Chapter 3: Entity Comparison

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Please note. Corrections were made to this workbook through January of 2019. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

Marc C. Lovell, JD, LLM, MS, has headed a private tax law practice since 2001 with principal practice areas in federal, state, local and international taxation and tax litigation. He served as Assistant Director, Tax Education and Outreach of the University of Illinois Tax School program from 2011 to 2016. In addition to his private practice, Marc heads a team of seven research and reference law librarians at the Department of Justice and the DOJ Main Library in Washington DC as a contractor through The Cadence Group. Marc obtained his JD and LLM from Wayne State University Law School, and his MS in Library and Information Science from the University of Illinois.

Other chapter contributors and reviewers are listed at the front of this volume.

TAX CUTS AND JOBS ACT

The Tax Cuts and Jobs Act of 2017 (TCJA), enacted on December 22, 2017,[1] ushers in major changes to both C corporation and pass-through entity taxation. These changes became effective January 1, 2018. Congressional goals relevant to these business entity tax changes include the permanent reduction of the corporate income tax rate, which Senator Orrin Hatch, Chair of the Senate Committee on Finance, described as "the highest in the industrialized world"[2] in his opening statement on November 13, 2017, at the Finance Committee markup of the original TCJA bill.

> **Note.** Senator Hatch's complete introductory statement in connection with the TCJA is available at **uofi.tax/18b3x1** [www.finance.senate.gov/hearings/open-executive-session-to-consider-an-original-bill-entitled-the-tax-cuts-and-jobs-act]. Senator Ron Wyden's introductory statement is also available at this same webpage.

There are different ways to measure the size and impact of corporate tax rates. Statutory rates are the corporate tax rates mandated by the actual tax law, while effective tax rates (ETRs) measure how much tax is paid relative to corporate economic income. Despite Senator Hatch's remarks, which focused on statutory rates, a March 2016 Government Accountability Office (GAO) study indicated that during each year from 2006 through 2012, at least two-thirds of active corporations had no federal tax liability, and larger corporations with at least $10 million in assets were the most likely to have some tax liability. The GAO study points out that from 2008 through 2012, these larger corporations had an ETR of approximately 14% of pretax net income as reported on their financial statements. Moreover, once foreign, state, and local taxes were accounted for, the average ETR during this period was slightly more than 22% (far less than the statutory tax rate of 35% that is frequently referred to in tax reform discussions).[3]

However, using statutory tax rates as a measure, other studies indicate that U.S. corporate tax rates, when compared to those of other nations, are high. On September 7, 2017, the Tax Foundation published the results of a survey of corporate tax rates for 202 countries. The table below shows the countries with the six highest rates, followed by a table showing those with the six lowest rates for comparative purposes.[4]

**Tax Foundation Survey —
Countries With the Six Highest
Corporate Tax Rates, September 2017**

Country	Corporate Tax Rate
United Arab Emirates	55%
Comoros	50%
Puerto Rico	39%
United States	38.91%
Suriname	36%
Argentina	35%

1. PL 115-97.
2. *Open Executive Session to Consider an Original Bill Entitled the Tax Cuts and Jobs Act*. Nov. 13, 2017. United States Senate Committee on Finance. [www.finance.senate.gov/hearings/open-executive-session-to-consider-an-original-bill-entitled-the-tax-cuts-and-jobs-act] Accessed on May 13, 2018.
3. *Corporate Income Tax.* Mar. 2016. GAO. [www.gao.gov/assets/680/675845.pdf] Accessed on Jun. 1, 2018.
4. *Corporate Income Tax Rates around the World, 2017.* Jahnsen, Kari and Pomerleau, Kyle. Sep. 7, 2017. Tax Foundation. [taxfoundation.org/corporate-income-tax-rates-around-the-world-2017/#_ftn1] Accessed on May 22, 2018.

Note. The U.S. corporate tax rate of 38.91% is composed of the federal statutory rate of 35% that prevails through the 2017 tax year (prior to the enactment of the TCJA), plus an average of the corporate income taxes imposed by individual states.

Tax Foundation Survey — Countries With the Six Lowest Corporate Tax Rates, September 2017 (Countries with Non-Zero Corporate Tax Rates)

Country	Corporate Tax Rate
Uzbekistan	7.5%
Turkmenistan	8%
Hungary	9%
Montenegro	9%
Andorra	10%
Bosnia and Herzegovina	10%

Based on the Organization for Economic Co-operation and Development's (OECD) tax database, the United States had the highest corporate tax rate among industrialized nations through 2016.[5]

Note. The OECD tax database's detailed compilation of corporate tax rates among nations can be found at **uofi.tax/18b3x2** [stats.oecd.org/index.aspx?DataSetCode=Table_II1]. In addition, the Tax Foundation survey can be found at **uofi.tax/18b3x3** [taxfoundation.org/corporate-income-tax-rates-around-the-world-2017/#_ftn1].

The Tax Foundation survey notes several relevant points regarding statutory corporate tax rates. These points include the following.[6]

- Of the 202 nations surveyed, 14 do not impose any corporate income tax (but most of these are small island nations such as the Cayman Islands and Bermuda).
- The average tax rate of the 202 countries surveyed is 22.96%.
- Of the 202 nations surveyed, only five countries impose a corporate tax rate higher than 35% (which included the United States).
- Gradually, since 1980, corporate tax rates have declined on a global basis (with the 1980 worldwide average of 38.68% declining to 22.96% in late 2017).

Accordingly, the TCJA's reduction in the U.S. corporate tax rate to a flat 21% seems not only in keeping with the worldwide trend in declining corporate tax rates, but it is also reflective of the average rate found among other nations.

5. *Table 11.1. Statutory corporate income tax rate.* Jun. 2, 2018. OECD. [stats.oecd.org/index.aspx?DataSetCode=Table_II1]. Accessed on Jun. 2, 2018. This table provides global corporate tax rate data for 2000 through 2018.

6. *Corporate Income Tax Rates around the World, 2017.* Jahnsen, Kari and Pomerleau, Kyle. Sep. 7, 2017. Tax Foundation. [taxfoundation.org/corporate-income-tax-rates-around-the-world-2017/#_ftn1] Accessed on May 22, 2018.

The new qualified business income deduction (QBID) rules for pass-through entities had the Congressional purpose of lowering "the [tax] burden on small business through a fairly unique approach."[7] Ultimately, this approach culminated in the new IRC §199A, which provides the QBID rules that are effective with the 2018 tax year for pass-through entities.

This chapter focuses on the impact of the TCJA changes on business entities and highlights how they compare to one another in our changed tax environment.

> **Note.** For additional legislative resources regarding the TCJA, the Congressional hearings can be viewed at www.finance.senate.gov/hearings. Analyses from the Joint Committee on Taxation can be found at **uofi.tax/18b3x4** [search.usa.gov/search?utf8=%E2%9C%93&affiliate=jct&query=://uofi.tax/18b3x4tax+cuts+and+jobs+act&commit=Search].

Other arguments have been made to justify corporate tax rate reforms, such as a behavioral response to lower corporate tax rates would lead to greater tax revenue, or the need to maintain a degree of parity between personal and corporate tax rates to prevent individuals or corporations from engaging in tax-avoidance behavior. Whatever merit such arguments have, the TCJA made dramatic changes to the corporate tax landscape, and these changes greatly affect how corporations compare to other types of business entities (e.g., pass-throughs) that are affected by the TCJA's personal tax rate changes.

> **Note.** For a detailed discussion that was prepared for Congress in September 2017 about the major arguments for corporate tax reform (which includes summaries of several studies completed to determine which arguments have merit), see the Congressional Research Service's report at **uofi.tax/18b3x11** [fas.org/sgp/crs/misc/RL34229.pdf].

CONCERNS, COMPLEXITY, AND CONTROVERSY

With the advent of the TCJA changes, particularly those associated with business entities, a major concern among tax practitioners is the added complexity associated with such changes. Shortly after the enactment of the TCJA, the AICPA sent letters to Congressional members, the IRS, and the Department of Treasury outlining many concerns. The AICPA called on these parties to provide the necessary resources for guidance and services that practitioners and taxpayers will require to navigate through the details and definitions of the new legislation. The AICPA letter noted 39 different areas that require immediate guidance in order for taxpayers to comply with their obligations.[8]

Among the top areas of concern was the need for additional guidance regarding the new QBID rules for pass-through entities, including the definition of specified service business and the calculation of the QBID for complex business structures.[9]

> **Note.** The AICPA letter is available at **uofi.tax/18b3x6** [www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/20180129-aicpa-guidance-request-on-pub-l-no-115-97.pdf].

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7. *Hatch Opening Statement at Finance Committee Markup of Tax Cuts and Jobs Act*. Nov. 13, 2017. U.S. Senate Committee on Finance. [www.finance.senate.gov/imo/media/doc/11.13.17%20Hatch%20Opening%20Statement%20at%20Finance%20Committee%20Markup%20of%20Tax%20Cuts%20and%20Jobs%20Act.pdf] Accessed on May 13, 2018.

8. *AICPA wants more guidance on new tax law and dedicated IRS unit for tax pros.* Cohn, Michael. Jan. 30, 2018. Accounting Today. [www.accountingtoday.com/news/aicpa-wants-more-guidance-on-new-tax-law-and-dedicated-irs-unit-for-tax-pros] Accessed on May 22, 2018.

9. Ibid.

In early 2018, the Joint Committee on Taxation began working on an initial list of technical corrections to the TCJA and hopes to introduce it in legislative language in the current Congressional session.[10]

In the Senate Finance Committee hearing on April 24, 2018,[11] controversy arose over the effects of the new QBID for pass-through entities after the Joint Committee on Taxation released its analysis estimating that in 2018, approximately 44% of the QBID's tax benefits will benefit households earning $1 million or more (and this percentage was expected to grow to 52% by 2024).[12] This was not viewed by many Congressional members as being in alignment with the "small business benefit" rationale for the QBID rules.

Note. As directed under the TCJA, the Treasury has the authority to prescribe such regulations as are necessary to carry out the purposes of IRC §199A.[13] A summary of the proposed regulations released by the IRS on August 8, 2018,[14] is provided as a supplement to this publication. It can be downloaded at **uofi.tax/supplement** [taxschool.illinois.edu/downloads.html].

The preamble to the IRC §199A Treasury Regulations states that "taxpayers may rely on the rules set forth in proposed §§1.199A-1 through 1.199A-6, in their entirety, until the date a Treasury Decision adopting these regulations as final regulations is published in the Federal Register."

NEW C CORPORATION TAX LANDSCAPE

Note. For more information on C corporations, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: C Corporations.

The TCJA changes some of the basic C corporation tax considerations that are relevant when comparing entities. Other pre-TCJA features associated with C corporations remain unchanged.

While the TCJA provides C corporations with a flat 21% tax rate, double taxation continues to be an aspect of the corporate tax structure. **Double taxation** refers to taxing income received by the corporation first at the corporate level, and then again at the shareholder level when that income is distributed to the shareholder.

Note. The TCJA permanently eliminated the application of alternative minimum tax to corporations effective January 1, 2018.[15]

The overall level of corporate taxation depends not only upon corporate tax liability, but also that of the shareholder, including the shareholder's marginal tax rate and how the distribution from the corporation to the shareholder is characterized.

10. See Bloomberg Tax, Daily Tax Report, Apr. 26, 2018, p. 5.

11. *Early Impressions of the New Tax Law.* Apr. 24, 2018. [www.finance.senate.gov/hearings/early-impressions-of-the-new-tax-law]. Accessed on Jun. 2, 2018.

12. Joint Committee on Taxation, *Tables Related to the Federal Tax System as in Effect 2017 through 2026* (JCX-32-18), Apr. 23, 2018.

13. IRC §199A(f)(4).

14. IRS News Rel. IR-2018-162 (Aug. 8, 2018); REG-107892-18.

15. IRC §55(a), as amended by the TCJA.

IRC §301 provides rules associated with the characterization of distributions to shareholders. To briefly summarize, for the characterization of a cash distribution, IRC §301 and Treas. Reg. §1.301-1 provide a 3-step rule applied in the following order.

