



# **The Adviser's Guide to Financial and Estate Planning:** **Tax reform and the choice of business entity**

Presented by:  
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# Today's Speaker



Steve G. Siegel, JD, LLM

The Siegel Group

# Consider Basic Ownership Issues, Objectives and Goals

- The choice of the form of business organization to utilize is one of the most important decisions a business owner can make
- Issues of taxation, liability and succession planning all flow from the choice of entity that is made

# Types of Entities to Be Considered

# The Sole Proprietorship

- A sole proprietorship is owned by a single individual
  - It is the simplest form of business entity
- A sole proprietor may operate the business in his or her own name, or in a business name other than the proprietor's own name

# The Sole Proprietorship

- The primary disadvantages of the sole proprietorship are
  - The unlimited liability of the proprietor;
  - The fact that it lacks continuity of existence;
  - All of the profits of the business are subject to both income tax and self-employment tax; and,
  - Fringe benefits are generally not deductible

# The Sole Proprietorship

- The sole proprietorship may be used to employ family members
- The sole proprietorship can generally be converted into an LLC or a corporation without triggering a taxable event



# The General Partnership

- This is the simplest way of operating a business with more than one owner
- A partnership is a separate taxpayer from its owners with various items and elections determined at the partnership level
- All general partners are jointly and severally liable with each other

# The Limited Partnership

- There must be at least two partners, one of which must be a general partner
  - The liability of the general partner is unlimited, while the liability of the limited partners is limited to their capital investment in the limited partnership
  - Limited partners may not be involved in the management of the business

# The Limited Partnership

- In most states, the limited partnership must file a Certificate of Limited Partnership
- In general, advantages of the partnership form include
  - Avoiding double taxation on income received
  - Tax-free formation
  - The ability to specifically allocate items of income and deduction
  - Inclusion of both capital contributed and a share of the entity's debt in the partner's basis

# The Limited Partnership

- Disadvantages of the partnership form include
  - The unlimited liability required of all general partners;
  - Required use of the calendar year of income tax reporting;
  - The inability of the partners to exclude fringe benefits from income;

# The Limited Liability Company

- A “hybrid” entity combines the limited liability attribute of a corporation with the pass-through single level of taxation attribute of a partnership
- An LLC is created under state law by the filing of a Certificate of Formation
- As a general rule, a single-member LLC, if permitted by state law, is taxed as a sole proprietorship

# The Limited Liability Company

- The LLC can make a tax election to be taxed as either a partnership or as a C corporation or as an S corporation
- LLCs with multiple members are generally taxed as partnerships
- A potential disadvantage of the LLC form is the fact that not all states are uniform in the way they treat the activities of LLCs and the way they tax LLCs

# The C Corporation

- A corporation is created under state law when a certificate of incorporation is filed in the corporation's state of domicile
- A corporation generally exhibits the following four characteristics
  - Limited Liability
  - Centralized Management
  - Free Transferability of Interests
  - Continuity of Life

# The C Corporation

- The C corporation's earnings are taxed at the corporate level at a flat rate of 21%, and the shareholders of the C corporation are taxed again when the corporate earnings are distributed to them



# The C Corporation

- The C corporation also has a number of advantages
  - A fiscal year may be elected
  - A variety of dividends received by a C corporation may be deducted in full
  - C corporations and their shareholders can participate in a broad range of fringe benefits, the cost of which may be deducted by the corporation
  - A C corporation is permitted to have more than one class of stock

# The C Corporation

- C corporation “disadvantages” include
- The “double tax” issue
  - A general requirement for larger C corporations that the accrual method of accounting must be used – but the 2017 Act allows taxpayers with less than \$25 million in prior 3 year average gross receipts use cash method. Personal service corps. can use cash method without revenue limit.
  - The possibility that shareholders will be taxed as having received constructive dividends where there is personal use of corporate assets or funds

# The C Corporation

- Personal service corporation—  
C corporation that performs most of its services in such fields as health, law, accounting and consulting
- Personal service corporations are now subject to a flat tax rate of 21 percent

# The C Corporation – Planning Issues

- Does the 21% rate suggest making all clients C corporations?
- Are distributions of salary, etc. needed (37% top rate).
- If earnings are held in the corporation – Dividends paid (23.8% top rate)? Will accumulated earnings tax be a factor?
- Alternatively – is reinvestment of profits and growth likely?

