Tax Reform Breathes New Life into the Choice of Entity Decision

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The recent changes in tax rates have altered the “choice of entity” determination for new and existing businesses. This article describes some of the federal tax considerations involved when choosing or changing the tax classification of a closely held business entity and explains how changes to the taxation of income earned or distributed by business entities may affect those considerations. The article also illustrates the consequences of the choice if additional changes in the federal tax law make the entity selected less desirable in the future.

When a taxpayer decides to engage in a trade or business, the first choices to be made may be whether to form a legal entity to hold and operate the business and, if so, which type of entity? Since the advent of the limited liability company, a major factor in that decision is the federal tax treatment of the selected entity. Minor changes to federal tax rates may affect the choice of entity decision for those looking to form new entities, but major fluctuations are often necessary to prompt taxpayers to consider the conversion of an existing entity from one federal tax classification to another.

The recent reduction in the corporate income tax rate has reignited the choice of entity debate for both newly formed and existing entities. Given this change—as well as certain changes that may affect the tax rate applicable to the income of passthrough entities or sole proprietorships—it is time to review the various considerations that influence the choice of entity decision from a U.S. federal tax perspective.

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We include below a basic overview of the different federal tax classifications of entities available for owning and operating a business and the federal income tax rates applicable to these entities (or in the case of passthrough entities, their owners) in effect for 2018 following enactment of H.R. 1 (the “2017 Act”). Next, we address certain federal income tax issues to be considered when choosing or changing the federal tax classification of a business entity. Finally, we illustrate consequences of the choice in the event that subsequent changes in the federal tax law make the entity selected less desirable in the future.

Note that this article is not intended to be a comprehensive analysis of all the federal tax factors that may weigh into a choice of entity decision. Rather, the article focuses on the choice of entity debate in the very simple fact pattern in which individuals that are U.S. citizens or residents own and operate a domestic business. Additional considerations may arise when making the same determination for a foreign entity or for a domestic entity with significant foreign operations. Further, federal estate tax consequences—including a potential increase in basis on date of death of an owner of a business—may affect a choice of entity analysis. These considerations are outside the scope of this analysis.

### Types of Entities

Although a variety of domestic entities exist for legal purposes, if those entities operate a trade or business they are limited to four possible federal tax classifications—(1) sole proprietorship; (2) partnership; (3) C corporation; and (4) S corporation. We provide below a basic overview of the federal entity classification rules. Next, we discuss the treatment of each type of entity, as well as the different legal forms in which the entity may be organized. Note, however, that certain C corporations may be eligible for a special federal tax status (such as a regulated investment company, real estate investment trust, cooperative, or insurance company). For simplicity, we do not discuss the special rules applicable to these entities, but rather limit our discussion to the general rules applicable to a C corporation.

### Entity Classification Regulations

The entity classification regulations under section 7701 (commonly referred to as the “check the box” regulations) generally allow a business entity that is not classified as a per se corporation under section 301.7701-2(b) (an “eligible entity”) to choose its classification for federal tax purposes. Specifically, an eligible entity with two or more members may elect to be classified as either an association taxable as a corporation or as a partnership. An entity with just one owner may elect to be

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2. State income and transfer taxes also are beyond the scope of this discussion. However, they will invariably play a role in the choice of entity decision. As more fully discussed below, as a result of the 2017 Act all or some portion of the state taxes paid by an individual owner of a passthrough entity may no longer be deductible. The states’ responses to this and other changes in the 2017 Act are in flux which makes planning difficult. However, other differences with respect to the amount of income subject to tax in a particular state—including sourcing, allocation, and apportionment—and state tax rates should factor into the analysis.
3. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).
classified as an association taxable as a corporation or as an entity disregarded as separate from its owner (a “disregarded entity”). Under these rules, a domestic entity formed as a limited liability company, partnership, or other non-corporate entity generally will be classified for federal tax purposes as a partnership or a disregarded entity in the absence of an election otherwise.

If a domestic eligible entity would like to elect to be classified as a corporation (either at the time of its formation or as a change in classification), the entity may do so by filing a properly completed and timely filed Form 8832, Entity Classification Election; the election may be effective up to 75 days prior to the date on which it is filed. This 75-day window may be important for existing entities that would prefer to change their classification in light of changes in the federal tax law, but would also like to have the same federal tax classification for the entire tax year. In such a case, the entity must file its election to be classified as a corporation within 75 days of the beginning of its tax year. Thus, an eligible entity that would like to be classified as a corporation effective on January 1, 2019, must have filed the election by March 16, 2019.4

If an entity is disregarded as an entity separate from its owner, the activities of the disregarded entity generally are treated in the same manner as a sole proprietorship, branch, or division of the owner. Thus, all the assets, liabilities, and items of income, deduction, and credit of the disregarded entity generally are treated as assets, liabilities, and such items (as the case may be) of the entity's owner.

**Sole Proprietorship**

A sole proprietorship is a business treated for federal tax purposes as being operated directly by an individual. As such, there is no entity level tax on the income of the business from a federal tax perspective. Instead, the items of income, gain, loss, and deduction generated by the business are taken into account by the individual owner and thus taxed at the owner's federal income tax rate. Moreover, there is no gain or loss recognized on the transfer of assets between the sole proprietorship and its owner.

Under the 2017 Act, the highest federal income tax rate applicable to individuals is 37 percent. In addition, depending on the facts and circumstances, certain income may be subject to the 3.8 percent net investment income tax (the “NIIT”) under section 1411.5 Note, however, that the 2017 Act allows individuals a 20 percent deduction for “qualified business income;”6 this deduction applies only for

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4 Late election relief under section 301.9100-3 may be available in certain situations. An entity may also accomplish a conversion by undertaking legal steps, but such a conversion generally should be treated as occurring on the date of the legal conversion.

5 Section 1411 does not apply to the distributive share of the active trade or business income of an individual. For simplicity, we generally assume in this article that an individual's entire share of pass-through income is subject to NIIT. To the extent that it is not the case, the federal tax cost of operating the business through a pass-through entity would be lower than illustrated. We point this out in various locations in the analysis below.

6 The definition of qualified business income and the extent to which the 20 percent deduction is allowed is beyond the scope of this article. For simplicity, we assume that all the income of a sole proprietorship, partnership, or S corporation is qualified business income fully eligible for the 20 percent deduction.
federal income tax purposes, and thus does not reduce the amount of income subject to the NIIT. If available, this deduction effectively reduces the highest applicable rate with respect to the qualified business income to 29.6 percent (33.4 percent including the NIIT).

It is important to note, however, that the reduction of the highest individual rate (from 39.6 percent to 37 percent) and the availability of the deduction with respect to qualified business income expire and thus are not available for tax years beginning after December 31, 2025. Absent a legislative change that extends the deduction, the highest individual tax rate will return to 39.6 percent and no deduction will be allowed with regard to qualified business income. Accordingly, the highest rate applicable to individuals for tax years beginning after December 31, 2025, will be 43.4 percent. Note that the 2017 Act did not change the maximum individual rates applicable to capital gains and qualified dividends; thus, the rates applicable to those items remains at 20 percent.

