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The Impact of the New Tax Law on Pass-Through Entities

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Virtually all taxpayers will be affected by the new tax reform law, introduced as the Tax Cuts and Jobs Act (TCJA), that recently passed in November of 2017. The TCJA is primarily designed to provide tax cuts for businesses of all types, and it delivers on that goal. Businesses structured as a PTE—sole proprietorships, partnerships, LLCs, and S corporations—are generally favored. If there are winners and losers under the new law, then pass-through entities can count themselves among the winners.

PTEs vs C Corporations

Under some circumstances, the potential tax savings for C corporations may exceed the tax savings available to PTEs. The TCJA reduces the corporate tax rate to 21 percent, but this only applies to C corporations. By contrast, individual income tax rates are as high as 37 percent. Therefore, owners of PTEs could pay tax at rates as high as 37 percent on business income.

In an attempt to mitigate the different treatment of income from C corporations and PTEs, the new law provides eligible PTEs a 20 percent deduction against qualified business income (QBI). As a result, business income taxed at the 37 percent maximum individual tax rate would be taxed at an effective rate of 29.6 percent.

While this disparity may initially raise some eyebrows, keep in mind that the corporate tax involves double taxation when profits are paid out to shareholders as dividends; whereas, the distributions from PTEs are generally tax-free.

Qualified Business Income Deduction

The QBI deduction is available for owners of PTEs if the taxpayer's taxable income (from all sources) does not exceed $157,500 or $315,000 for married taxpayers filing a joint return (MFJ). Once a taxpayer's income exceeds that threshold, then the QBI deduction is either phased out or subjected to additional tests.

For example, any PTE whose trade or business involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing or investment management services, or any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees or owners, it is considered a "specified service business."

If the PTE's trade or business is a specified service business, then the QBI deduction is phased out once the taxpayer's income exceeds $157,500/$315,000 (MFJ) and is unavailable once taxpayer's income exceeds $207,500/$415,000 (MFJ). It should also be noted that the performance of services as an employee is not QBI.

For PTEs that are not a specified service business, the QBI deduction is subject to further restrictions once taxpayer's income exceeds the initial threshold and the limitations are fully phased in once their income exceeds $207,500/415,000 (MFJ).

To Convert or Not?

In certain situations, a conversion from a PTE to a C corporation may be advantageous under the TCJA. The deduction of state and local income, property, and sales taxes is limited to $10,000 for individuals; whereas C corporations can deduct state income taxes without limitation. Additionally, the cuts in the individual tax rates—including the 20 percent deduction on QBI—are scheduled to expire after 2025. Conversely, the corporate tax rate reduction to 21 percent is permanent.

However, one should also weigh the other benefits of the pass-through structure against the lower 21 percent corporate tax rate, particularly if dividends or distributions will be made to shareholders. If a business that is taxed as a C corporation is planning to distribute a substantial portion of its earnings, then the C corporation will pay income taxes on the earnings and the shareholders will also pay taxes on the dividends received from the C corporation. As a result, that income may be subject to a combined federal income tax rate as high as 39.8 percent whereas, PTEs are subject to a maximum tax rate of 37 percent—even if the PTE does not have QBI.

It is important to remember that there are many nuances of the TCJA that are only beginning to take shape. When considering their business plans, owners of PTEs should work with an account to understand how the new law affects their businesses, along with other tax changes, and to evaluate their next moves in their overall strategy.

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Pat is a Tax Senior Manager in the Minneapolis office of CBIZ/Mayer Hoffman McCann P.C. He is an attorney and certified public accountant with over 20 years of tax experience in both law and accounting. This experience enables him to effectively assist a variety of clients ranging from small, closely held companies and their owners to large public corporations. During his career, Pat has worked closely with companies in a variety of industries including manufacturing, wholesale distribution, retail, service providers, automobile dealerships, and entities operating in multiple states and countries. He has a Juris Doctor from William Mitchel Collage of Law (now Mitchell Hamline School of Law) and a Bachelor of Arts – Accounting degree from the University of St Thomas.

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