1. An amount is a taxable dividend to the extent that it is paid out of the corporation's current or accumulated earnings and profits (E&P).
2. The amount of distribution in excess of E&P is treated as a return of stock basis to the shareholder (and reduces the shareholder's stock basis).
3. Distribution amounts in excess of the shareholder's stock basis are taxed as capital gain to the shareholder.

Note. The rules associated with the application of IRC §301, including the computation of E&P, are complex. For additional details on how these rules are applied, see **uofi.tax/18b3x7** [www.forbes.com/sites/anthonynitti/2014/08/26/tax-geek-tuesday-computing-earnings-and-profits/#291dd76c13d8] as well as IRC §301 and the underlying regulations.

Note. Unlike the permanent change to the corporate tax rate, many of the changes made by the TCJA are in effect beginning on January 1, 2018, through December 31, 2025. This period during which the TCJA changes remain effective is referred to in this chapter as the "TCJA period."

During the TCJA period, taxpayers who receive taxable dividends from a domestic corporation generally continue to benefit from a 0%, 15%, or 20% rate on the corporate dividends.[16] The taxpayer's total tax liability is higher if the shareholder is not a material participant in the corporate activity because the 3.8%[17] net investment income tax (NIIT) applies to the taxable dividend.

Note. The taxpayer is generally required to meet one of seven material participation tests under Temp. Treas. Reg. §1.469-5T with respect to the corporation's activity in order to be considered a material participant. For a thorough review of material participation, including its relevance to the NIIT, see the 2014 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Passive Activities. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

16. IRC §1(j).
17. IRC §1411.

Example 1. Jeanine is a shareholder in a family restaurant business, which is operated by her parents. Jeanine works full-time as a hospital administrator and does not work in the family restaurant business. She receives an annual dividend each year from the business. However, she has discussed with Maura, her tax advisor, the notion of changing careers and working full-time for the family business due to her parents' failing health. She would receive the same W-2 income from the family business as she now earns from the hospital and would also continue to receive an annual dividend.

Maura decides to determine Jeanine's tax rate on any dividend income she would continue to receive from the family business. Maura realizes that, with the new tax rules effective for the 2018 tax year, she should calculate the tax rate on a dividend for Jeanine in a manner that allows a comparison for Jeanine if she continues as an investor and if she becomes a material participant.

The overall tax rate applicable to the shareholder on income flowing to that shareholder as a taxable dividend can be calculated using the following assumptions.

- The corporation's taxable income is subject to a flat 21% tax rate.
- All after-tax corporate income is distributed as a taxable dividend to the shareholder.
- The dividend constitutes a qualified dividend to the shareholder.
- The shareholder who is a material participant in the corporate activity has a 20% tax rate that applies to the taxable dividend.
- A shareholder who is subject to the 3.8% NIIT (not a material participant) has a tax rate of 23.8% (20% tax rate on the dividend plus the 3.8% NIIT).

Based on these assumptions, the following table summarizes Maura's calculations for how $100 of corporate dividend income is taxed at the corporate level and subsequently at the shareholder level. It also compares rates for a material and nonmaterial participant.

	Material Participant Shareholder			Shareholder Not a Material Participant		
	Tax Rates		Amount of Tax	Tax Rates		Amount of Tax
Amount of corporate taxable income		$100			$100	
Corporate tax rate	21%			21%		
Corporate tax paid		(21)	$21		(21)	$21
After-tax corporate income used for taxable dividend distribution		$ 79			$ 79	
Shareholder's tax rate on dividend received	20%			23.8%		
Shareholder's tax paid (rounded)		(16)	16		(19)	19
After-tax dividend amount and total tax paid by corporation and shareholder (rounded)		$ 63	$37		$ 60	$40

Observation. For the material participant shareholder, a total tax of $36.80 is paid on $100 of corporate taxable income that is appropriately taxed at both the corporate and shareholder levels. This means an applicable tax rate of 36.8% (or 39.8% for a shareholder who is subject to the NIIT).

RETAINING CORPORATE EARNINGS

The amount of corporate taxable income that is not passed through to the shareholder is only subject to the flat 21% corporate tax rate. This may provide a lower tax rate than pre-TCJA rates on income retained in the corporation for purposes associated with further investment in the business or its assets.

Formation or use of a corporation for the purpose of accumulating earnings without distributing those earnings to shareholders (in order to avoid the tax at the shareholder level) may subject the corporation to the **accumulated earnings tax (AET).**[18]

Generally, a corporation may become subject to the AET if the corporation is being used for a tax-avoidance purpose.[19] The tax-avoidance purpose may exist even if it is not the only or dominant purpose in establishing or using the corporation.[20] Under the AET regulations, the IRS can require the corporation to provide a statement of E&P, history of dividend payments, identifying information about shareholders, and the amounts that would be payable to each shareholder if corporate income was distributed.[21]

A tax-avoidance purpose involves the intent or state of mind of the controlling shareholder(s), but such purpose may be established by the IRS through the shareholders' actions.[22] Mere knowledge of tax-avoidance opportunities is not enough by itself to constitute a tax-avoidance purpose, and the knowledge must contribute to a decision to accumulate earnings within the corporation.[23]

A tax-avoidance purpose is presumed if the corporation accumulates E&P beyond its reasonable business needs. This presumption can be rebutted by the shareholders.[24] In determining whether a tax-avoidance purpose exists, several factors are considered, including the following.[25]

- Transactions between the shareholders and the corporation that indicate the shareholders benefit from corporate earnings without actual distributions of those earnings
- Investment of accumulated earnings in corporate assets unrelated to the corporation's business
- The corporation's distribution history

In addition, characteristics of the shareholders that increase the likelihood of a tax-avoidance use of the corporation is another factor frequently looked to by the courts. For example, a corporation with a shareholder in a high tax bracket that fails to distribute earnings may be indicative of a tax-avoidance purpose.[26]

There must be some history of E&P accumulation within the corporation for the question of tax avoidance to arise, but corporations have been held to be established for a tax-avoidance purpose when shareholders have transferred personally held securities to a corporation that does not engage in a legitimate business but is used only for investment purposes.[27] By contrast, even if securities are contributed to a new corporation, a legitimate business purpose that informs the amount and nature of the securities contributed may not have a tax-avoidance purpose.[28]

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18. IRC §531.
19. IRC §532.
20. *U.S. v. The DonRuss Co*., 393 U.S. 297 (1969).
21. Treas. Reg. §1.533-2.
22. *United Business Corp. of America v. Comm'r,* 62 F.2d 754 (1933); *Bahan Textile Machinery Co., Inc. v. U.S.*, 453 F.2d 1100 (1972).
23. *William C. DeMille Prods., Inc. v. Comm'r,* 30 BTA 826 (1934).
24. IRC §533(a); Treas. Reg. §1.533-1(a)(1).
25. Treas. Reg. §1.533-1(a)(2).
26. *G.T. Helvering v. National Grocery Co.*, 304 U.S. 282 (1938); *Twin City Theatres, Inc. v. Comm'r,* 11 TCM 454 (1952).
27. *Almours Securities, Inc. v. Comm'r*, 35 BTA 61 (1936), *aff'd* 91 F.2d 427 (1937), *cert. denied* 302 U.S. 765; *Stanton Corp. v. Comm'r*, 44 BTA 56 (1941), *aff'd* 138 F.2d 512 (1943).
28. *Spitzner & Son, Inc. v. Comm'r,* 37 BTA 511 (1938).

At the end of 2016, the IRS Office of Chief Counsel advised[29] that the AET applies to "blocker" corporations within a hedge fund investment manager's chain of investment entities. A blocker corporation is generally a corporation deliberately established to report and pay tax on any income to prevent its owners from being exposed to that tax liability.[30] Generally, the blocker corporation involved in the Chief Counsel's announcement was viewed by the IRS as a holding company or investment company, which the IRS views as an indication of a tax-avoidance purpose.

Observation. With the TCJA's more favorable C corporation tax climate, taxpayers may seek to benefit from the lower corporate tax rates, perhaps by using corporations to "shelter" income at a tax rate lower than personal rates. This may result in increased IRS attention to, and expansion of, the AET.

The AET is equal to 20% of the corporation's accumulated taxable income (ATI).[31] For purposes of the AET, ATI is generally the corporation's taxable income with certain adjustments made to reflect the corporation's dividend-paying capacity, less the dividends paid deduction and any AET credit.[32]

Note. IRC §§531 through 535 and underlying regulations provide the applicable rules associated with the AET. Further information on the AET can be found in IRS Pub. 542, *Corporations,* and IRM 4.10.13.2.

Observation. The 20% AET rate is equal to the 20% maximum rate applicable to qualified dividends.

NEW PASS-THROUGH ENTITY TAX LANDSCAPE

In addition to the major changes that the TCJA made to the corporate tax framework, it also made major changes to the tax rules affecting pass-through business entities.

Perhaps the largest change associated with pass-through entities is the TJCA's repeal of the domestic production activities deduction (DPAD) under IRC §199 and the enactment of its replacement, the qualified business income deduction (QBID) under IRC §199A. **C corporations are not eligible for the QBID.**

Note. For more information about the relevant rules for the QBID, including examples showing how the QBID is calculated, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues.

The QBID for qualified trades and businesses is the **lesser** of:[33]

1. 20% of qualified business income (QBI), **or**
2. The **greater** of the W-2 wages/qualified property (QP) limit, which is:
   a. 50% of W-2 wages, **or**
   b. 25% of W-2 wages plus 2.5% of the unadjusted basis of all QP.

29. Chief Counsel Advice CCA 201653017 (Dec. 30, 2016).
30. *Blocker Corporation.* NASDAQ. [www.nasdaq.com/investing/glossary/b/blocker-corporation] Accessed on Jun. 12, 2018.
31. IRC §531.
32. IRC §535(a).
33. IRC §199A(b)(2).

Taxpayers whose taxable income does not exceed the threshold of $315,000 for married filing jointly (MFJ) taxpayers, or $157,500 for all other taxpayers, are not subject to the W-2 wages/QP limit.[34] The W-2 wages/QP limit is phased in for taxpayers with taxable income that exceeds the threshold plus up to $100,000 for MFJ taxpayers or $50,000 for all other taxpayers. Taxpayers with taxable income of at least $415,000 (MFJ), or $207,500 (all other taxpayers), are fully subject to the W-2 wages/QP limit.[35]

Applying this limitation requires calculating the applicable percentage of the **W-2 wages/QP** limit determined using the following formula.[36]

$$\textbf{Applicable percentage} = 1 - \frac{\textbf{Taxable income} - \textbf{Income threshold}}{\textbf{Phasein range}}$$

The **applicable percentage** is important in determining the difference between 20% of the business's QBI and the W-2 wages/QP limit that is phased in. The applicable percentage is applied to the W-2 wages/QP limit to arrive at the reduced QBID.

Reduced QBID = W-2 wages/QP limit + (((QBI × 20%) − W-2 wages/QP limit) × applicable percentage)

FINAL QBID

For any tax year, the **final QBID** for eligible taxpayers is calculated as follows.[37]

The **lesser** of:

1. The **combined** QBID of the taxpayer, **or**
2. An amount equal to 20% of the excess (if any) of:
   - **a.** The taxable income of the taxpayer for the tax year, **over**
   - **b.** The taxpayer's net capital gain for the tax year.

Item 2 of the above formula is sometimes referred to as the QBI **overall taxable income (OTI)** limitation.

> **Note.** For a thorough explanation of QBID, including the OTI limitation, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues.

THE SOLE OWNER S CORPORATION ADVANTAGE

Under the new QBID rules, not all pass-through entities are treated equally. Consider the following three examples.

Example 2. Kevin, who is married and files jointly with his wife, operates his pawnshop business as a **sole proprietor.** The business leases all of its required equipment and premises, so there is no QP. As a sole proprietor, he cannot pay himself either a wage or a guaranteed payment. His 2018 net income, shown on Schedule C, *Profit or Loss From Business,* is $600,000, which is also Kevin's QBI. Total taxable income for the year is $576,000.