From a legal perspective, a sole proprietorship may be found in the form of no legal entity whatsoever, a limited liability company wholly owned by an individual, a business trust, or a local law partnership formed with two legal owners that are treated as just one owner for federal tax purposes (e.g., a limited partnership formed between an individual and a limited liability company disregarded as an entity separate from the individual).

**Partnership**

Like a sole proprietorship, a partnership generally is not subject to an entity level tax on its income. Instead, the items of income, gain, loss, and deduction generated by the partnership generally are allocated among the partners in the partnership. The partners take those items into account in calculating their own income. Accordingly, any net income of the partnership generally is taxed at whatever tax rate applies to the partner that is allocated that income. Further, no gain or loss generally is recognized upon the contribution of property to a partnership in exchange for an interest therein, or on the distribution of property by a partnership to its partners.\(^7\)

Because the income of a partnership flows through to its partners, the amount of federal tax payable with regard to that income depends on the federal tax classification of its partners. For simplicity, we generally assume for purposes of this article that all the partners in a partnership are individuals (or trusts or estates generally taxed in the same manner as individuals) that are citizens or residents of the United States.\(^8\) Thus, they would be subject to the same federal tax rates applicable to individuals that are discussed above. If an interest in the partnership is owned by a corporation, that corporation (and its shareholders) would be subject to the federal tax rates described below with regard to its share of the partnership’s income.

\(^7\) There are several exceptions to these general rules that must be considered with respect to any contribution to or distribution from a partnership.

\(^8\) The choice of entity analysis may be affected by the extent to which investors already hold their interests through corporate blockers or the extent to which tax exempt investors may change how they hold their interests based on the new activity rules.
From a legal perspective, a partnership may be found in the form of a contractual arrangement between two or more persons to operate a trade or business without formation of a legal entity, a limited liability company, a business trust, or various forms of legal partnerships (e.g., a limited liability partnership or a limited partnership).

**C Corporation**

An entity classified as a corporation is a C corporation unless the corporation has an S election (discussed below) in effect for the tax year. Unlike a partnership, a C corporation is subject to an entity level tax on its net income. Further, a contribution of property to a C corporation may be a nonrecognition transaction, but only if certain requirements not applicable to partnerships are met. In addition, a C corporation generally will recognize gain (and, in the case of a liquidation, possibly loss) with respect to property in an amount equal to the gain that would be recognized by the corporation if the distributed property were sold for its fair market value. Moreover, the shareholders of a C corporation generally are subject to a shareholder level tax on the receipt of cash or other property distributed by the corporation. If a distribution received is characterized as a dividend, it is subject to any special rates applicable to the dividend. Any amount received that gives rise to a capital gain would also be subject to the applicable capital gains rate.

The 2017 Act significantly reduced the highest federal income tax rate applicable to a C corporation from 35 to 21 percent. Further, the 2017 Act repealed the corporate alternative minimum tax. Unlike the changes relating to individuals contained in the 2017 Act, the corporate rate reduction does not expire, but rather is “permanent.” Consequently, future legislation would be required to increase the rate.

From a legal perspective, a “per se” entity under the check the box regulations (which includes any domestic entity that formed under local law as an entity described as “incorporated” or a “corporation”) is a C corporation. Moreover, any eligible business entity may elect to be classified as a corporation. Thus, an entity formed as a limited liability company, a trust, or any form of a partnership may be classified as a corporation.

**S Corporation**

Small business corporations that elect to be subject to subchapter S of the Code—S corporations—are an interesting dichotomy between C corporations and partnerships. On the one hand, an S corporation resembles a partnership because an S corporation generally is not subject to federal income tax at the entity level; note, however, that certain exceptions may apply to subject some portion of an S corporation’s income to an entity level tax under section 1374 or section 1375. On the other hand, as a corporation for federal tax purposes, an S corporation generally is subject to many of the same provisions as a C corporation, including the rules for contributions and the treatment of the corporation upon a distribution. However, special rules apply in determining the consequences to a shareholder of a non-liquidating distribution by the corporation. Pursuant to these rules, a distribution of previously taxed income of the S corporation generally does not result in taxable income for the recipient. However, all of these special rules are available only to corporations that meet a list of requirements that often render S corporation status unavailable (or at least impractical).
Because the income of an S corporation generally flows through to its shareholders, the amount of federal tax payable with regard to that income depends on the federal tax classification of its shareholders. In most situations, the shareholders of an S corporation will be individuals (or trusts and estates that generally are taxed as individuals), although certain tax-exempt entities may also own stock in the corporation. Thus, the income of the S corporation generally is taxed at the individual rates described above.

From a legal perspective, an S corporation may come in the form of a “per se” entity under the check the box regulations or may be formed as an eligible entity that elects (or is deemed to elect) to be classified as a corporation. Thus, an entity formed as a limited liability company, a trust, or any form of a partnership may be classified as a corporation.

Changes in Rates under the 2017 Act

As noted above, the centerpiece of the 2017 Act is the reduction in the corporate income tax rate from 35 to 21 percent effective for tax years beginning after December 31, 2017. Further, the 2017 Act repealed the corporate alternative minimum tax (the “corporate AMT”). The significant reduction in the corporate tax rate and the repeal of the corporate AMT have made operating a business in a C corporation (as opposed to a sole proprietorship, partnership, or an S corporation) a more attractive prospect from a federal tax standpoint.

To put these changes in perspective, compare the taxation of $100 of income of a calendar-year C corporation at the pre-2017 rates with the taxation of the same income at post-2017 rates. If a domestic C corporation wholly owned by an individual shareholder earned $100 of taxable income that generated $100 of cash in 2017, the corporation generally would have paid $35 of federal income tax with respect to the income. If and when the remaining $65 of cash were distributed to the individual shareholder of the corporation as a dividend, the shareholder generally would pay an income tax of 20 percent and an NIIT of 3.8 percent; thus, the shareholder would pay $15.47 of tax with respect to the $65 distribution. For 2017, a total of $50.47 in tax would be paid with regard to the $100 of income, leaving just $49.53 in after-tax proceeds. Note, however, that the 23.8 percent tax paid by the shareholder might be deferred to another tax year if the corporation does not distribute all of its cash available after payment of the corporate tax.

If the same $100 of income were earned by the C corporation in 2018, the C corporation would pay just $21 of tax with respect to its income. If and when the corporation distributed the remaining $79 as a dividend to the individual shareholder, the shareholder would pay tax of 23.8 percent on the distribution. Thus, the shareholder would pay $18.80 of tax with respect to the distribution. Accordingly, a total of $39.80 in tax would be payable with regard to the $100 of income, leaving after-tax proceeds of $60.20. Again, the federal tax at the shareholder level could be deferred until a later year if the corporation does not distribute all of its available cash.