# The S Corporation

- An S corporation is distinguished from a C corporation by the fact that an election has been made to have the corporation's profits and losses pass through the corporation to become subject to a single level of taxation at the level of the shareholders

# The S Corporation

- Where the S corporation sustains losses, the S election allows such losses to flow through the corporation and be deducted by the shareholders against other income if they have basis in the corporation

# The S Corporation

- Shareholders of S corporations may only be individuals, another S corporation under certain circumstances, and certain trusts and estates
- An S corporation is generally required to utilize a calendar year for reporting
  - An S corporation may only have a single class of stock

# The S Corporation

- Where an S corporation pays certain fringe benefits, those benefits received by shareholders owning more than 2% of the S corporation's shares are required to be included in such shareholders' income



# Sole Proprietorships Special Issues to Consider

# Ownership

- Individual owner
- There are no “classes” of ownership to consider

# Liability

- A sole proprietor is not insulated from liability, either tort or contractual

# Required Formalities

- The only required registration is a trade name

# Tax Issues on Formation

- The formation of a sole proprietorship is not a taxable event

# Operational Issues Tax Considerations

- General rules of operation
  - Proprietorship's taxable year is based on the tax year of the owner
  - The income or loss from operations is reported by the owner on Schedule C of Form 1040
  - Ordinary income is taxed at the individual's rates
  - The owner may use the cash or accrual method of accounting
  - The Section 199A deduction may be available

# Operational Issues Tax Considerations

- Expenses and Losses
  - The owner may deduct all of the ordinary and necessary business expenses, including reasonable compensation paid to employees
- Withholding and Self-Employment Tax
  - The owner's earnings will be subject to self-employment tax (FICA) and the Medicare taxes

# Operational Issues Tax Considerations

- Retirement plans
- Sale of a Proprietorship
  - Each separate asset of the business is deemed to be sold, and not the business organization itself



# Operational Issues Tax Considerations

- Disposition of a Proprietorship Interest
  - May sell or transfer the business assets to another person or entity
  - The proprietor may not, however, transfer the business interest to another person or entity
  - Each asset is treated as if it were sold separately
  - The sale price must be allocated among all of the assets

# Partnership Issues to Consider

# Ownership

- Two or more “persons” are needed to form a partnership
- A partnership may include both C corporations and S corporations
- All types of trusts (grantor, revocable, irrevocable, inter vivos, testamentary, etc.) may participate in a partnership

# Liability

- General Partners
  - Personal liability—it is unlimited

# Liability

- Limited Partners
  - A limited partner is personally insulated from the liabilities of the partnership, both tort and contractual
  - The remedies of creditors against limited partners are limited by law; often to a “charging order”
  - Makes a limited partnership a favored vehicle in asset protection planning

# Tax Issues on Formation

- General rule
  - As a general rule, the formation of a partnership is a nontaxable event
- Property subject to liabilities
  - Being relieved of a liability is treated as if the partner received a distribution of cash

# Tax Issues on Formation

- The partner's basis in the partnership interest received
  - The partner's "outside basis" is the basis of the property transferred to the partnership
  - A partner's basis will include the partner's share of partnership liabilities

# Tax Issues on Formation

- The Partnership's Basis
  - The “inside basis”
  - A Section 754 election may be made to allow the partnership to adjust the inside basis of its assets upon either the sale or exchange of an interest in the partnership, a distribution to a partner, or upon the death of a partner
  - The election only affects the inside basis of the transferee partner



# Tax Issues on Formation

- Exception to non-recognition
  - Interest in partnership capital received for services
- Interest in profits for services

# Operational Issues Tax Considerations

- A partnership is a nontaxable entity
  - It serves as a conduit, pass-through entity
- The partnership files a tax return separate from its owners (Form 1065)
- As a pass through entity – Section 199A's deduction may apply to the partners
- The partnership must report on the basis of the taxable year that is determined by reference to either the partners' taxable years or a year reflecting the business purpose and activities of the partnership
- New partnership audit rules: Audit at partnership level; pay any tax due from the partnership, not each partner

# Operational Issues Tax Considerations

- Accounting Method
  - In general, a partnership may use either the cash or accrual method of reporting its income
- Deduction of Losses
  - Partnership losses may be deductible by the partners to the extent of their bases in the partnership
- Special Allocations
- Self-Employment Tax Issues

# Disposition of a Partnership Interest

- Sale of a Partnership Interest
  - General rule provides that a partner who disposes of his or her interest in a partnership is treated as disposing of a single asset, rather than a pro rata share of all of the underlying assets of the partnership
  - The gain or loss is generally capital in nature
  - An important exception to the general rule that a partnership is treated as an entity in determining the tax consequences of a taxable disposition of the partnership interest arises where the partnership owns assets described in Code Section 751
  - Section 751 property (“hot assets”) refers to unrealized receivables, inventory items and depreciation recapture