Kevin initially calculates his QBID by multiplying his $600,000 QBI by 20%, arriving at an initial QBID of $120,000. However, because taxable income is over the $415,000 QBID upper income limit for an MFJ taxpayer, the W-2 wages/QP limit fully applies. Because Kevin's wages are zero and he has no QP, his final QBID is zero.

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34. IRC §199A(e)(2).
35. IRC §199A(b)(3).
36. IRC §199A(b)(3)(B).
37. IRC §199A(a).

Example 3. Use the same facts as **Example 2,** except Kevin operates his pawnshop business as a **partnership.** Kevin owns a 99.9% interest, and his daughter, Karla, owns the remaining 0.1%. For simplicity, Karla's interest is ignored. The partnership generates $600,000 of net income for the year.

As a partner, Kevin cannot pay himself a W-2 wage.[38] Kevin can pay himself a guaranteed payment, but this is not properly reportable on a Form W-2. If Kevin pays himself a guaranteed payment of $100,000, his pass-through income of $600,000 is reduced to $500,000. Under IRC §199A(c)(4), QBI does not include a guaranteed payment paid to a partner in exchange for services. Therefore, the $100,000 guaranteed payment is not eligible for the 20% QBID.

The pass-through income of $500,000, shown on Kevin's partnership Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* constitutes QBI that is eligible for the QBID. Kevin initially calculates his QBID by multiplying his QBI of $500,000 by 20%, which provides an initial QBID of $100,000.

However, Kevin's taxable income for the year consists of his $100,000 guaranteed payment (also shown on his Schedule K-1) and his pass-through income of $500,000, for a total of $600,000. This taxable income is above the $415,000 QBID upper income limit. Accordingly, the W-2 wages/QP limit on the QBID fully applies and Kevin's QBID is the **lesser** of:

1. $100,000 (20% × $500,000 QBI), **or**
2. The **greater** of:
   a. 50% × W-2 wages ($0), **or**
   b. 25% × W-2 wages ($0) + 2.5% × QP ($0).

Because Kevin's wages and QP are zero, his final QBID is zero. Therefore, Kevin does not receive a QBID for the year.

Example 4. Use the same facts as **Example 2,** except Kevin operates his pawnshop business as an **S corporation.** The S corporation generates $500,000 of net income (after wages) for the year. Kevin pays himself a W-2 wage of $100,000. Kevin's taxable income for the year is composed of pass-through income of $500,000 plus the $100,000 wage amount, for a total of $600,000 of taxable income for the year.

The pass-through income of $500,000 constitutes QBI that is eligible for the QBID. Kevin calculates his initial QBID by multiplying his $500,000 QBI by 20%, arriving at an initial QBID of $100,000.

However, his $600,000 of taxable income is over the $415,000 upper threshold limit for the QBID. Therefore, the W-2 wages/QP limit fully applies. The S corporation has no QP, so Kevin's QBID is limited to 50% of W-2 wages paid during the year. Kevin can claim a $50,000 QBID for the year ($100,000 W-2 wages × 50%).

The following table summarizes the relevant amounts from the preceding three examples in which Kevin used different types of pass-through entities.

	Sole Proprietorship	Partnership	S Corporation
Net business income (before wages)	$600,000	$600,000	$600,000
W-2 wages paid			(100,000)
Guaranteed payments paid		(100,000)	
Net pass-through income/QBI	$600,000	$500,000	$500,000
	× 20%	× 20%	× 20%
Initial QBID	$120,000	$100,000	$100,000
W-2 wages/QP limit	$ 0	$ 0	$ 50,000
Final QBID claimed	$ 0	$ 0	$ 50,000

38. Rev. Rul. 69-184, 1969-1 CB 256.

All three examples represent the **same** business with the **same** income, but each example uses a different type of pass-through entity. In the previous examples, the QBID rules favor S corporations, not only because the QBID limit is wage-based, but also because the S corporation is unique among pass-through entities in providing an owner with the ability to receive a wage that qualifies for the W-2 wages/QP limit. Owners of other pass-through entities are required to pay wages to another person for the wage limit to exceed zero.

Moreover, the S corporation has a reasonable compensation requirement (discussed in greater detail later in this chapter). Payment of a W-2 wage to meet that requirement increases the wage limit for QBID purposes. This is an important feature of the QBID rules for S corporation owners with income high enough for the W-2 wages/QP limit to place them within the phasein range of these rules.

The tax savings that result from the QBID can be viewed as an offset to the employment tax that must be paid on the wage amount.

> **Observation.** It is unclear whether Congress intended this unequal treatment of pass-through entities but the advantage provided to an S corporation should not be overlooked.

SPECIFIED SERVICE BUSINESSES

A tax practitioner comparing entities under the new rules ushered in by the TCJA must be aware of the special rules associated with certain types of businesses that fall under the definition of "specified service businesses" (SSBs).

As mentioned earlier, only QBI generated from a qualified trade or business is eligible for a QBID[39] if all other requirements are met. An SSB is not considered a qualified trade or business that generates QBI unless a specific exception applies.[40] A specified trade or business is a trade or business that involves the provision of services in the following areas.[41]

- Accounting
- Actuarial science
- Athletics
- Brokerage
- Consulting
- Financial services (including investing, investment management, and trading or dealing in securities or commodities)
- Health
- Law
- Performing arts
- **Any business in which the reputation or skill of one or more owners is the principal asset of the business**

> **Observation.** The definition of an SSB closely parallels the definition of a personal service corporation (PSC). However, unlike PSCs, SSBs do not include businesses that perform architecture or engineering services. Accordingly, such businesses may be considered a qualified trade or business that generates QBI. For further details on PSCs, see IRS Pub. 542, *Corporations*.

39. IRC §199A(b)(1)(A).

40. IRC §199A(d)(1).

41. IRC §§199A(d)(2) and 1202(e)(3)(A).

> **Note.** For clarifications in the proposed IRC §199A regulations regarding SSBs, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues. These clarifications include the definition of SSBs where the principal asset is the reputation or skill of one or more of its employees or owners, de minimis exceptions, and aggregation of SSBs with common ownership.

Exceptions to the SSB Rule

While an SSB generally is disqualified from claiming a QBID, there is an income-based exception. If the taxpayer engaged in an SSB has taxable income lower than the $157,500 threshold (or $315,000 for an MFJ filer), they are eligible for the 20% QBID. In addition, an SSB may qualify for a reduced QBID if the taxpayer engaged in the SSB has taxable income for the year that is less than:

- $415,000 for MFJ filers, **or**
- $207,500 for other filers.[42]

> **Note.** These thresholds are the same as those applied to general trades or businesses. The threshold amounts are subject to an annual inflation adjustment.

Taxpayers with SSBs whose taxable income falls within the phasein range are eligible for an SSB reduced QBID. Just like for businesses that are not SSBs and the W-2 wages/QP limit applies, a key element for this calculation is the **applicable percentage.**[43]

$$\text{Applicable percentage} = 1 - \frac{\text{Taxable income} - \text{Income threshold}}{\text{Phasein range}}$$

An SSB's QBID is the **lesser** of:

1. QBI × 20%, **or**
2. The **greater** of:
   a. 50% of the W-2 wages for the business, **or**
   b. 25% of W-2 wages for the business, plus 2.5% of the unadjusted basis immediately after acquisition of all QP.

Unlike a general trade or business, in the case of an SSB, the applicable percentage must be **applied to each** of these amounts.[44]

$$\begin{aligned}\text{SSB reduced QBID} = \; & (\text{W-2 wages/QP limit} \times \text{applicable percentage}) + \\ & ((\text{QBI} \times 20\% \times \text{applicable percentage}) - \\ & (\text{W-2 wages/QP limit} \times \text{applicable percentage})) \times \text{applicable percentage}\end{aligned}$$

42. IRC §199A(d)(3).
43. IRC §199A(d)(3)(B).
44. IRC §199A(d)(3)(A)(ii).

Example 5. Sven and Inga are married and file MFJ for 2018. Their 2018 return shows taxable income (without regard to any QBID) of $350,000. Sven is one of two partners who operate a Swedish restaurant and coffee shop. Inga has a solo law practice. The restaurant operation has no QP because it leases all of its equipment and premises. Inga's law practice is an SSB, but Sven's restaurant operation is not.

Sven's allocable share of the QBI from the restaurant partnership is $280,000. The amount of W-2 wages paid by the restaurant operation that is allocable to Sven is $90,000.

- Sven's initial QBID is $56,000 ($280,000 QBI × 20%)[45]
- 50% of the wage amount is $45,000 ($90,000 × 50%), referred to in this example as the "W-2 wages/QP limit."[46]

Because Sven and Inga have taxable income in excess of the $315,000 QBID threshold but less than the $415,000 threshold, they are in the phasein range under the QBID rules. Accordingly, Sven's $56,000 initial QBID must be reduced.

$$\begin{aligned}\textbf{Sven's applicable percentage} &= 1 - \frac{\text{Taxable income} - \text{Income threshold}}{\text{Phasein range}} \\ &= 1 - \frac{\$350{,}000 - \$315{,}000}{\$100{,}000} \\ &= 1 - \frac{\$35{,}000}{\$100{,}000} \\ &= 1 - .35 \\ &= .65 \text{ (or 65\%)}\end{aligned}$$

$$\begin{aligned}\textbf{Sven's reduced QBID} &= \text{W-2 wages/QP limit} + (((\text{QBI} \times 20\%) - \text{W-2 wages/QP limit}) \times \text{applicable percentage}) \\ &= \$45{,}000 + (((\$280{,}000 \times 20\%) - \$45{,}000) \times 65\%) \\ &= \$45{,}000 + ((\$56{,}000 - \$45{,}000) \times 65\%) \\ &= \$45{,}000 + (\$11{,}000 \times 65\%) \\ &= \$45{,}000 + \$7{,}150 \\ &= \$52{,}150\end{aligned}$$

To calculate Inga's QBID, she must first determine the applicable percentage that applies to her SSB's QBI and wage amount. Inga's applicable percentage is the same as Sven's (65%). Her QBI is $230,000 and her W-2 wages are $100,000.

Inga has an SSB. An SSB's QBID is the **lesser** of:

1. QBI × 20%, **or**
2. The **greater** of:
   a. 50% of the W-2 wages for the business, **or**
   b. 25% of W-2 wages for the business, plus 2.5% of the unadjusted basis immediately after acquisition of all QP.

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45. IRC §§199A(b)(3)(B)(iii)(I) and 199A(b)(2)(A).

46. IRC §§199A(b)(3)(B)(iii)(II) and 199A(b)(2)(B).

Unlike general trade or business, in the case of an SSB, the applicable percentage must be **applied to each** of these amounts.

Accordingly, Inga's QBID is the **lesser** of the following amounts.

1. $230,000 QBI × 20% × 65% applicable percentage = $29,900, **or**
2. The **greater** of:
   a. $100,000 W-2 wages × 50% × 65% = $32,500, **or**
   b. ($100,000 W-2 wages × 25% + $0 QP × 2.5%) × 65% = $16,250

Therefore, Inga's QBID is $29,900.

Sven and Inga have an initial QBID of $82,050 ($52,150 + $29,900). However, their combined deduction is limited by 20% of their total overall taxable income,[47] which is $70,000 ($350,000 × 20%). Accordingly, Sven and Inga may claim a final QBID of $70,000 for 2018.

TAX PLANNING CONSIDERATIONS

The new QBID rules under IRC §199A provide several planning opportunities. Different tax reduction strategies are applied to individual client circumstances; however, some broad planning ideas are discussed in this section.

Tax practitioners should consider the various limits on the QBID.

- The QBID may not create a net operating loss.
- The QBID is limited by the W-2 wages/QP limitation (for taxpayers over a threshold amount).[48]
- There is a greater reduction to the QBID in the phasein range[49] (and for SSBs qualifying for a QBID[50]) as the amount of taxable income in excess of an applicable threshold amount increases.
- The QBID is limited by the amount of QBI.[51]

Wage Payments

Closely held businesses now organized as corporations, partnerships, or sole proprietorships may wish to consider operating as an S corporation in order to enable the payment of wages to the business owners.