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9 For simplicity, we do not describe herein any potential impact of the corporate AMT when describing the federal income tax rate applicable to pre-2018 income.
As illustrated by the above, the 2017 Act reduced the total federal tax payable with respect to $100 of C corporation income by $10.67. Clearly, that makes operating a business in C corporation form during 2018 more advantageous than it was during 2017. However, a choice of entity decision is not based on a comparison of the same type of entity from one year to another. Rather, it is a comparison of operating as one form of entity as opposed to another. Thus, we consider below the 2017 and 2018 taxation of the same $100 of income earned by an entity classified as a passthrough entity (a sole proprietorship, partnership, or S corporation).

If a passthrough entity owned by individuals earned $100 of income in 2017, that income would not have been subject to federal income tax at the entity level. Instead, the income would have been passed through to the individual owner or owners to be included in calculating their income. Assuming an individual was subject to the highest applicable individual federal income tax rate (which in 2017 was 39.6 percent) and that the income was subject to the 3.8 percent NIIT, the individual owner would have paid $43.40 of tax with respect to the $100 of income. Thus, the after-tax proceeds would be $56.60. If the income was not subject to the NIIT, the after-tax proceeds would be $60.40; this would be the case regardless of whether the entity distributed the cash in the year it was earned.

If a passthrough entity earned the same $100 of income in 2018, again that income would not be subject to federal income tax at the entity level. Assuming the individual was subject to the highest applicable individual federal income tax rate (which in 2018 is 37 percent) and the income is subject to the 3.8 percent NIIT, the income would be subject to federal income tax of $40.80, leaving after-tax proceeds of $59.20 ($63.00 if the NIIT did not apply). Note that this amount of tax might be reduced if the $100 of income is eligible for the full 20 percent deduction for qualified business income under newly enacted section 199A. In such case, the individual would be taxable on $80 of income at a 37 percent rate. However, as the 20 percent deduction is not available for NIIT purposes, the full $100 of income would be subject to the 3.8 percent rate. Thus, the income would be subject to a total federal tax of $33.40, leaving $66.60 of after-tax proceeds ($70.40 without the NIIT). Again, this is true regardless of whether the cash is distributed in 2018. As illustrated by the above, the 2017 Act reduced the total federal tax payable with respect to $100 of partnership income that is qualified business income fully eligible for the 20 percent deduction by $10.

As another comparison, before the 2017 Act, $100 of income of a C corporation was ultimately subject to $7.07 more federal tax than the same income generated by a passthrough entity. After the 2017 Act, the same $100 of C corporation income ultimately will be subject to $6.40 more than the same income earned by a passthrough entity, provided the passthrough entity generates qualified business income that is fully eligible for the 20 percent deduction. Thus, assuming no other differences, it continues to be more efficient to operate a business that earns qualified business income that is fully eligible for the 20 percent deduction in a passthrough entity, rather than in a C corporation. This may also be the case if the business generates significant investment income that is taxed at a rate less than 37 percent (generally 20 percent). However, if the passthrough entity does not generate qualified business income (or the owners are not eligible for the 20 percent deduction) then the relevant owners may pay $1 (or one percent) more in tax on the same income than ultimately would be paid if the business operated as a C corporation. As a result, the owners of a business that does not generate qualified business income are perhaps the most likely to consider formation of (or conversion to) a C corporation.
Although one percent of $100 may seem insignificant, the more zeroes that are added to the $100, the more significant the difference may be—particularly for businesses that typically do not distribute all available cash. Thus, it is worth considering other factors in determining whether a new entity should be formed as a corporation or a passthrough entity, as well as whether an existing entity should convert from passthrough to corporate status. We discuss certain of these other factors below.

Factors to be Considered in Choosing Between a C Corporation and a Passthrough Entity

We included above a very high level overview of the treatment of the different types of entities in which a business may be operated. This overview did not focus on specific issues that—depending on the facts and circumstances—may heavily influence a choice of entity decision. Now we turn our focus to these more specific issues and their differences for different entities. We first consider the differences between passthrough entities and C corporations.

Levels of Tax

As indicated above, a C corporation is subject to federal income tax at the corporate level. In contrast, passthrough entities generally are not subject to federal income tax at the entity level. However, there are certain exceptions pursuant to which an S corporation that was formerly a C corporation (or that acquired the assets of a C corporation in a tax-free reorganization or liquidation) may be subject to tax at the entity level with regard to some portion of their income.

To the extent a C corporation and its shareholders actually would be subject to two layers of tax, a passthrough entity has an advantage over a C corporation. As a practical matter, however, a closely held C corporation often is able to avoid or defer double taxation by treating payments to shareholder-employees as deductible compensation, rather than as dividends or by retaining earnings and not paying dividends. Moreover, as noted above, under the provisions of the 2017 Act, even in the event the income of a C corporation is subject to two layers of tax, the total tax paid may nevertheless be less than that paid with respect to the same income by the owner of a passthrough entity.

Differences in Amount of Income Subject to Tax

The comparison of federal tax consequences of income earned by a passthrough entity or a C corporation above was based on the assumption that the total income of the entities were identical. In certain situations, however, that will not be the case as the timing and amount of income and deduction may be different for passthrough entities and C corporations. For example, a C corporation is permitted a deduction for dividends received from another corporation; neither a partnership nor an S corporation is entitled to the same deduction. In this situation, the taxable income of the C corporation would be reduced (as would its federal tax bill), and thus more cash may be available for distribution to (and taxable in the hands of) the shareholder. In contrast, a publicly traded corporation’s deduction for compensation of certain employees might be limited under section 162(m); that provision does not apply to a partnership and may not apply to an S corporation. In such a case, the net income to be passed through to the partner or shareholder would be lower. Thus, in comparing the overall federal income tax consequences of one business form over another, differences in the amount of income should be considered.
Additionally, included in the 2017 Act is a provision that limits an individual’s deduction for state and local taxes to just $10,000 per year; that limitation does not apply to the same taxes paid by a corporation. If a business is operated in pass-through form, the limitation may mean that the owner’s deduction for state and local taxes by the entity are not fully deductible. Thus, the total amount of income resulting from operation of the business may be higher—in some cases significantly higher—in the case of a pass-through entity than it will be for a C corporation. Indeed, if the income of the business is taxed in a high state tax jurisdiction, this may be a determinative factor.

**Pass Through of Losses to Shareholders**

The above discussion of federal tax rates under the 2017 Act assumed that the relevant business would generate positive net income. If, however, the business is expected to generate losses for some period of time, the choice of entity decision matrix may be reversed. Like income, losses of a pass-through entity generally flow through to its owners and are deductible by them—subject to basis limitations, the at-risk limitations of section 465, the passive activity loss limitation rules of section 469, the recently enacted excess business loss limitation of section 461(l), and potential limitations as a net operating loss (“NOL”) under section 172. If the losses have successfully navigated those limitations, the losses become losses of the business owner that may be available to offset other items of income at the business owner level and would be retained if the business were sold.