# Disposition of a Partnership Interest

- Non-liquidating distributions of partnership property

# Limited Liability Companies Issues to Consider

# Ownership

- Essentially anyone can be a member of an LLC without limitation
- More than one class of member is permitted

# Liability

Members of an LLC enjoy insulation from personal liability for the obligations of the LLC, both tort and contractual



# Required Formalities

- An LLC may elect how it wishes to be classified by filing Form 8832
- This Form allows the LLC to indicate that it wishes to be taxed either as a partnership or as a corporation, or, if a single owner, to be disregarded as a separate entity

# Required Formalities

- If Form 8832 is not filed, the IRS imposes “default” classifications
- States may prohibit an LLC from conducting certain types of activities (typically professional practices)

# Tax Issues on Formation

- An LLC will be taxed in a manner commensurate with the type of entity it has elected to become
- An LLC may be eligible to claim the Section 199A deduction

# Operational Issues Tax Considerations

**The taxation of the limited liability company depends upon the elections made by the LLC when it filed Form 8832, or its default classification for tax purposes if no Form 8832 was filed**

# Disposition of a Limited Liability Company Interest

- The disposition of an LLC interest will be taxed in a manner commensurate with the type of entity it has elected to become

# C Corporations Issues to Consider

# Ownership

As a general rule, there are no limitations or restrictions on who may be a shareholder of a C corporation

# Liability

- A shareholder in a C corporation is insulated from liability



# Required Formalities

**Formation of a C corporation requires the filing of a Certificate of Incorporation (called in some states Articles of Incorporation) with the Secretary of State of the state in which the entity is organized**

# Tax Issues on Formation

- General rule
  - Transfers of money and property to a corporation in exchange for its stock may be structured on a tax-free basis under the rules of Code Section 351

# Tax Issues on Formation

- Transfer of property for stock; 80 percent control
  - Property must be transferred to the corporation solely in exchange for the corporation's stock
  - Immediately after the transfer, the transferors must control the corporation through ownership of 80 percent or more of the voting power of the corporation

# Tax Issues on Formation

- Property to be transferred
  - The term “property” is broadly defined
- Only stock is received tax-free by the transferor
  - Gain may be required to be recognized by the transferor if the transferor of property to the corporation receives other property or money (called “boot”)

# Tax Issues on Formation

- Property subject to liabilities
  - As a general rule, transferors are not treated as receiving boot as a result of their transfer of assets subject to liabilities to the corporation
- Stock for services
  - The receipt of stock for services is a taxable event

# Tax Issues on Formation

- No loss may be recognized by a shareholder in a transfer of property to a corporation for stock in a Section 351 transaction
- No gain or loss is recognized by a corporation from the receipt of property or money in exchange for its stock

# Tax Issues on Formation

- Basis of stock to shareholder and corporation
  - When a Section 351 transaction occurs, the income tax basis to the transferor in the stock received will be equal to the adjusted basis of the property transferred by the transferor to the corporation

# Operational Issues Tax Considerations

- General rules
  - A C corporation is treated as a separate taxpayer
  - C corporations are said to be “double taxation” vehicles—generating a tax at the corporate level on income earned, and a tax at the shareholder level on the corporation’s after tax income distributed to the shareholders
  - Section 199A is not available to a C corporation – but the corporation’s income is taxed at 21%



# Operational Issues Tax Considerations

- Loss deductions
  - If a C corporation sustains operating losses, such losses are not deductible by the shareholders – the losses can be carried forward indefinitely – new losses can no longer be carried back after 2017.
- Fringe benefits
  - Persons who are shareholder-employees of a C corporation are eligible for certain employee fringe benefits

# Operational Issues Tax Considerations

- Planning to avoid double taxation
  - Payment of compensation to shareholder employees
  - What constitutes “reasonable” compensation may become an issue
  - Another technique used to reduce the effect of double taxation is to find ways other than through compensation to make payments to shareholder-employees
  - Consider allocations to “personal goodwill”

# Operational Issues Tax Considerations

- Special taxes imposed on C corporations
  - Accumulated Earnings tax
  - Personal Holding Company tax
  - The corporate Alternative Minimum Tax (AMT) has been repealed after 2017

# Disposition of a C Corporation Interest

- General Considerations
  - Overriding consideration involves the issue of double taxation, and efforts to avoid it
  - A seller prefers to sell the stock of the C corporation
  - The buyer generally prefers to purchase the assets of the seller, rather than the stock

