive income tax and the shareholder will report a net passive income gain of $215,463 on their personal tax return. If taxable income is less than $116,842, the 21 percent rate is applied to the taxable income (say $100,000) and the $16,842 is carried into the next year and treated as passive investment income.

Deciding to Switch From an S Corporation

An S corporation that is a specified service trade or business and above the $315,000 phaseout level for the 20 percent deduction may want to consider reorganizing. Some advantages of regular corporation treatment include:

- being the best entity to deduct fringe benefits for the owners;
- the low 21 percent flat tax rate for all C corporations, including personal service corporations;
- the ability to pay dividends at capital gains rates;
- the ability to have, for lower-income taxpayers, a 0 percent capital gains rate;
- the availability of section 1202 treatment (qualified small business stock);
- the availability of section 1244 treatment (small business stock);
- avoidance of the AMT;
- an unrestricted tax year;
- income not being taxed to owners until distributed; and
- no built-in gains tax or passive investment income tax.

Disadvantages of C corporation treatment include:

- the net investment income tax on dividends (3.8 percent);
- double taxation (39.8 percent overall maximum rate);
- the inability to make profitable noncash distributions;
- the need to make the termination election by March 15 to change to a C corporation retroactive to January 1 during the same year, with late retroactive termination unavailable;
- the possible personal holding company or accumulated earnings tax;
- a $1 million compensation limitation;
- capital gains, losses, and tax-exempt income losing their identity; and
- generally, an accrual-basis accounting requirement.

S corporation treatment advantages include:

- no double taxation (29.6 percent maximum rate);
- NOL flow-through;
- capital losses and other items retaining their identity;
- capital gains and tax-exempt income retaining their identity;
- not being subject to the 10 percent of income limitation that applies to C corporations;

[18] Craig W. Smalley, "Estate Planning and the New 2018 Tax Law," *CPA Practice Advisor* (Jan. 9, 2018).

[19] Section 461(l).

- the ability to issue section 1244 stock;
- distributions not being subject to self-employment taxes; and
- the easier conversion to C corporation than LLC status.

Possible disadvantages of an S corporation election include:

- the need to be a domestic corporation;
- the limit on the number of shareholders (about 100);
- the limit on shareholders to individuals, estates, and some trusts;
- the limit to one class of stock;
- the nonresident shareholder limitation;
- possible built-in gains or passive investment income taxes (21 percent);
- the general restriction to a calendar year;
- being subject to the passive activity loss rule at the shareholder level;
- many fringe benefits being taxable as compensation to employees and shareholders who own more than 2 percent of the stock;
- having less flexibility in allocating income and losses than a partnership;
- accidental termination of the S election;
- the section 1202 exclusion of gain on disposition of small business stock being unavailable for S corporation stock;
- needing to pay reasonable salaries subject to self-employment tax (15.3 percent);
- some states not recognizing an S corporation election;
- income distributions not counting as compensation for computing an employee's contribution formula for a qualified retirement plan;
- the inability to avoid state and local taxes imposed on corporations; and
- less suitability for estate planning purposes.

Conclusion

The 20 percent QBI deduction will require additional patience, work, and time at both the S corporation and shareholder levels. The S corporation must separately report shareholder items required to calculate the amount each shareholder may use for the deduction, such as QBI, the shareholder's applicable share of business W-2 wages, and the shareholder's appropriate share of qualified depreciable property's unadjusted basis (not including land).

The items must be calculated annually for each entity because of the uncertainty of the ultimate shareholder's ability to claim this new deduction. Because the deductible amount must be calculated separately for each trade or business, the W-2 wages and depreciable basis amounts cannot be aggregately reported to shareholders by an S corporation with more than one trade or business.

Several gray areas remain, which must be addressed by the IRS and future court decisions. ■