In contrast, net losses incurred by a C corporation accumulated as NOLs may offset future income of the corporation, but are not available for use by the shareholders of the corporation. If the business of the C corporation is transferred, the NOLs either—(1) stay with the entity (in the case of a taxable or non-taxable stock acquisition); (2) transfer to the acquiring entity (in the case of a non-taxable asset reorganization); or (3) disappear (after offsetting any gain recognized by the corporation as a result of a taxable transfer of its assets). If the NOLs survive the acquisition as NOLs of the target corporation or the acquiror, they may be subject to limitation under rules such as section 382 and/or the separate return limitation year rules of section 1.1502-21. Thus, a buyer may place a lower value on the losses.

**Basis Increase for Undistributed Income**

An owner of a passthrough entity obtains an increase in basis for the entity’s undistributed income. In contrast, a shareholder of a C corporation does not. This difference can have a significant impact on the tax treatment of the eventual sale of an interest in the entity. An owner of a passthrough entity may recognize less gain (or more loss) on the sale of an entity with undistributed earnings than it would in a similar sale of C corporation stock.

**Ownership of Foreign Corporate Subsidiaries**

In many situations, a domestic entity may own (or potentially could acquire) stock in a foreign corporation. This ownership may raise additional choice of entity considerations for the domestic entity. For example, as described below, ownership of a controlled foreign corporation (a “CFC”) by a domestic passthrough entity often leads to undesirable federal tax consequences under the 2017 Act (as well as under prior law), as compared with ownership by a C corporation. Nonetheless, as further described below, when the domestic passthrough entity is an S corporation that held stock in certain...
foreign corporations (including CFCs) on December 31, 2017, there may be a significant federal tax reason to avoid converting the S corporation to a C corporation.

While, as a mechanical matter, the existing subpart F regime was largely unchanged by the 2017 Act, the overall scheme of CFC taxation was drastically altered. Prior to and after the 2017 Act, an entity that was (and is) a 10 percent “U.S. shareholder” of a CFC generally currently includes in income “subpart F inclusions” when the CFC earns subpart F income (generally, passive types of income or income from certain related party sales or services transactions). The 2017 Act creates an additional category of income inclusions for U.S. shareholders of CFCs: a global intangible low-taxed income (“GILTI”) inclusion.

At a high level, the GILTI inclusion is based on all of a CFC’s income that is not subpart F income or effectively connected income, unless it falls into one of the specifically enumerated exempt income categories (related party dividends, income subject to the subpart F high tax exception, and certain foreign oil and gas income). In general, the excess of this GILTI base over a “deemed return” based on certain tangible depreciable assets (and reduced by certain interest expense) is included in a U.S. shareholder’s income as a GILTI inclusion, in a manner generally similar to a subpart F inclusion. Any U.S. shareholder of a CFC that is a C corporation is entitled to a deduction on its GILTI inclusion (subject to a taxable income limitation), initially at 50 percent (reduced to 37.5 percent in 2026 and thereafter). Thus, the effective tax rate on a GILTI inclusion for a C corporation when the full deduction is allowed is 10.5 percent (increased to 13.125 percent in 2026). In addition, a deemed paid foreign tax credit (“FTC”) based on 80 percent of the relevant foreign taxes generally is available to a C corporations with respect to its GILTI inclusion, although the benefit of the FTC may be limited for a variety of reasons.

Dividend distributions from a CFC to a U.S. shareholder that is a C corporation (which generally would have been subject to tax before the 2017 Act) generally now are tax-free as the result of a new dividends received deduction applicable to C corporations. U.S. shareholders that are passthrough entities are not allowed the GILTI deduction, the GILTI FTC, or the 100 percent dividends received deduction applicable to C corporations.

Based on the rules generally discussed above, certain types of income derived from a CFC held by a passthrough entity with individual owners may be subject to a higher effective tax rate than if derived from a CFC held by a C corporation. Nonetheless, individuals, estates, or trusts that own at least 10 percent of a CFC (directly or indirectly, including through an S corporation) may make a section 962 election to have amounts included in income as a “subpart F inclusion” (including the mandatory repatriation amount) or a GILTI inclusion taxed at the rates applicable to C corporations, and to claim deemed paid FTCs as though they were a C corporation. Although there is no specific guidance in the 2017 Act on whether the mandatory repatriation and GILTI deductions are allowed in determining the tax due under section 962, Treasury stated in Notice 2018-26 that only the mandatory repatriation deduction will be taken into account when a section 962 election is made. Treasury has not yet addressed whether the taxable portion of a section 962 previously taxed income (“PTI”) distribution is eligible for the reduced rates under section 1(h)(11). Although our view is that section 1(h)(11) would be applicable when the requirements of section 1(h)(11) are satisfied with respect to the CFC that makes
the PTI distribution, future guidance from the government could provide otherwise, potentially with retroactive effect to the date of the 2017 Act. If the individual owners held the CFC through a domestic corporation rather than a passthrough entity, the domestic corporation would include in income the subpart F inclusions and GILTI inclusions, and would be able to take the GILTI deduction as well as deemed paid FTCs. In addition, distributions from a domestic corporation to individuals shareholders would be eligible for the section 1(h)(11) rates. This structure would eliminate the risk of adverse guidance that could preclude section 1(h)(11) rates on taxable section 962 PTI distributions, and would allow all shareholders the benefit of the section 1(h)(11) rates rather than only the 10 percent U.S. shareholders that are allowed to make a section 962 election.

In addition, choice of entity considerations can be raised with respect to the foreign entity. For example, a foreign business could be held through a foreign passthrough entity rather than an entity treated as a corporation for U.S. tax purposes. In that case, the CFC rules in subpart F (including the GILTI rules) would not apply to the domestic entity with respect to the foreign entity because the foreign passthrough entity would not be a CFC. Nonetheless, the domestic entity would need to consider the interaction of other new provisions added by the 2017 Act (including the base erosion and anti-abuse tax, or “BEAT,” and the foreign-derived intangible income, or “FDII,” rules discussed below), with respect to ownership through a foreign passthrough entity rather than a corporate entity. A structure that maximizes the benefits of one set of rules might have a detrimental effect on another set of rules. These considerations might be particularly meaningful when the domestic entity is a C corporation that could be subject to the BEAT, FDII, and GILTI rules. Further, a domestic entity that is a passthrough entity may want to consider owning the foreign entity through a domestic C corporation, particularly if the foreign entity is a CFC, for the reasons discussed above.