# S Corporations Issues to Consider

# Ownership

- The S corporation has the most restrictions on ownership of any of the forms of business organization beyond the sole proprietorship
- An S corporation is limited to 100 shareholders
- For tax years beginning after 2004, Code Section 1361(c) was amended to permit a family to be treated as one shareholder

# Liability

- Shareholder in a S corporation is insulated from liability

# Required Formalities

- The corporation must file an S corporation election form with the Internal Revenue Service (Form 2553)
- The form must be filed not later than two months and 15 days after the beginning of the tax year for which it is desired to be effective



# Required Formalities

- The S election can be made for any taxable year
- If the election is terminated or revoked, the corporation must generally wait five years before S status can be reinstated, unless the consent of the IRS for an earlier restatement of S status is obtained
- Caution: Convert an S corporation to a C corporation to get the 21% flat rate tax. Happy? Great! Unhappy? 5 year waiting period before S election allowed again – then 5 year built-in gain tax re: C corporation history. (What if law changes?)

# Tax Issues on Formation

- U.S. domestic corporation
- Limitations on eligible S corporation shareholders
  - General rule, all of the corporate shareholders must be individuals who are United States citizens or residents
  - Charitable organizations qualified under Code Section 501(c)(3) are eligible shareholders

# Tax Issues on Formation

- A variety of trusts may also qualify to be S corporation shareholders
  - Grantor Trusts
  - Qualified Subchapter S Trusts (QSSTs)
  - Electing Small Business Trusts (ESBTs)
  - Voting Trusts
  - Qualified Revocable Trusts
  - Trusts Created under Estates
  - Tax-Exempt Retirement Plan Trusts

# Tax Issues on Formation

- Ineligible entities
  - Partnerships, LLCs and C corporations are not eligible S corporation shareholders
  - A single member LLC may be an S corporation shareholder if the single member LLC is taxed as an individual
  - Retirement plan accounts such as IRAs, SIMPLEs, SEPs and Roth IRAs are not eligible S corporation shareholders
  - Charitable remainder trusts are not eligible to be S corporation shareholders

# Tax Issues on Formation

- The S corporation may be a shareholder of another corporation
- Revocation of S election
  - The election can be revoked voluntarily by the vote of shareholders holding more than one-half of the voting stock of the corporation

# Operational Issues Tax Considerations

- A Pass-Through entity
  - It is a conduit entity
  - Section 199A deduction may be available to shareholders

# Operational Issues Tax Considerations

- Self-employment taxes and reasonable compensation
  - An S corporation shareholder is not subject to self-employment taxes on either the dividends received from the corporation or on the pass-through of the S corporation's taxable income.
  - The issue of “reasonable compensation” arises in the S corporation context when the compensation paid to shareholder employees appears to be too low (Watson v. U.S.)

# Operational Issues Tax Considerations

- No special allocations
  - S corporation items may not be specially allocated to the various shareholders
- Taxable year – calendar year required.
- Method of accounting – Cash method allowed – under \$25 million in prior three year average gross receipts.



# Operational Issues Tax Considerations

- Loss deductions; Shareholder's basis
  - The shareholder's basis is not increased by loans made to the corporation by others, or by the shareholder's guarantees of such loans or by other liabilities of the corporation
  - S Corporation is not subject to the Accumulated Earnings Tax or the Personal Holding Company Tax

# Operational Issues Tax Considerations

- The built-in gains tax (The five-year lookback is now permanent) may be imposed on the S corporation
- The tax on passive income may be imposed on the S corporation

# Disposition of an S Corporation Interest

- Asset Sale
  - Usually one level of tax to the shareholder
  - The buyer of assets receives a cost basis in the assets acquired
- Stock Sale
  - The selling shareholder(s) will realize gain or loss
  - The buyer in a taxable stock acquisition acquires a cost basis in the acquired stock

## 20% Qualified Business Income Deduction –IRC 199A (1)

- Starting Point: The General Rule: 20% deduction. New §199A provides that an individual taxpayer generally may deduct 20% of Qualified Business Income (QBI) from a partnership, S corporation, or sole proprietorship, REIT dividends, cooperative dividends, and publicly traded partnerships. The deduction is subject to several limitations, and may not exceed the lesser of the QBI deduction (to be described) or 20% of the taxpayer's taxable income (reduced by net capital gains and co-op dividends)

