January 20, 2020

To our valued clients and friends:

Changes included in the Tax Cuts and Jobs Act (TCJA) force you and other small-business owners to reconsider whether a new venture should be conducted as a pass-through entity or as a C corporation.

Pass-through entities include partnerships and multi-member LLCs that are treated as partnerships for tax purposes.

So, what should you think about the advisability of operating a business as an LLC or a partnership in the post-TCJA world? Good question.

Multi-Member LLC Option Still Looks Good in Common Scenarios

Before the TCJA, LLCs were often the preferred small-business entity choice, mainly because they can take advantage of the favorable federal income tax rules for partnerships.

Operating as an LLC also generally protects your personal assets from exposure to business-related liabilities. Such exposure can include everything from a lawsuit filed by the FedEx guy who slips on your ice-covered steps to the seemingly endless variety of liabilities that can be caused by the actions or inactions of employees.

Key point. No type of entity (including an LLC) will protect your personal assets from exposure to liabilities related to your own professional malpractice or your own tortious acts. Tortious acts are wrongful deeds other than by breach of contract, such as negligent operation of a motor vehicle resulting in property damage or injuries.

The issue of liability exposure is a matter of state law, and you should seek advice from a competent business attorney for full details.

Partnership Taxation Advantages

The generally favorable partnership tax rules, which apply equally to multi-member LLCs treated as partnerships for tax purposes, can be summarized as follows.

You Get Pass-Through Taxation

Your share of LLC taxable income items, gains, deductions, losses, and credits are passed through to your personal return. You then pay taxes at the personal level. You don’t have to worry about the double taxation issue that can potentially haunt C corporations.

You Can Deduct LLC Losses on Your Personal Return (within Limits)

You can deduct LLC losses passed through to you on your personal return, subject to various limitations. These can include the passive loss rules, the at-risk rules, the excess business loss disallowance rule, and the ownership interest basis limitation rule.

You May Be Eligible for QBI Deduction

Thanks to the TCJA, the qualified business income (QBI) deduction is potentially available to individual LLC members. The deduction can be up to 20 percent of QBI passed through to you from an LLC. However, limitations apply at higher levels of personal income. The QBI deduction will expire at the end of 2025 unless Congress extends it. And it could go bye-bye much sooner, depending on political developments.

You Get Basis from LLC Debts

You receive additional tax basis from your share of LLC liabilities for pass-through loss deduction purposes.

You Get Basis Step-Up for Purchased Interests

If you purchase an LLC membership interest from another member, you can step up the tax basis of your share of LLC assets, which minimizes taxes for you when the LLC sells those assets or converts them to cash.

You Can Make Tax-Free Transactions with the LLC

As an LLC member, you have much greater flexibility to make tax-free transfers of assets (including cash) between yourself and the LLC than you would if you were an S or C corporation shareholder.

You Can Benefit from Special Tax Allocations

LLCs can make special (disproportionate) allocations of taxable income, tax losses, and other tax items among the members. For example, a 50 percent high-tax-bracket member (you) could be allocated 80 percent of LLC depreciation deductions, while the 50 percent low-tax-bracket member (the other guy) is allocated only 20 percent of the depreciation deductions.

Later on, the high-bracket member (you) could be allocated more of the LLC’s gains from selling depreciable assets to compensate for the earlier special allocations of depreciation.

Partnership Taxation Disadvantages

Partnership taxation is not all sweetness and light. There are a couple of important disadvantages to consider.

More Exposure to Self-Employment Tax

You may owe self-employment tax—consisting of the 12.4 percent Social Security tax component and the 2.9 percent Medicare tax component—on most or all of the income passed through to you by an LLC.

At higher income levels, you may also owe the 0.9 percent additional Medicare tax.

In contrast, if you run your business as a corporation, Social Security and Medicare taxes hit only the amounts paid out as salary to you and the other owners. This factor favors operating as a corporation, and it can be an important factor.

Unfavorable Fringe Benefit Tax Rules

Compared with C corporations, multimember LLCs that are treated as partnerships for tax purposes cannot provide as many tax-free fringe benefits to their members (like you). This factor favors operating as a C corporation, but it's usually not an important factor.

Key point. The unfavorable partnership fringe benefit tax rules that apply equally to multi-member LLCs treated as partnerships also apply to S corporations.

Your choice of business entity is not easy and it changes as your business situation changes. If you would like to discuss your business entity choice with me, please call us at 859—331-5622 or via our web site www.ahm-cpa.com.

Sincerely,

Anneken, Huey & Moser, PLLC