As the above illustrates, an entity that owns (or is expected to own) a foreign corporation should consider the federal tax impact of that ownership in deciding which type of federal tax entities to select for holding the equity interest. This consideration may lead an existing domestic passthrough entity to consider conversion to a C corporation, or consider converting a foreign entity treated as a corporation to a passthrough entity. Note, however, that an existing S corporation considering a conversion to a C corporation must take into account another important—in some cases, a very important—consideration.

The shareholders of an S corporation that was subject to the mandatory repatriation rules in the 2017 Act may derive a significant benefit from the S corporation status as a result of a special election. The mandatory repatriation rules generally would apply when an S corporation held stock in a CFC or other “specified foreign corporation” (“SFC”) on November 2, 2017, or December 31, 2017, if the SFC had certain earnings and profits that had not been subject to U.S. tax. In this case, the S corporation shareholders generally would include in income a “mandatory repatriation inclusion.” The 2017 Act provides a special deferral election that is available only to shareholders of an S corporation. When a shareholder makes the election, the shareholder defers the payment of tax on its mandatory repatriation inclusion until a “triggering event.” Given the limited definition of triggering event for this purpose, the S corporation shareholder potentially could defer the payment of tax on the mandatory repatriation inclusion for a significant period of time.
Of importance here, the termination of a corporation’s S corporation election is a triggering event. Thus, termination of an S corporation’s election would accelerate the tax liability of the corporation’s shareholders that made the deferral election. If this triggering event occurs, the shareholders who elected deferral could then choose to use the eight-year installment method to pay the tax on the mandatory repatriation inclusion. An S corporation that owns stock in an SFC (including a CFC) should consider whether any benefit obtained by terminating its S election is offset by the loss of what could have been a lengthy deferral of tax on its shareholders’ mandatory repatriation inclusions.

**Foreign-Derived Intangible Income**

A domestic C corporation is allowed a deduction based on its FDII. In general, FDII is based on income from sales (including licenses and leases) of property to foreign persons for use outside of the United States, or services rendered to persons or with respect to property located outside the United States. Only domestic C corporations are allowed a FDII deduction (which is subject to a taxable income limitation rule), which reduces the effective rate of tax on FDII to 13.125 percent when the full deduction is allowed (which increases to 16.406 percent in 2026).

**Differences in NIIT**

The NIIT under section 1411 generally applies a 3.8 percent tax rate to the net investment income of a taxpayer. “Net investment income” is defined as the excess (if any) of the sum of—(1) gross income from interest, dividends, annuities, royalties, and rents (other than such income derived in the ordinary course of a trade or business to which the tax does not apply); (2) other gross income from trade or business to which the tax applies; and (3) net gain attributable to the disposition of property other than property held in the conduct of a trade or business, over deductions allowed for income tax purposes that are properly allocable to the gross income or net gain. Items of net investment income that pass through to the taxpayer from a partnership or S corporation must be taken into account in this calculation. An individual’s income from a sole proprietorship, partnership, or S corporation in which the taxpayer does not materially participate (within the meaning of section 469) generally is subject to the NIIT.

Under the rules described above, a dividend received by an individual from a C corporation generally is characterized as net investment income. In contrast, an individual’s distributive share of the active trade or business income of a passthrough entity is not subject to section 1411. Thus, if a taxpayer materially participates in a business, there may be an advantage to operating the business through a passthrough entity because doing so may avoid imposition of the 3.8 percent NIIT.

**Avoidance of Personal Holding Company and Accumulated Earnings Taxes**

Passthrough entities are not subject to the section 541 personal holding company tax or the section 531 accumulated earnings tax, both of which generally relate to undistributed business earnings. Thus, there are no restrictions on the ability of a business operated as a passthrough entity to retain and reinvest (rather than distribute) its earnings. In contrast, C corporations that do not distribute all of their earnings should be conscious of the possibility these taxes may be imposed. Thus, any comparison of the federal tax consequences of operating as a C corporation or a passthrough entity that is based on an assumption of undistributed earnings should consider both of these issues.
Flexibility in Selection of Tax Year

A C corporation generally may elect any tax year. In contrast, a sole proprietorship is on the same tax year as its owner, which generally should be the calendar year. Further, an S corporation generally is limited to—(1) a calendar tax year; (2) the tax year of the shareholder(s) owning more than 50 percent of the stock; (3) a natural business year; or (4) a September, October, or November year-end, for which it makes a section 444 election. Partnerships have similar tax year limitations.

Greater Ability to Use the Cash Method of Accounting

Under section 448, certain passthrough entities are eligible to use the cash method of accounting, without regard to their level of gross receipts. In contrast, a C corporation (other than a qualified personal service corporation) with gross receipts in excess of $25 million (under the 2017 Act) must use the accrual method of accounting. Using the cash method may be a particularly valuable option for certain passthrough entities, particularly those that provide professional services. For those entities, operation as a C corporation may have a significant cost.

Excessive Compensation Generally Not an Issue for Passthrough Entities

A C corporation that pays what the IRS may determine to be an excessive amount of compensation to a shareholder-employee risks having the “excessive” portion reclassified from deductible compensation to a non-deductible dividend. The IRS has long raised this issue in smaller and closely held companies, often successfully. Moreover, section 162(m), as amended by the 2017 Act, limits the deduction for compensation of certain employees of a publicly traded corporation to $1 million.

Generally, excessive compensation is not an issue with respect to passthrough entities. Section 162(m) would not be an issue for a partnership and may not be an issue for an S corporation. Further, an adjustment by the IRS relating to excessive compensation typically would result either in no increase in income tax and possibly a reduction in payroll taxes. Indeed, unlike an owner of a C corporation, an owner of an S corporation or a partner in a partnership may have an incentive to be paid a smaller “salary” and to have a larger distributive share. Because of this, the concern is likely to be that the owner of the business is not being paid enough for his services, as opposed to too much.

In the case of a passthrough entity, there also is little (if any) advantage to paying excessive compensation as a result of changes made by the 2017 Act. Under section 199A, the owner of a trade or business generally is entitled to a 20 percent deduction with respect to qualified business income attributable to the business. Reasonable compensation paid to the owner of the passthrough entity is not eligible for the qualified business income deduction of section 199A, while the shareholder’s share of the income of the corporation that flows through may be eligible for the deduction. Note, however, that the section 199A deduction is dependent in part on wages paid by the business. For this purpose, “wages” appears to include salary payments to a shareholder of an S corporation, but not equivalent

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10 The cash method generally is not available to a partnerships with a C corporation partner or to a “tax shelter” (as defined in section 448(d)(3)).
payments to a partner in a partnership or a sole proprietor. Thus, if an entity is to be operated as a passthrough entity, this may provide an advantage to doing so in S corporation form.

Equity in Passthrough Entities Not Eligible for Section 1202 Exclusion

Subject to certain limitations, section 1202 allows the owner of “qualified small business stock” to exclude from income some or all of the eligible gain from the sale or exchange of such stock that has been held for more than five years. However, the exclusion only applies to stock of a C corporation (section 1202(c)(1)); S corporation stock and partnership interests are not eligible. However, stock in both an S corporation and a C corporation potentially is eligible for gain rollover under section 1045; no equivalent rollover applies to interests in a partnership or sole proprietorship.