## 20% Qualified Business Income Deduction IRC 199A (2)

- Definition: Qualified business income. Qualified business income (QBI) is determined for each qualified trade or business. QBI is the net income of a domestic business. It does not include any investment income (interest, dividends, capital gains, and losses). Reasonable compensation in the S corporation and guaranteed payments from a partnership reduce QBI. If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward and reduces QBI in the next taxable year. QBI includes both passive and active income
- The rules may apply to filers of Schedule C, E (including rental activity), F as well as partnership and S Corporation pass through income

## 20% Qualified Business Income Deduction –IRC 199A (3)

- High income taxpayers: 2 Additional Limitations:
- W-2 limits. Subject to a taxable income threshold, the deductible amount for each qualified trade or business is the lesser of (a) 20% of the taxpayer's QBI with respect to the trade or business, or (b) the greater of 50% of the W-2 wages with respect to the trade or business or the sum of 25% of the W-2 wages with respect to the trade or business and 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property
- Qualified property means tangible property of a character subject to depreciation that: (i) is held by, and available for use in, the qualified trade or business at the close of the tax year; (ii) is used at any point during the tax year in the production of QBI; and (iii) for which the later of the depreciable period or 10 years has not ended before the close of the tax year, i.e. the business's furniture, equipment, buildings, etc. that has not yet exceed its depreciable life

## 20% Qualified Business Income Deduction –IRC 199A (4)

- Specified service trades or businesses. Subject to a taxable income threshold, the deduction is not allowed with respect to “specified service trades or businesses.” Specified service trades or businesses are any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests or commodities, and 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. Engineers and architects are omitted from specified service trades or businesses

## 20% Qualified Business Income Deduction –IRC 199A (5)

- Phase-in of specified service business limitation. The exclusion from the definition of a qualified business for specified service trades or businesses does not apply for a taxpayer with taxable income less than a threshold amount. The “threshold amount” is \$315,000 MFJ (\$157,500 if single) and is indexed for inflation. For those with income above the threshold amount, the deduction phases out over the next \$100,000 of taxable income (MFJ) (\$50,000 for other individuals)
- Taxpayers in “specified service businesses” whose taxable income
  - Is below the minimum threshold amounts (\$315,000 for MFJ, \$157,500 for all others) may claim the full §199A deduction
  - Is above the maximum threshold amounts (\$415,000 for MFJ, \$207,500 for all others) may not claim any §199A deduction
  - Is in between the minimum and maximum threshold amounts may claim a partial §199A deduction
  - Planning Idea: Maximize contributions to defined benefit and contribution plans to reduce taxable income



## 20% Qualified Business Income Deduction –IRC 199A (6)

- The 20% deduction is not allowed in computing adjusted gross income; instead, it is allowed as a deduction reducing taxable income. The deduction does not affect limitations based on adjusted gross income. It is computed at the 1040 level, not the 1065 or 1120S. It is allowed for AMT purposes with no adjustments. The deduction is available to taxpayers that itemize deductions, as well as those that do not
- The new law provides a similar deduction for specified agricultural or horticultural cooperatives
- The provision is effective for tax years beginning after December 31, 2017. However, the 20% deduction sunsets for tax years beginning after December 31, 2025 – i.e., the deduction is temporary unless legislation is enacted extending it. Contrast this with the now “permanent” 21% corporate tax rate

## 20% Qualified Business Income Deduction –IRC 199A (7)

- Planning Concern:
- The definition of “W-2 wages” in the new law appears to provide different results for taxpayers that operate a business in an S corporation than for taxpayers that operate as a partnership or sole proprietorship. Wages paid by an S corporation to its owners are W-2 wages, but an equivalent payment made by a partnership or a sole proprietorship to an owner is not
- Being above or below the threshold where the wage limitation applies can make an important difference. Below: sole proprietor may be best; Above: S corp with wages may be best
- QBI deduction at top rates results in 29.6% effective rate ( $37\% - 20\% \text{ of } 37\% = 29.6\%$ ) compared to 21% C Corporation rate

# Questions?

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Webcasts (4 free events per year with CPE for PFP/PFS members)

October 3 1-2:45pm ET	<b>The Adviser's Guide to Financial and Estate Planning</b> Estate, Gift, Trust and Charitable Planning after TCJA
October 16 1-2:45pm ET	<b>Tax Reform: Year-End Financial and Tax Planning Strategies</b>
November 7 1-2:45pm ET	<b>The Adviser's Guide to Financial and Estate Planning</b> Planning for the Section 199A Deduction for Pass Through Entities

## Conferences

January 2018	AICPA Personal Financial Planning Leadership Summit
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