Example 6. Nora operates a successful sales business as a sole proprietorship. She is a single filer and the only person involved in the operation of the business, which sells luxury items, including rare watches and jewelry. Nora has no QP because she rents the office space and all of the equipment her business requires. For 2018, she expects $500,000 of taxable income. Of this $500,000, $400,000 is QBI. Because Nora's taxable income is above the $207,500 upper threshold, her QBID is zero. This is because the W-2 wages/QP limit fully applies. As a sole proprietor, Nora cannot pay herself a wage. Because wages and QP are zero, her QBID is zero.

47. IRC §199A(a).
48. IRC §199A(b)(2).
49. IRC §§199A(b)(3)(A) and (e)(2)(A).
50. IRC §§199A(d)(3)(A) and (e)(2).
51. IRC §199A(a).

Example 7. Use the same facts as **Example 6,** except Nora establishes an LLC that elects S corporation tax treatment. Nora pays herself a wage of $50,000 for 2018.

Nora's initial QBID is limited to the lesser of $70,000 ($400,000 original QBl – $50,000 wages = $350,000 revised QBI ×20%) or $25,000 ($50,000 W-2 wages × 50%). Therefore, Nora has a $25,000 initial QBID.

Wage payments to Nora reduce taxable income and are not includable in the QBI computation. Accordingly, as Nora's wage amount is increased, the point is reached where the favorable increase in the W-2 wages/QP limit is more than offset by a disadvantageous reduction in the business owner's QBI (with the limits on this amount reducing the QBID below the level that the W-2 wages/QP limit would otherwise allow).

Example 8. Use the same facts as in **Example 7,** except Nora's wages are $200,000. This increases the amount of the W-2 wages/QP limit to $100,000 ($200,000 wages × 50%). However, because Nora's wage is deducted from the business income and is not considered part of QBI, her initial QBID for the year is limited by 20% of her QBI. The QBI and wage limits are calculated as follows.

- $400,000 original QBl – $200,000 wages = $200,000 revised QBI × 20% = **$40,000**
- $200,000 wages × 50% = $100,000

Her initial QBID equals $40,000, the lesser of these amounts.

The higher wage reduces her QBI, which makes the QBI the relevant limit on her initial QBID.

Wages paid to other employees may reduce taxable income enough to make the taxable income limitation determinative. This is also true for MFJ filers paying wages to employees that are not reported on the MFJ return (because the wages, deductible from the business, do not appear as part of the taxable income on the MFJ return).

Lease Arrangements

If the business is currently leasing assets or renting premises that would constitute QP if owned, purchasing such assets may allow the business to claim a QBID (or an increased QBID for businesses that already otherwise qualify).

Example 9. Use the same facts as **Example 7,** except Nora pays herself wages of $40,000. Her accountant assured her this amount was sufficient to meet the reasonable compensation requirement and also minimizes payroll taxes. This provides a reduced QBID of $20,000 for the year ($40,000 wages × 50%). The W-2 wages/QP factor limits the QBID.

At the beginning of the year, she purchases equipment for $850,000. This provides new QP for the business, and the QP component of the W-2 wages/QP limit becomes a factor in the QBID calculation. Nora's W-2 wages/QP limit is now $31,250 (($40,000 wages × 25%) + ($850,000 QP × 2.5%)). Thus, Nora's initial QBID is $31,250 which is the lesser of her $31,250 W-2 wages/QP limit and $72,000 ($400,000 original QBl – $40,000 wages = $360,000 revised QBI × 20%).

Observation. Nora must be a qualified S corporation shareholder in order to establish an S corporation. A business owner who is not a qualified S corporation shareholder, such as a nonresident alien, could still augment their QBID by investing in QP and selecting a partnership or sole proprietorship entity structure.

Tax-Preferred Investing

The QBID rules include a provision that make real estate investment trust (REIT) dividends and publicly traded partnership (PTP) income advantageous.[52] These investments qualify for the QBID for a taxpayer at any income level. The amount of the QBID for such investments is 20% of the aggregate qualified REIT dividends and qualified PTP income for the tax year. However, the QBID cannot exceed 20% of the excess of the taxpayer's taxable income for the year over the taxpayer's net capital gain (the OTI limit).[53]

Example 10. Frank and Lila are both cardiac surgeons in New York. For 2018, they have taxable income of $1 million. Both are employed by a hospital system and neither spouse owns a qualified trade or business or has qualified business income under the QBID rules. During 2018, Frank and Lila's investment portfolio generated $100,000 of REIT dividends and PTP income. Frank and Lila qualify for a $20,000 QBID ($100,000 × 20%) with respect to this investment income.

Interestingly, when a taxpayer has a net qualified business loss (QBL) from trade or business activities for a tax year, this QBL does not offset the taxpayer's QBID from REIT dividends and PTP income for that year. Instead, the QBL is carried forward and offsets QBI arising in subsequent years thus preserving the taxpayer's entire QBID from REIT dividends and PTP income in the current year.[54]

Under the QBID rules, if the net amount of qualified income, gain, deduction, or loss is less than zero, the loss amount carries over to the following tax year.[55] In addition, a current year loss from one qualified trade or business offsets QBI from another qualified trade or business.[56]

Note. For more information about the treatment of QBLs and REIT dividends and PTP income, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues.

Example 11. Michael and Mary, who are married, each have a qualified trade or business. Neither business is an SSB. For 2018, their MFJ return shows taxable income of $200,000 (without regard to any QBID). Mary's business had a successful year, generating $160,000 of QBI. Because Michael and Mary are below the $315,000 income threshold, the W-2 wages/QP limit is inapplicable. Based on Mary's QBI, the spouses have an initial QBID of $32,000 ($160,000 QBI × 20%).

Michael's business was not as successful in 2018, and he had a QBL of $100,000. Accordingly, Michael's QBL reduces Mary's QBI for the year and also reduces the QBID that the spouses are entitled to for 2018. Their net QBI is $60,000 ($160,000 QBI – $100,000 QBL). With the QBL, their initial QBID is reduced to $12,000 ($60,000 × 20%).

Michael and Mary also have a portfolio that generates $50,000 of PTP income and REIT dividends, which also qualify for a QBID. This $50,000 of investment income increases their QBID by $10,000 ($50,000 × 20%), providing them with a $22,000 final QBID for the year.

The netting of QBI income and losses occurs before application of the qualified business's W-2 wages/QP limit (as defined in the next section). When a taxpayer has one or more businesses with QBLs but net positive overall QBI, the taxpayer must apportion these QBLs among the businesses with positive QBI in proportion to the relative amounts of their positive QBI. The business's QBI **less** its allocation of losses from other businesses is its **adjusted QBI** which becomes its QBI for the purposes of the initial QBID calculation discussed next.[57]

52. IRC §199A(b)(1)(B).

53. IRC §199A(a).

54. Prop. Treas. Reg. §1.199A-1(c).

55. IRC §199A(c)(2).

56. IRC §199A(b)(1).

57. Prop. Treas. Regs. §§1.199A-1(c)(2) and 1.199A-1(d)(2)(iii).

When a taxpayer has a net QBL then this is treated as negative QBI from a separate trade or business in the taxpayer's succeeding tax year.[58]

These rules are illustrated in the next example.

Example 12. Use the same facts as **Example 11,** except Michael's QBL is $210,000 for 2018 and the couple had no REIT dividends or PTP income. This results in a net QBL of $50,000 ($160,000 QBI – $210,000 QBL). Accordingly, Michael and Mary have no QBID for 2018 from their businesses and the $50,000 QBL carries forward to 2019.

In 2019, Michael has a QBL of $60,000, while Mary's business generates QBI of $160,000, as it did in 2018.

For 2019 Mary and Michael have a net QBL of $110,000 consisting of Michael's 2019 QBL of $60,000 and the 2018 QBL carryover of $50,000. This $110,000 QBL reduces Mary's 2019 QBI of $160,000, giving Mary an adjusted QBI of $50,000.

Consequently, for 2019, Michael has a zero initial QBID (because a QBL cannot generate a QBID) and Mary has a $10,000 initial QBID ($50,000 adjusted QBI ×20%).

Observation. For taxpayers in the phasein or high-income ranges of the QBID rules in which W-2 wage amounts allow (or increase) the QBID, years in which a loss carryover eliminates a QBID may be favorable years to defer W-2 wage payments to owners (as long as reasonable compensation requirements, if applicable, are met). This reduces payroll taxes in that year and maximizes wages paid only in the years in which those wages beneficially increase the W-2 wages/QP limit.

Many taxpayers with businesses involving real estate or a high investment in equipment may depend on the QP component of the W-2 wages/QP limit (using a combination of 25% of the W-2 wages and 2.5 % of QP basis amounts as a QBID limit instead of 50% of wages). Claiming depreciation on QP does not cause attrition of the limit for at least 10 years after the QP's placed-in-service date.[59] The **unadjusted basis** of the property immediately after acquisition is used in the limit calculation until the later of:

- The date that is 10 years after the date the property was first placed in service by the taxpayer, or
- The last day of the last full year in the QP's recovery period.[60]

Passive Income Investment

Nothing in the QBID rules makes a distinction between passive and nonpassive income. As long as the business is a qualified trade or business that generates QBI, the taxpayer is eligible for the QBID if the other eligibility rules are satisfied.

Accordingly, the increased use of pass-through entities for investment purposes may prove advantageous for the taxpayer. This is true for any activity in which the taxpayer is not a material participant under the rules of IRC §469 and Temp. Treas. Reg. §1.469-5T and for real estate income that is generally considered to be per se passive in nature.

The QBID for partnerships and S corporations is applied at the partner or shareholder level. Each partner or shareholder takes into account their respective pro rata share of income, gains, losses, and deductions in connection with the qualified trade or business in which they are investors.[61]

Observation. Schedules K-1 for both partnerships and S corporations will become more complex because of the need to allocate wage limits, QP basis amounts, and other items affecting QBID on a pro rata basis to investors and business owners.

58. Prop. Treas. Reg. §1.199A-1(d)(2)(iii)(B).

59. IRC §199A(b)(6)(B).

60. Ibid.

61. IRC §199A(f)(1)(A).

C CORPORATION AND PASS-THROUGH ENTITY COMPARISON

While a C corporation has the advantage of a permanent flat 21% tax rate, a pass-through entity has the ability to claim a QBID during the TCJA period. This section compares C corporations and pass-through entities at varying levels of income, while discussing other variables that may affect the advantages of one entity type over another for a particular taxpayer's situation.

In the examples that follow, it is assumed that all C corporation distributions are characterized as taxable qualified dividends to the recipient shareholder. All S corporation income is the distributive share, taxable at ordinary income rates.

For simplification from this point forward, the term "corporation" is used to refer to C corporations. A subchapter S corporation is referred to as an "S corporation."

In addition, the calculated tax liability uses the tax brackets and rates that are effective for the 2018 tax year under the TCJA.

LOWER-INCOME BUSINESS

While the TCJA's new QBID rules and corporate tax changes certainly affect higher-income businesses, this section discusses some important ways in which these new rules affect lower-income businesses (for taxpayers with taxable incomes under the $315,000 and $157,500 QBID thresholds for MFJ filers and other filers, respectively).

For such taxpayers, changes brought about by the TCJA for corporations and pass-through businesses require several new considerations to be taken into account when comparing entities.

Example 13. Rebecca, a single taxpayer, is a recent graduate with a master's degree in fine arts. She wants to start a new antique furniture business, Rebecca's Antique Sourcing (RAS). Her business will purchase select items of furniture from estate sales and auctions in Europe and ship the purchased items to the United States to be wholesaled to antique and furniture dealers and retailers. She already has purchase commitments from several customers. After reading about some of the new tax rules effective in 2018, Rebecca seeks advice from her CPA, Lara, on what business entity to use to start her new business. Rebecca plans to hire one part-time employee and rent a small warehouse. The income and expenses estimated for the business are as follows.