Limitation on Excludable Fringe Benefits

Shareholder-employees of a C corporation are eligible to exclude a number of employer-provided fringe benefits. However, partners in a partnership are not allowed to exclude most employer-provided fringe benefits. S corporation shareholder-employees who own (or are treated as owning under the attribution rules of section 318) more than two percent of the outstanding stock or stock representing more than two percent of the voting power of the corporation are treated as partners in a partnership for fringe benefit purposes. Thus, partners in a partnership and two percent shareholders of a corporation include fringe benefits in income, while shareholders of a C corporation—regardless of the extent of their ownership—do not.

Factors to be Considered in Choosing Between Passthrough Entities

We considered above the factors to be considered in choosing whether to operate a business in a C corporation or a passthrough entity. The focus of that discussion was on differences between a C corporation and all types of passthrough entities. As noted above, however, an S corporation generally is subject to many of the same provisions as a C corporation. Further, an S corporation election is available only if certain eligibility requirements are satisfied. These differences mean that, even if a taxpayer chooses to operate its business in a passthrough entity, further consideration should be given to what type of passthrough entity should be used. We discuss some of those issues below.

“Salaries” Paid to Owners

The choice of entity considerations in relation to salaries (or their equivalent) paid to owners of business entities vary between different types of passthrough entities. An S corporation is effectively the same as a C corporation in this regard. Under current law, flow-through income from an S corporation to its shareholders is not classified as self-employment income. Thus, compensation paid to a two percent S corporation shareholder is reported on a Form W-2, while the shareholder’s distributive share of income flows through as non-compensatory income. The flow through income is not subject to the 12.4 percent self-employment tax or the 2.9 percent Medicare hospitalization insurance tax. Instead, an S corporation shareholder that receives salary or other wages from its S corporation generally is treated
as an employee of the S corporation, just as it would be of a C corporation.\textsuperscript{11} For a C corporation or an S corporation, compensatory amounts are subject to FICA/Medicare. This includes 6.2 percent employer and 6.2 percent employee payroll taxes plus 1.45 percent employer and 1.45 percent employee Medicare on all wages and the 0.9 percent additional Medicare required withholding on employee compensation above $200,000 and applicable state and local income tax withholding.

In contrast, flow-through income to a general partner of a partnership and to certain active members of a limited liability company is treated as self-employment income subject to self-employment tax and Medicare taxes. Because the 2.9 percent (and, if applicable, the additional 0.9 percent) Medicare tax is imposed on the entire amount of a taxpayer’s self-employment income, without limitation, C corporation or S corporation status can save $35,750 of Medicare tax per $1 million of taxable income of a married shareholder that files a joint return, compared to a sole proprietorship or a partnership. Moreover, partners or sole proprietors may find the estimated tax payments generally associated with self-employment status to be onerous, thus making C corporation or S status more attractive. However, the more beneficial treatment of certain employee benefits (such as health plan, section 401(k) plan treatment, and fringe benefit treatment) does not apply to a two percent or greater S corporation shareholder, but does apply to employees of a C corporation. However, it is possible for partners to continue to receive compensation as W-2 wages with proper structuring (i.e., through use of a separate entity).\textsuperscript{12}

\textit{Eligibility Limitations}

One of the biggest disadvantages of operating a business as an S corporation is the array of eligibility limitations that must be satisfied to qualify for (or maintain) S corporation status. In contrast, there are few (if any) limitations on the ability of an entity to qualify as a partnership or sole proprietorship.\textsuperscript{13} Further, an S corporation’s income, gain, or loss must be allocated pro rata among its shareholders; thus, no special allocations like those permitted for partnerships are allowed. In addition, the federal tax benefit or burden of any built-in gains or losses inherent in property at the time it is contributed to an S corporation will be shared equally by the corporation’s shareholders at the time the gain or loss is recognized. In contrast, in the partnership context, those gains or losses are allocated under section 704(c) to the partner that contributed the property.

There are also significant restrictions on the ability of an S corporation to make disproportionate distributions to its shareholders. Although differences in the timing of distributions to shareholders are allowed, the aggregate amounts of distributions generally must be pro rata. A partnership or sole

\textsuperscript{11} Note that, as mentioned below, for fringe benefit purposes, certain S corporation shareholders are treated in the same manner as partners in a partnership.

\textsuperscript{12} If structuring in this regard is contemplated, please consult with Washington National Tax.

\textsuperscript{13} Note, however, that an entity that otherwise would be classified as a partnership is classified as a corporation if it runs afoul of the publicly traded partnership rules of section 7704.
proprietorship is under no such constraint. Non-pro rata distributions can be made to partners, provided that certain capital account maintenance requirements are satisfied. 14

No Basis for Third Party Debt

If passthrough status is desirable, an S corporation may be a bad choice for an entity that is heavily funded by third party debt. An important disadvantage of an S corporation, compared to a partnership or limited liability company, is that the stock basis of an S corporation shareholder is not increased to reflect debt of the S corporation. Instead, for purposes of taking its allocable share of deductions of the S corporation, a shareholder may only take advantage of its own loans to the corporation. In contrast, a partner’s or a limited liability company member’s basis in a partnership interest does include the partner’s allocable share of partnership or limited liability company debt. This can be a disadvantage for an S corporation in terms of the loss flow through limitation and the treatment of distributions.

Gain or Loss on Contributions and Distributions

An S corporation generally is subject to the rules applicable to a C corporations that relate to contributions to and distributions of property by the corporation. Appreciated property may be transferred to an S corporation (or a C corporation) without recognition of gain only if—(1) the transferor (and any other parties transferring property at the same time) has at least 80 percent control of the corporation immediately following the transfer; (2) the transfer is not a transfer to an investment company described in section 351(e) and the regulations thereunder; and (3) other requirements are satisfied. In the case of a transfer of property to a partnership that is an investment company within the meaning of section 721(b), appreciated property generally may be contributed in exchange for an interest in the partnership at any time, without regard to the percentage ownership interest of the transferor partner. Further, both an S corporation and a C corporation generally must recognize gain on the distribution of appreciated property to, or for the benefit of, shareholders for both ordinary and non-liquidating distributions. In contrast, no gain or loss generally is recognized by a partnership or its partners on a distribution of property, other than cash or marketable securities, by a partnership. 15 Thus, a partnership provides greater flexibility than a C corporation or an S corporation with respect to both contributions to and distributions by the entity.

Ability to Compensate Employees with Ownership Interests

In many situations, a business entity may want to incentivize its employees by transferring an ownership interest in the entity to the employee in exchange for services. If the business entity is a C or S corporation, the issuance of stock to the employee in exchange for services generally gives rise to compensation income for the recipient and a compensation deduction for the issuing corporation. In contrast, provided certain requirements are satisfied, the issuance of a profits interests in a partnership

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14 Note, however, that disproportionate distributions to partners raise the possibility that section 751(b) may apply to the distribution.
15 As noted above, there are several exceptions to these general rules that must be considered with respect to any contribution to or distribution from a partnership.
to an employee in exchange for services generally does not give rise to taxable income for the partner or a compensation deduction for the partnership. From the employee’s perspective, an eventual sale of any stock in a C or S corporation received and held by the employee may give rise to capital gain. In contrast, the eventual sale of a compensatory partnership interest will give rise to ordinary income or capital gain, depending on the assets of the partnership. Moreover, the 2017 Act added section 1061, a provision applicable to compensatory partnership interests that may cause a sale of those interests to give rise to short-term capital gain, even if they would otherwise have given rise to long-term capital gain. However, section 1061 may not apply in many situations. These differences in tax treatment should be considered if the owners of the business anticipate the issuance of incentive ownership.

Note, however, that a special rule applicable to S corporations makes them particularly attractive vehicles for operating a business a significant portion of which is owned by an employee stock ownership plan (an “ESOP”). Subject to a certain requirements, an ESOP that owns stock in an S corporation generally is not subject to unrelated business income tax on its distributive share of the income and gain of the S corporation. Thus, the portion of income and gain of an S corporation owned by an ESOP is not subject to current income taxation. This is major factor to be considered by a passthrough entity that anticipates significant employee ownership.

**Ability to Engage in Corporate Reorganizations**

Some of the issues described above may make an S corporation less desirable than another type of passthrough entity. However, an S corporation has in its favor the ability to enter into corporation reorganizations. As noted above, S corporations generally are subject to the rules applicable to C corporations (at least to the extent they are not inconsistent with subchapter S). As a result, an S corporation may enter into a corporate reorganization (as a target company or an acquiror), which may allow the shareholders of an S corporation to transfer their stock in the corporation (or for the corporation to transfer its assets) to an acquiring corporation in a transaction in which no gain or loss is recognized. Further, if an S corporation owns all the stock of another corporation, a liquidation of the subsidiary corporation may qualify for nonrecognition treatment under section 332. In contrast, a partnership falls outside the application of the reorganization rules. Thus, if the partners in a partnership transfer their interests in a partnership (or a partnership transfers its assets) to an existing corporation, there may be significant limitations on the ability of the transaction to qualify for nonrecognition treatment. However, transfers of a partnership’s assets or of partnership interest to a newly-formed corporation may be subject to nonrecognition treatment under section 351.

**Differences in the Treatment of Excess Business Interest Expense**

Another difference between a partnership and an S corporation arises from a new provision in the 2017 Act. New section 163(j) generally disallows a deduction for the net business interest expense of any taxpayer in excess of the sum of 30 percent of the business’s adjusted taxable income plus its floor plan financing interest. The limitation does not apply to certain small businesses, and thus many partnerships and S corporations (which may be more likely to be small) may be excluded.

For businesses subject to interest disallowance under section 163(j), there are differences in the treatment of partnerships and S corporations. For partnerships, the section 163(j) limitation is
determined first at the partnership level. Any excess business interest that is disallowed (or any excess taxable income) at the partnership level is then allocated to the partners. Excess business interest of the partnership allocated to a partner is subject to carryforward and treated as business interest paid or accrued by the partner in a future tax year to the extent the partner is allocated “excess taxable income” from the partnership. In contrast, section 163(j) applies to an S corporation only at the entity level. Thus, S corporations are subject to an entity level determination of disallowance. Any nondeductible business interest expense is subject to carry forward at the S corporation level, and may be subject to limitation under section 382. It appears that a shareholder’s basis in its S corporation stock is not reduced by the nondeductible portion of its business interest expense.

Costs of Conversion

After analyzing the factors described above and any other relevant factors, the owner or owners of an existing passthrough entity may consider converting the entity to a C corporation. Depending on the facts and circumstances, there may be federal tax consequences of the conversion to consider. Moreover, before converting an existing passthrough entity to a C corporation, the owner or owners of a business should consider the cost of converting back to passthrough entity status in the event of subsequent changes in the federal tax law.

Costs of Converting a Passthrough Entity to a C Corporation

Depending on the facts and circumstances, there may be tax costs to converting a passthrough entity to a C corporation. As described below, the costs of converting an existing passthrough entity to a C corporation include costs that may arise as a result of actual or deemed transactions that occur as a result of a conversion, as well as costs unrelated to those transactions but arising simply from the entity’s change in federal tax classification. We discuss each of these below.

If a sole proprietorship or partnership converts to a corporation (either actually or through an entity classification election), then certain transactions occur or are deemed to occur for federal tax purposes. Those transactions may vary slightly depending on the form of the conversion. However, every form involves a contribution of property to a newly formed corporation in exchange for stock therein; in the case of a conversion of a partnership, there also is an actual or deemed liquidation of the partnership. A full analysis of all the potential issues to be considered is beyond the scope of this article, but we do include a brief analysis below of the aspects of formation or liquidation most likely to have significant federal tax consequences.

If property is transferred to a corporation in exchange for its stock, then the transaction is fully taxable transaction unless section 351 applies. For a transaction to qualify under section 351(a), at a minimum there must be a transfer of property to a corporation solely in exchange for stock and, immediately after the transfer, the transfer (or transferors) must be in control of the transferee corporation immediately after the exchange. If these (as well as other) requirements are not satisfied, the transfer of property in exchange for stock will be a completely taxable transaction. Even if the requirements are satisfied, the transaction may nevertheless be fully taxable if the transfer is a transfer of property to an investment company (as defined in section 351(e) and the regulations thereunder). Moreover, if the general
The nonrecognition rule of section 351 applies, some or all of any gain inherent in the transferred property nevertheless may be recognized under section 351(b), 357(b), 357(c), or 351(g), but no loss would be recognized.

In addition to the possibility of gain recognition as a result of actual or deemed transactions occurring as a result of a conversion from a pass-through entity to a C corporation, the conversion itself may result in the accelerated recognition of income. Specifically, as noted above, a pass-through entity may be allowed to use the cash method in situations in which the method would not be available to a C corporation. Thus, the conversion of a pass-through entity to a C corporation in certain situations may result in a required change from the cash to the accrual method of accounting. Although the section 481 adjustment resulting from the change may be spread over four years, the cost of the conversion may nevertheless be quite high.

In recognition of this, Congress included in the 2017 Act a special rule relating to certain corporations that revoke an S election within two years of the date of the 2017 Act’s enactment. Specifically, the 2017 Act provides that an “eligible terminated S corporation” may spread the section 481 adjustment arising from its conversion to a C corporation over six years, rather than four. For this purpose, an eligible terminated S corporation is any C corporation—(1) that was an S corporation on the day before the date the 2017 Act was enacted and revokes its S election during the two-year period beginning on the date of enactment; and (2) the owners of the stock of which (determined on the date on which the revocation is made) are the same as those on the date of enactment and those owners hold the stock in identical proportions.