Gross income		$180,000
Less expenses:		
Officer's compensation	$ 60,000	
Advertising	20,000	
Employee wages	50,000	
Rent	25,000	
Total expenses	$155,000	(155,000)
Net income		$ 25,000

The officer's compensation and employee wage amount includes the estimated employer share of social security and Medicare taxes. Rebecca has no income other than the wages and net income from RAS and requires this income for living expenses.

Lara's calculation of Rebecca's after-tax cash income from the business follows, assuming Rebecca chooses to form RAS as a **corporation.**

		Total Tax
Corporation's net income	$25,000	
Corporation tax paid (21%)	(5,250)	$ 5,250
After-tax cash paid as taxable dividend	$19,750	
Wages	60,000	
AGI	$79,750	
Less: standard deduction	(12,000)	
Taxable income	$67,750	
Total individual income tax (capital gains tax)		9,463
Total corporate and individual income tax		$14,713
FICA tax on officer's compensation ($60,000 × 15.3%)		9,180
Total FICA and income tax		$23,893

Example 14. Use the same facts as **Example 13,** except Lara calculates Rebecca's tax liability with the business established as a **sole proprietorship.** Lara calculates Rebecca's sole proprietorship tax liability as follows.

		Total Tax
Net profit from Schedule C	$85,000 [a]	
Less: deduction for ½ SE tax	(6,005)	
AGI	$78,995	
Less: standard deduction	(12,000)	
Income before QBID	$66,995	
Less: QBID	(13,399) [b]	
Taxable income	$53,596	
Income tax		$ 7,731
SE Tax		12,010 [c]
Total tax		$19,741

[a] Net profit as sole proprietorship does not include expenses for officer's compensation. Net profit equals gross income of $180,000 less expenses of $95,000 ($20,000 + $50,000 + $25,000).

[b] QBID is the **lesser** of:

- QBI = ($85,000 − $6,005) × 20% = $15,799
- OTI limit = ($78,995 − $12,000) × 20% = **$13,399**

[c] SE tax equals net profit from Schedule C of $85,000 × 0.9235 × 0.153.

Example 15. Use the same facts as **Example 13,** except Lara uses an **S corporation** structure for Rebecca. After making relevant inquiries of Rebecca about her role in RAS and reviewing the applicable information, Lara determines that a reasonable salary for Rebecca is $60,000 per year.

Note. For purposes of this chapter and to facilitate comparison between different types of entities, the reasonable salary requirement for an S corporation is considered to be met with an annual salary of $60,000.

Lara calculates Rebecca's individual tax if the business is structured as an S corporation as follows.

		Total Tax
Wages	$60,000	
S corporation distributive share	25,000	
AGI	$85,000	
Less: standard deduction	(12,000)	
Income before QBID	$73,000	
Less: QBID ($25,000 × 20%)	(5,000)	
Taxable income	$68,000	
Income tax: (($68,000 − $38,700) × 22%) + $4,454		$10,900
FICA tax on wages: $60,000 × 15.3%		9,180
Total individual income and FICA tax		$20,080

The tax liability associated with the use of each entity is summarized as follows.

Entity	Corporation	Sole Proprietorship	S Corporation
QBID amount	$ 0	$13,399	$ 5,000
Total tax liability	23,893	19,741	20,080

Adhering to the reasonable compensation requirement serves to reduce the amount of S corporation business income that constitutes QBI. The QBID rules provide that QBI does not include reasonable compensation paid to the taxpayer.[62]

Note. Reasonable compensation is addressed in greater detail later in this chapter.

62. IRC §199A(c)(4).

Example 16. Use the same facts as **Example 13,** except when Rebecca discusses her income and expenses with Lara, Rebecca expresses some uncertainty about her gross income estimate. Lara considers how the tax liability for the entity options would compare at varying levels of income.

Lara completes similar tax calculations for a corporation, sole proprietorship, and S corporation at different income levels. All the income levels considered are under the threshold amount for purposes of the W-2 wages/QP limit. Lara's calculations are shown in the following table.

	Total Tax Liability	Sole Proprietorship		S Corporation	
Net Business Income [a]	**Corporation**	**Tax Liability**	**QBID**	**Tax Liability**	**QBID**
$ 60,000	$15,680	$12,489	$ 8,752	$15,680	$ 0
85,000	23,893	19,741	13,399	20,080	5,000
100,000	28,820	24,313	16,187	22,720	8,000
157,500	47,709	40,432	27,086	33,710	19,500

[a] Net business income is calculated prior to deducting officer's compensation.

Observation. Based on the assumptions made, SE tax under the S corporation scenario is limited to the $60,000 wage paid in order to meet the reasonable wage requirement. The SE tax savings associated with an S corporation distribution provide significantly reduced tax liability once there is enough income in excess of reasonable wages to characterize as a distribution not subject to SE tax, despite the lower S corporation QBID caused by the reasonable wage requirement.

As mentioned earlier, for a single taxpayer with taxable income below $157,500, any QBID is generally limited only by the amount of the taxable income that is QBI because the W-2 wages/QP limit does not apply. If the lower-income taxpayer files as MFJ, the relevant QBID taxable income threshold is $315,000.

HIGHER-INCOME BUSINESS

For MFJ filers and other filers with total taxable incomes in excess of $315,000 or $157,500, respectively, W-2 wages paid by the business entity (or a combination of W-2 wages and QP basis) reduce the amount of QBID and corresponding tax liability.

Example 17. Larson, who is single, owns a highly successful clothing retail store that he currently operates as a corporation. The business was originally established as a corporation by his late father, who founded the business. Larson consults with Mario, his new tax advisor, about whether his retail store would benefit from the QBID rules if he used a pass-through entity instead. The choice of business entity is particularly important at this point for Larson because the business is growing and he plans to open a second store on the other side of town. He also receives $40,000 in interest income from a family trust.

Larson provides Mario with the following estimates for 2018.

Gross income	$210,000
Advertising	(20,000)
Employee wages	(10,000)
Rent	(20,000)
Officer's compensation	(60,000)
Net income	$100,000

Mario calculates the total 2018 tax liability as follows.

Tax Liability with Corporation

		Total Tax
FICA tax on officer's compensation [a]		$ 9,180
Corporation's net income	$100,000	
Corporation tax paid (21%)	(21,000)	$21,000
After-tax amount paid as taxable dividend	$ 79,000	
Income reported:		
Trust income	$ 40,000	
Dividend income [b]	79,000	
Wages	60,000	27,260
Total corporate and individual tax liability		$57,440

[a] $60,000 × 15.3% = $9,180

[a] (($40,000 + $60,000 − $82,500 − $12,000) × 24%) + $14,090 + ($79,000 × 15%) = $27,260

A sole proprietorship qualifies for the QBID, but this requires a liquidation of the corporation. Mario decides to calculate the estimated taxes for a sole proprietorship to see how the tax liability compares with that for the corporation.

Mario prepares a pro forma tax return for 2018 for Larson. That return shows Larson's taxable income is $177,896 ($160,000 QBI + $40,000 trust income – $10,104 SE tax – $12,000 standard deduction).

Because Larson's $177,896 of taxable income is more than $157,500 but not more than $207,500, Mario notes that Larson is in the phasein range of the QBID rules. This requires a calculation to arrive at a final QBID.

Mario calculates Larson's QBID for 2018 as follows.

$$\begin{aligned}\textbf{Initial QBID} &= \textbf{QBI} \times \textbf{20\%}\\ &= \textbf{\$160,000} \times \textbf{20\%}\\ &= \textbf{\$32,000}\end{aligned}$$

The reduction amount is calculated by using the following formula.[63]

$$\begin{aligned}\textbf{Reduction amount} &= (\textbf{Initial QBID} - \textbf{50\% of wages}) \times \frac{\textbf{Taxable income} - \textbf{Threshold amount}}{\textbf{\$50,000}}\\ &= (\textbf{\$32,000} - \textbf{\$5,000}) \times \frac{\textbf{\$177,896} - \textbf{\$157,500}}{\textbf{\$50,000}}\\ &= \textbf{\$27,000} \times \frac{\textbf{\$20,396}}{\textbf{\$50,000}}\\ &= \textbf{\$27,000} \times \textbf{0.4079}\\ &= \textbf{\$11,013}\end{aligned}$$

Larson may claim a 2018 QBID equal to the initial QBID less the reduction amount, or $20,987 ($32,000 – $11,013).

63. IRC §199A(b)(3)(B)(ii).

Mario's 2018 tax calculations for Larson are as follows.

		Total Tax
Interest from trust	$ 40,000	
Net profit from Schedule C	160,000	
Less: deduction for ½ SE tax	(10,104)	
AGI	$189,896	
Less: standard deduction	(12,000)	
Income before QBID	$177,896	
Less: QBID	(20,987)	
Taxable income	$156,909	
Income tax (($156,909 − $82,500) × 24% + $14,090)		$31,948
SE tax		20,208
Total tax		$52,156

Mario notes that the QBID for the sole proprietorship of $20,987 is less than 20% of the initial QBID (which is $160,000 × 20% = $32,000). This is because Larson's taxable income is over the $157,500 QBID threshold, placing him in the QBID phasein range.

Observation. When taxable income is greater than $157,500 (or $315,000 for MFJ filers) and not more than $207,500 ($315,000 for MFJ filers), the taxpayer is within the phasein range of the QBID rules and must generally reduce their QBID (which would otherwise be 20% of QBI). Based on the reduction formula (used above), the higher the taxable income within the range, the higher the reduction will be. However, if the sole proprietor pays out a larger wage amount to employees, this has the effect of allowing a larger QBID (because this reduces the downward adjustment of the QBID).

Another pass-through option for Larson is an S corporation. After making relevant inquiries of Larson about his role in the retail business and reviewing the applicable information, Mario determines that a reasonable salary for Larson is $60,000 per year.

Mario summarizes his tax calculations for an S corporation as follows.

		Total Tax
Wages	$ 60,000	
Interest income	40,000	
S corporation distributive share	100,000	
AGI	$200,000	
Less: standard deduction	(12,000)	
Income before QBID	$188,000	
Less: QBID	(20,000)	
Taxable income	$168,000	
Income tax: (($168,000 − $157,000) × 32%) + $32,090		$35,450
FICA tax on wages		9,180
Total individual income and FICA tax		$44,630

Mario notices that, with the S corporation, the reasonable salary reduces the amount of QBI. However, reasonable compensation is $60,000 of W-2 wages. These wages both reduce QBI[64] and increase the W-2 wages/QP limit. The QBID is the **lesser** of the following amounts ($20,000).

1. $100,000 QBI × 20% = **$20,000**
2. $70,000 wages × 50% = $35,000

Because Larson has growth plans for the business, Mario computes total tax liability estimates for the existing corporation, a sole proprietorship, and an S corporation at varying levels of income for the business. He summarizes his tax calculations in the following table.

	Total Tax Liability	Sole Proprietorship		S Corporation	
Net Business Income [a]	**Corporation**	**Tax Liability**	**QBID**	**Tax Liability**	**QBID**
$160,000	$ 57,440	$ 52,156	$32,000	$ 44,630	$20,000
200,000	70,983	72,410	5,000	56,390	28,000
400,000	142,687	148,758	5,000	123,940	35,000
600,000	218,831	226,979	5,000	195,800	35,000

[a] Net business income is calculated prior to deducting officer's compensation.

THE WAGE EFFECT

As mentioned earlier, at higher-income levels, W-2 wage payments (or alternatively, a combination of W-2 wages and QP basis) serve to reduce tax liability by increasing the W-2 wages/QP limit for the QBID.

Example 18. Use the same facts as **Example 17,** except Larson is confident, based on his recent sales levels, that if he opens a second location, he will have gross income of $640,000. A second location, however, would require him to hire additional sales staff. He may also require additional administrative personnel. Mario summarizes some projected income statements for 2018 with varying wage levels as follows.

	Scenario A	Scenario B	Scenario C
Gross income	$640,000	$640,000	$640,000
Advertising	(20,000)	(20,000)	(20,000)
Officer's compensation	0	(70,000)	(100,000)
Employee wages	(100,000)	(200,000)	(400,000)
Rent	(20,000)	(20,000)	(20,000)
Net income	$500,000	$330,000	$100,000

The following table compares the tax liability and QBIDs for Larson under each scenario.

	Total Tax Liability	Sole Proprietorship		S Corporation	
Scenario	**Corporation**	**Tax Liability**	**QBID**	**Tax Liability**	**QBID**
A	$174,760	$171,049	$50,000	$144,510	$50,000
B	143,412	122,508	80,000	114,620	66,000
C	73,882	60,839	40,000	65,310	20,000

64. IRC §199A(c)(4).

> **Observation.** While wages increase the W-2 wages/QP limit to potentially provide a larger QBID, increased wages also reduce net income (invoking the QBI limitation). Accordingly, careful planning may be necessary to find an optimal level of wages based on the amount of net income for a pass-through entity. In practice, managing the business toward this optimal point may prove difficult or impossible.

The officer's compensation paid by an S corporation, along with other W-2 compensation paid **does not constitute QBI** (because it was a deduction in arriving at net income) **but is included in W-2 wages for purposes of the W-2 wages/QP limit.**

CONVERSIONS

S corporations have substantial requirements to obtain and maintain their subchapter S tax election. These requirements include the following.[65]

- There can be no more than 100 shareholders.
- There can only be one class of stock.
- Only qualified shareholders are eligible to hold S corporation shares.
- The S corporation must be a domestic corporation.

> **Note.** For further details on these requirements, which must generally be maintained in order to prevent termination of the S corporation's pass-through status under subchapter S, see IRC §1361 and the underlying regulations.

Because it may be difficult, impossible, or undesirable for some taxpayers to continually meet the rigorous S corporation requirements, conversion to a C corporation may prove to be worthwhile, especially with the substantially reduced tax rate associated with the C corporation ushered in by the TCJA. In addition, the TCJA may provide a C corporation with a more favorable flat-tax environment if taxable income was high enough to trigger higher tax liability under the pre-TCJA tax brackets and rates.

> **Caution.** When considering whether to convert to a C corporation, all relevant issues should be carefully analyzed. Important issues could involve sale or disposition of corporate assets, changes in future tax laws, or liquidation of the corporation.

For these reasons, during the TCJA period, conversions from an S corporation to a C corporation or from a C corporation to an S corporation may be considered. In addition to making some key changes affecting such conversions, the TCJA also makes a noteworthy amendment associated with certain partnership interest changes.

> **Note.** For more information on the procedures necessary to terminate an S corporation election, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: New Legislation — Business Concerns, and Chapter 4: C Corporations.

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65. IRC §1361.

ACCOUNTING METHOD CHANGE FOR CONVERTING S CORPORATIONS

Generally, IRC §481 is invoked for a change in accounting method. An accounting method is the consistent application of rules for determining when items of income or deduction are recognized. A change of accounting method is generally a modification of these rules affecting the timing for income or expense recognition.[66] Changes in accounting methods may require the calculation of a catch-up period of adjustment,[67] which requires a determination of various account balances and tax liability as if a new method was in use in prior years. The resulting adjustment in tax liability is typically referred to as an IRC §481(a) adjustment.

> **Note.** For a good overview of changes in accounting methods, including the use of Form 3115, *Application for Change in Accounting Method,* see the 2015 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 5: Capitalization and Repair Update. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].
>
> Additional guidance is available from the Internal Revenue Manual at **uofi.tax/18b3x9** [www.irs.gov/irm/part4/irm_04-011-006#idm140266558850016].

The TCJA makes a change to the Code that eases the tax treatment of the required catch-up period for an S corporation that converts to a C corporation. Under the new rule,[68] an "eligible terminated S corporation" converting to a C corporation should take any IRC §481(a) adjustment into account over a 6-year period.

An eligible terminated S corporation is defined as a C corporation that was an S corporation on December 21, 2017, (the day before the TCJA was enacted) and which, during the 2-year period after that date, revokes its S election and therefore reverts to a C corporation. In addition, the owners of the revoking S corporation must be the same as the owners of the resulting C corporation, and each owner's respective proportionate ownership interest must remain the same.[69]

Under the new rules, if money is distributed by an eligible terminated S corporation during the post-termination transition period,[70] the accumulated adjustments account (AAA) is allocated to that distribution.[71]

> **Observation.** Because these distributions are specifically chargeable to AAA, they are not subject to double taxation even though paid by the C corporation. The AAA tracks undistributed earnings of the S corporation. In essence, this TCJA change preserves the pass-through tax treatment associated with funds up to the amount of the AAA.

Moreover, the distribution is chargeable to the C corporation's accumulated earnings and profits (AEP) in the same ratio as the amount that the AAA bears to the AEP amount.[72]

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66. IRM 4.11.6.2 (2017).
67. IRC §481(a)(2).
68. IRC §481(d).
69. IRC §481(d)(2).
70. Treas. Reg. §1.1377-2.
71. IRC §1371(f).
72. Ibid.

PARTNERSHIP CHANGE

Through December 31, 2017, if a partnership experiences a sale or exchange of at least 50% of the total interest in partnership capital and profits within any 12-month period, the partnership experiences a technical termination.[73] A technical termination triggers two deemed transfers. First, this results in a deemed contribution of all partnership assets and liabilities to a new partnership in exchange for an ownership interest in that new partnership. Second, there is subsequently a deemed distribution of interests in the new partnership to the purchasing partners and the other partners in the technically terminated partnership.[74]

The technical termination not only could trigger adverse tax consequences to partners but also may result in other tax consequences, including the following.

- The partnership's tax year closes on the date of the terminating sale or exchange, triggering a short tax year and a possible bunching of income for the remaining partners.[75]
- The resulting new partnership must file new elections, because all partnership-level elections of the old partnership terminate. This includes elections regarding accounting methods, depreciation methods, and other items.
- Generally, depreciation recovery periods of the partnership restart.

The TCJA repeals the technical termination rule. Accordingly, a sale or exchange of 50% or more of the total partnership capital and profits interests within a 12-month period that takes place after December 31, 2017, does not result in partnership termination.[76] After that date, a partnership is still considered terminated if none of the partners carry on any business or financial operation of the partnership[77] (which was the case prior to the TCJA).

S CORPORATIONS AND REASONABLE COMPENSATION

Tax practitioners comparing entities must be aware of the reasonable compensation requirement that is unique to the S corporation, particularly because the IRS can recharacterize some or all of an S corporation distribution as W-2 wages if insufficient wages are paid. Reasonable compensation has been the subject of frequent litigation between S corporation owners and the IRS. Sole proprietorships and partnerships are not subject to the reasonable compensation requirement and may be better options when the payment of sufficient W-2 wages, and corresponding SE tax, is not desirable from a tax planning perspective.

Litigation on this subject generally falls into two categories: cases in which the IRS believes the compensation paid to owners or employees of an S corporation is unreasonably low, and cases in which the compensation is believed to be unreasonably high.

While the S corporation provides an opportunity to minimize SE tax (as mentioned earlier), this opportunity is frequently tempered by the requirement to pay the owner(s) a reasonable amount of compensation. S corporation owners and their tax advisors are aware that distributions are not subject to SE tax. Accordingly, an incentive exists to minimize the amount of W-2 wages while maximizing distributions. Such an attempt to circumvent SE tax is typically the reason for an IRS contention that an S corporation's owner has received W-2 wages that are unreasonably low.

> **Note.** The facts of the following example are based on *David E. Watson, P.C. v. U.S.*[78]

73. Treas. Reg. §1.708-1(b)(2).
74. Treas. Reg. §1.708-1(b)(4).
75. Treas. Reg. §1.708-1(b)(3).
76. IRC §708(b)(1).
77. IRC §708(b)(1)(A).
78. *David E. Watson, P.C. v. U.S.,* 757 F.Supp.2d 877 (S.D. Iowa 2010), *aff'd* 668 F.3d 1008 (8th Cir. 2012).

Example 19. Matilda graduated from a university 28 years ago with a bachelor's degree in business administration. She majored in accounting and became a CPA shortly after graduation. A few years later, she obtained a master's degree in taxation from a prestigious university. Since the time she became a CPA, she has continually practiced accounting on a full-time basis. Prior to establishing her own CPA firm 14 years ago, she was employed by a "Big 4" accounting firm and also had employment experience with smaller, private accounting firms.

Matilda's CPA firm has been successful, and it acquired another private CPA firm that also had a substantial number of clients and partners. The merged firm, an S corporation, that resulted from this acquisition is large and successful. It has approximately 30 CPAs, with annual revenue of approximately $2.5 million to $3 million. The merged firm has several partners, including Matilda.

Matilda and the other partners agreed on a regular salary of $2,000 per month, with the remaining profits being distributed as dividends. Relevant amounts are shown in the following table for the S corporation for two years of its operation.

	Year 1	Year 2
Firm revenue	$2.4 million	$3 million
Revenue generated by Matilda	198,000	200,380
Matilda's salary	24,000	24,000
Matilda's distribution	204,000	175,000

In Tax Court, the IRS challenged the salary as unreasonably low. The IRS sought to recharacterize some of the S corporation distributions as a W-2 wage. The IRS had an expert testify that the fair market value (FMV) of Matilda's accounting services to the S corporation is $91,000 per year.

The expert, in part, relied on starting salaries for students graduating from the university from which Matilda was an alumna, placement agency data, and pay rates for professionals with Matilda's background. The expert also relied on the profitability of accounting firms relative to other types of businesses, the actual financial performance of Matilda's firm, and various surveys conducted by the AICPA for CPA salaries in similar-sized firms.

The Tax Court agreed with the IRS, holding that Matilda was a highly educated CPA with an advanced degree. She also has over 20 years of experience. Her $24,000 salary did not represent an FMV amount, given the revenue she generated from clients. In addition, her $24,000 salary is not reflective of the FMV for an experienced CPA working in a firm with the levels of revenue received by the S corporation.

Moreover, the Tax Court found that the methodology used by the expert and the information relied upon to arrive at an FMV salary were sound and reasonable.

The IRS may recharacterize some of the distributions in each of the two years to reflect the $91,000 FMV salary. The S corporation is obligated to pay the payroll taxes on the recharacterized amounts, plus interest and penalties.

IRS contentions that an owner's or employee's compensation is too high typically revolves around the deduction of excessive wage amounts as ordinary and necessary business expenses under IRC §162(a). Frequently, with such challenges, the IRS seeks to recharacterize some or all of the W-2 compensation as a constructive dividend.[79]

79. For an example of a case in which the IRS contended that wages paid in excess of reasonable compensation constitute a constructive dividend, see *Joseph E. Proctor and Shirley I. Proctor, et al., v. Comm'r,* TC Memo 1981-436 (Aug. 17, 1981).

The amount of compensation for a particular taxpayer that is reasonable is a question of fact and varies depending upon several factors. In an April 2018 reasonable compensation case, the Tax Court summarized the "profusion of possibly relevant facts" that reasonable compensation "caselaw has sprouted," specifically mentioning several factors courts have looked to in such cases, including the following.[80]

- The employee's qualifications
- The nature, extent, and scope of the employee's work
- The size and complexities of the business
- A comparison of salaries paid with the gross income and the net income
- The prevailing general economic conditions
- Comparison of salaries with distributions to stockholders
- The prevailing rates of compensation for comparable positions in other comparable businesses
- The salary policy of the taxpayer as to all employees
- Historical levels of compensation paid to the employee

The numerous and varied factors that have evolved through reasonable compensation litigation indicate that such cases turn on factual analyses on a case-by-case basis. There is no correct amount of S corporation compensation. This makes the determination of reasonable compensation uncertain for S corporation owners.

Note. Historically, reasonable compensation guidance grew from IRS challenges to excessive compensation paid. Accordingly, much of that guidance was drafted with excessive compensation challenges in mind, even though the IRS may now challenge a compensation amount as being unreasonably low.