The 2017 Act contains another special rule applicable to an eligible terminated S corporation that also may alleviate some of the “cost” of converting an S corporation to a C corporation. As noted above, distributions by a C corporation generally are taxable as a dividend to the shareholders. In contrast, a distribution by an S corporation of previously taxed income generally does not result in taxable income for the recipient. A special rule applies S corporation treatment to certain distributions of money by a C corporation out of the accumulated adjustments account (“AAA”) from its time as an S corporation during the “post-termination transition period” or “PTTP” (generally, the one year period following termination of the corporation’s S election). For a shareholder, these distributions from AAA generally are more favorable, because the distributions are tax-free to the extent of the shareholder’s basis in its S corporation stock and then as giving rise to capital gain for the shareholder. In contrast, distributions out of earnings and profits are treated as dividends and taxed accordingly. After expiration of the PTTP, any distributions made by the former S corporation would be treated as coming first from the corporation’s earnings and profits and thus taxable as a dividend to the extent of the earnings and profits.

The 2017 Act extends in part the generally beneficial treatment of distributions for certain former S corporations beyond the PTTP. Specifically, a distribution of money by an eligible terminated S corporation following the PTTP would be treated as coming out of the corporation’s AAA (which would give rise to return of basis or capital gain) or earnings and profits (which would give rise to a dividend) in the same ratio as the amount of the corporation’s AAA bears to the amount of the
Corporation’s accumulated earnings and profits. Thus, even after expiration of the corporation’s PTTP, some portion of any money distributed by the corporation may nevertheless be treated as a reduction in the shareholder’s basis in its stock followed by a capital gain.

**Costs of Converting from a C Corporation to a Passthrough Entity**

A business owner considering whether to operate in corporate or partnership form may focus only on current income tax rates and thus fail to “see the forest for the trees.” For example, partners in a partnership that look only to current federal income tax rates and concludes that its business currently operated in passthrough form should be converted to a corporation may regret the decision if the individual and/or corporate federal income tax rates change in the future, making partnership status again more attractive.

To illustrate, assume that an entity currently operating as a partnership converts to a C corporation to take advantage of the lower corporate federal income tax rate. If the federal tax law later changes so that C corporation status is no longer desirable, the owners of the entity may find themselves in an inescapable predicament. To reobtain passthrough treatment for the business, its owners may have only two choices: an S corporation election or a conversion of the entity to a partnership.

A conversion of a C corporation to an S corporation generally would be taxable only to the extent of any last-in, first-out (LIFO) reserve recapture under section 1363(d) plus the corporate level tax on any net recognized built-in gains under section 1374. Thus, returning to passthrough status in the form of an S corporation may not involve significant cost. However, this option is available only for entities that satisfy the rather onerous S corporation eligibility requirements. Thus, an S corporation election would not be available for a C corporation with classes of stock that provide for disparate distributions. It also would not be available to any corporation with a corporate, partnership, non-qualifying trust, or other ineligible owner, nor would it be available to a corporation with more than 100 shareholders (determined by treating members of the same family as one shareholder). Thus, returning to passthrough status through an S corporation election may not be an option for many entities.

If an S corporation election is not available, a corporation’s only means of returning to passthrough status would be through a conversion of the C corporation to a partnership or sole proprietorship. Such a conversion would result in a liquidation of the C corporation. That liquidation would be fully taxable, with the corporation generally recognizing gain or loss as though it sold its assets for fair market value and the shareholders of the corporation recognizing gain or loss equal to the difference between the fair market value of the property treated as received and the shareholder’s adjusted basis in the stock.16

For example, assume that a C corporation owned by an individual converts to a disregarded entity (a sole proprietorship for federal tax purposes) at a time when the corporation has a basis of $10 in its assets, which have a net fair market value of $100. Further assume that the corporation’s sole shareholder has a $10 basis in its stock in the corporation. If the corporation converts to a partnership, 

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16 In limited situations, loss recognized by the corporation on liquidation may be reduced or not recognized under section 336(d).
the corporation should be treated as liquidating. In the liquidation, the corporation will recognize a $90 gain ($100 fair market value of assets less a $10 basis therein). That gain will give rise to $18.90 of federal income tax. The shareholders of the C corporation will then be treated as having received $81.10 ($100 pre-liquidation net fair market value of assets less the $18.90 federal tax liability of the C corporation) in exchange for stock with a basis of $10. Thus, the shareholder will have capital gain of $71.10; at a 20 percent capital gains rate and an NIIT rate of 3.8 percent, the shareholder will pay $16.92 of tax on the liquidation. Thus, the liquidation will result in a combined federal tax bill of $35.82 (more than one-third of the fair market value of the assets). However, the shareholder will take the assets treated as received with a $100 basis.

The example above illustrates that there would be significant costs to converting back to passthrough status if an entity determines that C corporation status is no longer desirable as a result of future federal tax law changes; this cost would be even higher if the impetus for converting is a significant corporate income tax rate increase and the liquidation cannot be accomplished before the new rate takes effect. Thus, a C corporation that is not eligible for an S corporation election may find itself effectively economically trapped in undesirable C corporation status.

Note, however, there may be situations in which a deemed liquidation of a C corporation would not result in significant gain for federal tax purposes. For example, if the C corporation has no unrealized gain with respect to any assets (including intangibles) or has sufficient losses (or credits) to offset recognized gains (or the tax thereon), conversion to a partnership may be feasible. The possibility that, in certain situations, any goodwill associated with the business may be personal goodwill of the business owner (and thus held outside the entity) is relevant in determining the amount of gain recognized. Further, the conversion may be feasible if there is little to no appreciation in the C corporation’s assets, and thus the income tax “hit” of the liquidation at the corporate level is low. Absent these facts or the existence of NOL carryovers or unrealized built-in losses available to offset any gains on conversion, converting an existing C corporation into a partnership often is not desirable because of the immediate tax cost that would be incurred.

Conclusion

The above discussion provides an overview of certain tax issues to be considered when choosing whether to operate a business in a C corporation or a passthrough entity, as well as factors involved in determining which type of passthrough entity to employ. This list is not intended to fully address those factors, nor does it purport to highlight every issue involved in the decision. If a taxpayer is faced with a choice of entity question—particularly in light of changes in the 2017 Act—a full analysis of any relevant issues and modeling of the consequences of converting to a corporation (as well as the potential costs of returning to passthrough status) should precede the decision. In addition, modeling can help provide quantitative information that will be necessary to the choice of entity determination. Contact Deanna Harris (with regard to domestic issues) or Barbara Rasch (with regard to foreign entities) of KPMG LLP’s Washington National Tax practice to assist with these issues.