Generally, compensation is reasonable if it is at least an amount that represents the FMV of the owner's or employee's services. In addition to the courts developing a number of factors to review, the IRS provided a summary of key factors in a publication developed for IRS valuation professionals, agents, and field personnel.[81] These factors coincide, in part, with those noted by the Tax Court, but other important factors are included. The IRS outlined several factors that relate to the following three areas.

1. The owner or employee
2. The S corporation business
3. The compensation

These factors are frequently referred to in an IRS reasonable compensation review and are discussed in the following sections.

80. *Povolny Group, Incorporated, et al., v. Comm'r*, TC Memo 2018-37 (Apr. 3, 2018).

81. *Reasonable Compensation, Job Aid for IRS Valuation Professionals.* Oct. 29, 2014. IRS. [www.irs.gov/pub/irs-utl/Reasonable%20Compensation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf] Accessed on May 13, 2018.

FACTORS RELATING TO OWNER OR EMPLOYEE[82]

Arm's-Length Relationship

The IRS wants to determine whether the owner had to negotiate for compensation at arm's length. The existence of a compensation review panel or committee or a requirement for a higher level of approval from an independent body may establish the existence of an arm's-length relationship between the owner/employee and the S corporation.[83] Use of salary surveys and comparables, as well as the maintenance of contemporaneous records to document compensation decisions may be helpful to establish an arm's-length relationship. The presence of an arm's-length relationship substantially reduces the risk of compensation levels that are unreasonable. This is considered one of the more important factors.

Related-Party Control

Under this factor, the IRS wants to determine whether related parties exercise control over the business. If so, such control may influence compensation paid to owners.

Availability of Comparable Services

This factor involves whether the business could obtain comparable services elsewhere at a lower cost than the owner/employee. This factor is more important when the typical IRS challenge involves excessive compensation.

Nature of the Duties

S corporation owners performing highly specialized, skilled tasks are required to pay themselves a salary commensurate with the market value of those skills. Moreover, the overall level of responsibility of the owner within the operation of the business is relevant, including supervisory duties over employees.

Background and Experience

Aspects such as the owner's education, experience, professional track record, and any specialization are relevant in placing a value on the compensation amount that is reasonable for that owner.

Time Devoted

The amount of time the owner devotes to the S corporation activity is relevant. A higher amount of compensation is generally called for with full-time activity. On the other hand, part-time work for the S corporation, or work time that is split between the S corporation's activity and other employment tends to reduce the level of compensation considered reasonable.

Earning History

The earning history of the S corporation owner is relevant in determining the reasonableness of their current level of compensation.

FACTORS RELATING TO S CORPORATION'S BUSINESS[84]

Market Level of Salaries in Similar Businesses

Generally, this factor looks at what similar businesses pay their employees in similar jobs to determine the market-level of compensation that should be paid.

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82. Ibid.

83. *Kerrigan Iron Works, Inc. v. Comm'r,* 17 TC 566 (Sep. 28, 1951); *Vegetable Farms, Inc. v. Comm'r,* 14 TC 850 (May 16, 1950).

84. *Reasonable Compensation, Job Aid for IRS Valuation Professionals.* Oct. 29, 2014. IRS. [www.irs.gov/pub/irs-utl/Reasonable%20Compensation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf] Accessed on May 13, 2018.

Size of the Business

Heading a larger business may command a higher level of compensation than the same job at a smaller organization, because of the higher degree of complexity associated with the job duties.

Salary Scale for Employees

The amount of compensation for the owner/employee relative to the level of compensation paid to others involved in the business may be relevant in determining whether the owner is being paid less (or more) than a reasonable amount of compensation.

FACTORS RELATING TO COMPENSATION[85]

Determination Criteria

This factor determines whether the S corporation's governing body clearly establishes criteria for the determination of compensation level, including a consideration of the job duties, responsibilities, and performance criteria.

Salary Fixed in Advance

Under this factor, an owner might not have compensation that is reasonable if the amount of that compensation was established far in advance of the actual provision of services to the business.

Substantiation of Duties and Salary

In order to justify the amount of compensation as reasonable, records should be kept that document the duties performed and the hours worked by the owner.

ADVISING CLIENTS ON REASONABLE COMPENSATION

Reasonable compensation has been an IRS focal point since 1974, at which time the IRS concluded in a revenue ruling[86] that nonwage S corporation distributions received by S corporation shareholders should be recharacterized as wages subject to payroll taxes. The rationale for this recharacterization was that the nonwage distributions were paid instead of compensation, and such distributions met the statutory definition of wages.

Case law is helpful in determining not only which circumstances within this area the IRS has challenged, but also how the courts have addressed reasonable compensation cases. Methodologies used by the IRS to establish an appropriate wage with which a court agrees may provide the practitioner with some insight on reliable resources to use in advising clients on the subject of reasonable compensation.

JD & Associates, Ltd. v. U.S.

In *JD & Associates, Ltd. v. U.S.,*[87] Jeffrey Dahl was the sole shareholder, officer, and director of an S corporation. He received an annual salary of $19,000, $30,000, and $30,000 in 1997, 1998, and 1999, respectively. However, his distributions for those respective years were $47,000, $50,000, and $50,000. He ran a very successful accounting firm, and he made all of the hiring decisions, paid the firm's bills, maintained its records, and completed client work for the firm. The IRS asserted Dahl's salary was unreasonably low and engaged an engineer to place an FMV on Dahl's services.

The engineer consulted studies performed by the Risk Management Association (RMA). This allowed the engineer, who testified for the IRS, to compare financial ratios for Dahl's accounting firm with similar ratios for other accounting firms that had comparable levels of assets.

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85. Ibid.

86. Rev. Rul. 74-44, 1974-1 CB 287.

87. *JD & Associates, Ltd. v. U.S.*, No. 3:04-cv-59 (D.N.D. 2006).

The engineer confirmed that while Dahl's firm was approximately 200% to 300% more profitable than similarly situated accounting firms, his compensation level compared to such other firms was 166% to 266% less. The IRS engineer then referred to average officers' compensation percentages found in the RMA and concluded his reasonable compensation was $69,584, $79,823, and $79,711 in 1997, 1998, and 1999, respectively. The relevant part of his distribution in each of those years was recharacterized to reflect the increased compensation for each year.

The Dahl court reviewed the available financial data for Dahl's firm on several levels, including the following.

1. Owner performance
2. Comparative salaries within the firm
3. Circumstances of the firm

Owner Performance. The court noted that Dahl's firm had a highly favorable after-tax profit when expressed as a percentage of sales. The court concluded that Dahl's performance as an accounting executive was exemplary.

Comparative Salaries within the Firm. The court looked at Dahl's compensation relative to his subordinate employees and noted that there was not much difference in these compensation levels. In addition, the firm's increase in revenues from 1998 to 1999 was not reflected in any increase in Dahl's own compensation.

Circumstances of the Firm. The court agreed with the IRS that the firm generated excess capital for employee compensation. Dahl's accounting firm was not a capital-intensive business and had little need for annual reinvestment.

David E. Watson, P.C. v. U.S.

In the *Watson* case,[88] the IRS used the same engineer it used in *JD & Associates* to assist with its reasonable compensation challenge.

The engineer again used RMA annual statement data in determining that Watson's accounting firm was about 300% more profitable than similar firms in the accounting industry. The engineer also referred to data from Robert Half (a placement organization for individuals in the accounting and finance fields) and salary data from the University of Iowa (from which Watson graduated) in building the IRS case.

Watson received an annual salary of $24,000 for the years at issue in this case. To arrive at an FMV for Watson's services, the IRS engineer focused on the AICPA's Management of an Accounting Practice (MAP) survey, which indicated that an average director (who has no share ownership) in a firm the size of Watson's firm would receive approximately $70,000 of compensation annually. Subsequently, the IRS engineer determined that owners with share ownership (such as Watson) tended to invoice about one-third more than a director without share ownership. Accordingly, the $70,000 compensation amount was increased by one-third to arrive at a $93,000 FMV-level of compensation.

The court agreed with the IRS engineer's approach, specifically noting Watson's 20 years of experience, advanced education, and the number of hours he spent each week working in his firm. The court concluded that an annual salary of $24,000 was simply not reflective of a reasonable, fair market level of compensation for an accountant in his position.

88. *David E. Watson, P.C. v. U.S.,* 757 F.Supp.2d 877 (S.D. Iowa 2010), *aff'd* 668 F.3d 1008 (8th Cir. 2012).

Sean McAlary Ltd., Inc. v. Comm'r

In a 2013 case, a taxpayer engaging in egregious reasonable compensation practices culminated in the holding in *Sean McAlary Ltd., Inc. v. Comm'r*.[89] McAlary, a real estate agent in southern California, owned an S corporation as sole shareholder and was its secretary, treasurer, and director. He handled all administrative aspects of the business, working 12-hour days with very little vacation time. He supervised several other real estate agents. He established his annual compensation at $24,000. However, this amount was never actually paid as wages, and, instead, McAlary received a distribution of $240,000.

Again, the IRS, in its challenge, used the same engineer that it used as an expert witness in the *JD & Associates* and *Watson* cases. The engineer again used RMA studies, as well as other data from a California occupational employment statistics survey.

From the RMA studies, the engineer concluded that McAlary's profit margin for the period involved in the case was 44.7% (far in excess of the 21.9% industry average). He determined that the median hourly wage for a real estate broker in southern California who supervised other agents was approximately $48.44. The engineer then multiplied this hourly wage by 2,080 hours (40 hours weekly × 52 weeks), to arrive at annual compensation of $100,755. This amount was approximately 19.4% of McAlary's gross receipts. The engineer concluded that this comported with RMA statistics showing officers and directors in comparable real estate businesses received compensation ranging from 7% to 18.9% of net sales.

The Tax Court agreed with this approach, and the relevant amount of McAlary's distribution was recharacterized as a wage to reflect the FMV level of compensation.

Establishing Reasonable Compensation

The three cases summarized in this section provide significant guidance in connection with establishing reasonable compensation for clients with S corporations.

> **Note.** RMA is an association composed of financial institutions, including non-bank financial institutions that have an interest in risk analysis and management. For further information, see **uofi.tax/18b3x10** [www.rmahq.org/who-we-are/].

These three key cases indicate that establishing reasonable compensation that survives IRS scrutiny cannot involve the same information for all clients in all professions or areas of business. These cases greatly inform the approach to establishing reasonable compensation amounts for clients with S corporations. Some of the aspects of this process to consider include the following.

- Make relevant inquiries of clients owning S corporations to determine the scope of their professional, administrative, supervisory, and other duties performed within the business. Case law indicates that establishing reasonable compensation is a highly fact-specific process.
- Use objective, market-related data for salaries in the client's industry as a benchmark to obtain insight on what other similarly situated firms would pay the S corporation owner for their services. Case law indicates that establishing reasonable compensation involves using appropriate comparative data to establish an FMV for the S corporation owner's services.

> **Note.** While the RMA has helpful statistics, other sources are available to obtain market-value amounts and financial information. These other sources include professional and business associations, universities, state and federal employment agencies, and other federal resources such as the Bureau of Labor Statistics' Industries at a Glance data, found at **uofi.tax/18b3x11** [www.bls.gov/iag/home.htm]. In addition, the Robert Half salary guide, found at **uofi.tax/18b3x12** [www.roberthalf.com/salary-guide], is another source for industry-specific salary information.

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89. *Sean McAlary Ltd., Inc. v. Comm'r*, TC Summ. Op. 2013-62 (Aug. 12, 2013).

- Use an objective methodology to arrive at a high and low value representing the range of the FMVs for comparable work in a comparable firm in the client's industry or profession. In setting the reasonable compensation amount, ensure the client's amount is within that objectively established FMV range.
- Document the data used and the sources of that data, the methodology used, and the information provided by the client. Ensure the client also maintains documentation of the duties performed, so that the compensation established may be justified later if there is an audit or litigation.

Because a business and business data change over time, an annual reasonable compensation review is advisable. This ensures up-to-date data is being used and any changes in the client's scope of duties are accurately reflected in the annual compensation.

LIABILITY PROTECTION CONSIDERATIONS

Caution. Competent legal advice should be sought regarding liability issues, which vary from state to state.

Even for businesses that do not involve high-risk activity, it is prudent to select a business entity that provides the business owner or owners with personal liability protection. This is especially true if the risks inherent in the business cannot be appropriately addressed by insurance or if insurance is prohibitively expensive. Liability protection is one of the most important considerations in selecting the appropriate type of entity for a new business or when restructuring an existing business to minimize the personal liability of the owners.

The following table summarizes the personal liability protection **generally** available to owners from the various types of business entities.

Entity	Owner Liability Protection
Sole proprietorship	No
C corporation	Yes
S corporation	Yes
General partnership	No
LP	Yes, for limited partners; no for general partners
LLP	Yes
LLC	Yes

Entities are formed under state law, and the degree of liability protection provided to an entity may vary widely across states. State statutory law under which the entity is created and operated, as well as case law, generally defines the degree of liability protection provided by a particular entity type within the state and any limitations that may exist on that liability protection.

Example 20. Paula operates her landscaping and yard maintenance business as a sole proprietor. She expresses concerns about personal injuries to a subcontractor, employee, or customer because her business involves the use of large mowing equipment, cranes for tree pruning, and several vehicles with trailers. Establishing an LLC provides more protection for Paula individually under the laws of her state than operating as a sole proprietorship without any liability protection.

Note. The above example underscores the need to consult legal counsel regarding entity choice and liability protection. Use of a single-member LLC (SMLLC) in some states may not provide much additional protection. The area of law dealing with SMLLCs continues to evolve (and SMLLC liability protection is discussed later in this section).

Generally, state law does not provide liability protection even for an entity that would otherwise provide the owners with such protection in the event the entity is misused or used fraudulently. For further details on what may constitute such misuse or fraud and the limits placed on liability, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Entity Selection. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

SPECIAL CONSIDERATIONS FOR AN LLC

Limited liability companies (LLC) are unique in two principal ways. First, the LLC is flexible from a tax standpoint. An LLC may be taxed as a C corporation, an S corporation, a partnership, or a sole proprietorship. Second, the LLC generally may provide a unique form of liability protection, called a charging order.

Note. Once established, an LLC becomes subject to the "check the box" tax election requirements, including the default rules. For further details on these rules, see Treas. Reg. §301.7701-3 and the instructions for Form 8832, *Entity Classification Election.*

Because of charging order protection, use of an LLC may provide liability protection for an entity for which liability protection would otherwise not exist. Whether charging order protection exists, and the degree of its protection, **depends upon the applicable statutes of the state under which the LLC was formed.**

Charging Order Protection

Charging order protection is a form of liability protection generally not associated with a traditional corporate entity or traditional partnership.

Charging order protection refers to liability that is limited to a **charging order**, which is a court order to charge a partner's transferable interest in the partnership to satisfy a debt. The charging order remedy for a creditor of a general or limited partnership originated with the drafting of the Uniform Limited Partnership Act (ULPA) in 2001.[90] Prior to the development of the charging order remedy, a creditor with a judgment against a partner had the power to seize partnership assets and sell those assets to satisfy the judgment. The charging order was developed as a means to allow the creditor to obtain satisfaction of such a judgment without the adverse disruption or destruction of the general or limited partnership's business frequently caused by an asset seizure and sale.

90. Forsberg, W.S. (2009, Nov./Dec.). Asset Protection and the Limited Liability Company. *American Bar Association, Probate and Property.*

Generally, the charging order provisions for general partnerships, limited partnerships, and LLCs are similar. A typical charging order provision is found in the Revised Uniform Limited Partnership Act (RULPA),[91] which states that the following rules apply when a partner is a debtor against whom a creditor has an unsatisfied judgment.

- The creditor can apply to the proper state court to charge the limited or general partner's transferable interest in the partnership to satisfy the unpaid amount of the judgment.

> **Note.** Transferable interest is generally defined as the right to receive distributions from the partnership, LP, or LLC as provided by the partnership or operating agreement.[92] This interest is also referred to as a distributional interest and does not constitute the partner's or member's full ownership interest in the entity. It also does not include managerial or voting rights.

- The court can appoint a receiver to administer the share of the partner's distributions that are owed to the debtor and administer other aspects of the charging order.
- The charging order constitutes a lien against the partner's transferable interest in the LP.
- Upon request by the creditor, the court may order foreclosure upon the transferable interest that is the subject of the charging order.
- The charging order and the option to foreclose provide the only remedies available for the creditor against the partner. (This is often referred to as the exclusive remedy provision.)

The appointment of a receiver, the availability of a foreclosure option for the creditor, and the exclusive remedy provision to maximize charging order protection for a partner or LLC member are provisions that a state may or may not have enacted in its partnership, LP, or LLC statutes.

> **Observation.** In order to obtain a charging order, the creditor must generally first obtain a judgment against the partner or member in connection with the debt owed. Subsequently, the creditor can apply to the court for the charging order as a means to obtain payment of the debt.

Rights of a Creditor with a Charging Order. A judgment creditor with a charging order receives payments from the debtor partner's distributions for the partnership interest or LLC member's interest that is the subject of that charging order. Generally, the charging order does not entitle the creditor to become the owner of the partner or member's interest in the business. Moreover, the charging order does not entitle the creditor to voting rights or any right to participate in the decision making or activity of the business operations. The charging order does not provide the creditor with any ownership interest in the assets of the business. The creditor is only entitled to distributions to satisfy the unpaid amount of the judgment against the partner or member if the partners or members choose to make such distributions.[93]

> **Note.** Statutes in states that provide charging order protection vary in defining the scope of interest that a creditor has once a charging order is obtained. In addition, this area of law is still evolving and, within each state, case law also may play a large role in defining the creditor's rights under the charging order. Legal advice should be obtained to determine the rights of a holder of a charging order.

91. See Revised Uniform Limited Partnership Act, §703.

92. For example, see the Uniform Limited Liability Company Act, §102(21).

93. See, e.g., 805 ILCS 180/30-20.

A court held that a creditor holding a charging order does not have the right to obligate an LLC to disclose books and records.[94] The court confirmed that even after entry of the charging order against the debtor, the debtor retained management power and information rights.

Foreclosure and Exclusivity. By statute, a charging order is generally considered a lien against the debtor's distributional interest in the partnership, limited partnership, or LLC. A creditor with a charging order may find that there were no distributions made to pay the debt. If the applicable state statute allows, the creditor may foreclose on the partner's or member's interest, thereby obtaining ownership of that distributional interest. Although this divests the partner or member of the economic benefit of their interest (because the creditor becomes owner of any distribution rights), it does not confer any rights to the creditor to manage, vote, or own assets in the partnership or LLC.[95] Although the affected partner or member loses the right to distributions, the business entity itself and its day-to-day management are protected from the creditor. This is especially true if the charging order is the exclusive remedy available to the creditor by statute, even in states that permit foreclosure. As a practical matter, foreclosure on the lien created by the charging order has only limited value to the creditor but may put the creditor in a much better bargaining position to negotiate settlement of the debt.[96]

> **Note.** In June 2011, Nevada became the first state to amend its corporation statute to provide charging order protection to certain corporations, including corporations with only one shareholder.[97] Only corporations with less than 100 shareholders may qualify. This may reflect the beginning of a trend among states that wish to make their business environment more attractive by providing more powerful charging order protection to traditional corporations.

Charging Orders and Tax Issues. Laws governing tax treatment of the holder of a charging order are gradually developing. Conflicting guidance has created two different theories on the tax status of the holder of a charging order. One theory is that the holder of the charging order becomes liable for any tax liability associated with the distributional share of income generated by the partnership or LLC. This may deter creditors from applying for a charging order, which may provide greater protection for the partner or member who is a debtor. This is because the holder of a charging order may become liable for the tax liability on phantom income if there is a distributive share allocated to the interest subject to the charging order without any actual cash distribution.

Support for this theory is provided by Rev. Rul. 77-137.[98] In this ruling, party A is a limited partner in an LP. Under the LP's partnership agreement, assignees of interests do not become limited partners unless all general partners provide written consent. The agreement also states that a limited partner may assign their right to profits and losses, as well as the right to receive distributions for their limited partnership interest, to another party without the consent of the general partners. Party A assigned his limited partnership interest to party B. The revenue ruling held that because party B acquired substantially all the dominion and control over the LP interest, he is treated as a substitute limited partner for federal tax purposes, even if the general partners do not admit him as a limited partner under the terms of the agreement.

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94. *Wells Fargo Bank, N.A. v. Continuous Control Solutions, Inc.,* No. 2-431/11-1285 (Iowa Ct. App. 2012).

95. Schurig, E. M. & Jetel, A. P. (2006, May/June).The Alarming Potential for Foreclosure and Dissolution by an LLC Member's Personal Creditors. *American Bar Association, Probate & Property,* 42–48.

96. Ibid.

97. See Nevada Revised Statutes, Chapter 78, Private Corporations, §746.

98. Rev. Rul. 77-137, 1977-1 CB 178.

A second theory indicates that the holder only has a lien on the distributional interest, which is not the same as holding an entire partnership or member interest. This viewpoint indicates that Rev. Rul. 77-137 should be interpreted to distinguish the limited charging order lien interest from the interest obtained from other types of transfers of a greater degree of dominion and control, with rights beyond those provided by a charging order.

> **Note.** For further discussion of each theory, see **uofi.tax/18b3x13** [www.cpajournal.com/2017/01/22/who-gets-k-o-d-by-the-k-1/].

Single-Member LLC Entities. Although many state statutes provide charging order protection to partnerships, LPs, and LLCs, substantial authority has developed that indicates charging order protection may not exist with SMLLCs, at least in some jurisdictions.

One case indicating that SMLLCs may not have charging order protection is *Olmstead v. Federal Trade Commission.*[99] Shaun Olmstead and Julie Connell had substantial assets within several Florida SMLLCs that they respectively owned. The Federal Trade Commission (FTC) determined that Olmstead and Connell were operating an advance-fee credit card scam and subsequently obtained a judgment against them at a hearing for deceptive trade practices.[100] The FTC filed suit in Florida to obtain the assets in the SMLLCs in restitution and obtained a court order compelling Olmstead and Connell to surrender their assets in their respective Florida SMLLCs.

This court order was the subject of *Olmstead.* Olmstead and Connell argued that their SMLLCs provided charging order protection and the FTC, in the capacity of judgment creditor, would have to use a charging order under Florida law as a remedy, instead of the court order the FTC obtained. The FTC argued that it could pursue its court order and compel the surrender of assets. The Supreme Court of Florida reviewed applicable Florida law and observed that although a charging order was the "sole and exclusive remedy" for a judgment creditor under Florida's partnership and limited partnership acts, such a provision was notably absent in Florida's LLC statute. The court therefore concluded that other remedies, such as the FTC's court order, were available to judgment creditors seeking to obtain redress from Florida LLC entities. In addition, the court noted that the notion of charging order protection, which originated in partnership law before becoming applicable to LLCs, was designed to serve the purpose of protecting other partners from actions against a debtor partner. With an SMLLC, there could be no concern for protecting other members because there is only one member.

After the *Olmstead* case, the Florida legislature passed into law the "Olmstead patch," which added the missing language to the LLC statute and established that the charging order was the sole and exclusive remedy for all Florida LLC entities, including SMLLCs.[101]

Other cases have also served as precedent for denying charging order protection with SMLLCs.[102]

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99. *Olmstead, et al v. Federal Trade Commission,* 44 So.3d 76 (Jun. 24, 2010).

100. *Federal Trade Commission v. Olmstead et al.,* 528 F.3d 1310 (11th Cir. 2008).

101. See Florida Limited Liability Company Act, §608.433.

102. See *In re Ashley Albright,* 291 B.R. 538 (Bankr. D. Colo. 2003); *In re Modonlo,* 412 B.R. 715 (Bankr. D. Md. 2006); and *Heckert v. Heckert*, 2017 WL 5184840 (Tex. App. 2017).