Capital vs. Profits Interest, Allowable Deductions, Distributions, Exclusions and Other Planning Considerations

WEDNESDAY, JANUARY 23, 2019
1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today’s faculty features:

Meghan Jodz, Partner, Tax Services, Grant Thornton, Philadelphia
G. Thomas Stromberg, Partner, Jenner & Block, Los Angeles

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• Print the slides by clicking on the printer icon.
Meghan R. Jodz is a partner in Grant Thornton’s Philadelphia office with 18 years of public accounting experience. Meghan heads the M&A tax practice for the Atlantic Coast Market. She has extensive experience working in M&A with both financial and strategic buyers conducting tax due diligence reviews and has significant technical expertise in S and C corporations, internal restructurings, deal structuring, section 382 ownership changes, consolidated stock basis and accounting methods. Meghan has worked on numerous private and public company transactions ranging in size from $10 million to over $1 billion for both simple and complex groups. She also has extensive experience in accounting for income taxes for both private and public companies and advises on the financial statement implications of M&A transactions. Recently Meghan has helped develop the firm’s tools for evaluating whether a company should convert from a pass-through to a C corporation and spends time advising clients on the tax implications of converting.

Meghan was named to Mergers & Acquisitions magazine’s 2019 Most Influential Women in Mid-Market M&A.

Meghan is a Certified Public Accountant in the Commonwealth of Pennsylvania and is also a member of the American Institute of Certified Public Accountants. She graduated from Georgetown University in 2000, magna cum laude, with a BS in Accounting and a minor in Spanish. She earned her Master’s Degree in Taxation from Villanova University in 2013.
G. Thomas Stromberg is a partner in Perkins Coie’s corporate transaction group. He has decades of experience counseling clients on corporate structuring, mergers and acquisitions, financings and general corporate matters. Tom is known for managing complex cross-border transactions involving parties across North America, Europe, Asia and Australia. Fluent in Japanese, Tom’s background includes a tenure practicing law in Tokyo.

In addition to experience leading private equity, venture capital and strategic acquisition transactions, Tom regularly advises on joint ventures, spinoffs, mezzanine and junior capital financings and restructurings, asset-based financings, convertible debt financings, multibank credits, underwriting facilities, project financings, debt and equity restructurings, recapitalizations and workouts.

Tom helps his emerging growth clients expand with a variety of investment vehicles, including utilizing securities and other capital raise transactions. His Silicon Valley practice extends to advising on M&A transactions for tech and IP-heavy clients. In the cryptocurrency space, Tom advises clients on regulatory, corporate and commercial issues related to initial coin offerings, and he closely follows securities law developments related to issuing and trading crypto assets.

A frequent author on M&A and blockchain topics, Tom has also lectured at Stanford Law School, the Haas School of Business at the University of California Berkeley and the Kellogg School of Business at Northwestern University.
Program Outline

• General Choice of Entity Issues
  — C corporations, S corporations, LLCs and LPs
• Tax Reform Impact on Entity Choice
• State Taxation Differences
• Exit Strategies Impact on Entity Choice
• Conversion of Legal Entity Form
• Q&A
General Choice of Entity Issues
General Choice of Entity Issues

C Corps, S Corps, LLCs and LPs

- Organizational differences
- Structural differences
- Governance issues
- Distribute or reinvest
- Differences under Delaware law
- Tax treatment
Tax Reform Impact on Entity Choice
Tax Reform Provisions Impacting Entity Choice

• Corporate tax rate reduction
• Pass-through tax deduction
• Net operating loss changes
• New international provisions
Corporate tax rate reduction

- Top corporate income tax rate reduced from 35% to 21%
- Corporate alternative minimum tax ("AMT") repealed
- State tax deductions preserved
Pass-through tax deduction

• Individual income tax rates not materially changed (top marginal rate reduced from 39.6% to 37%)

• AMT still applicable to individuals

• State tax deduction limited

• Partners and sole proprietors subject to self-employment tax

• Passive income subject to 3.8% Net Investment Income tax

• New section 199A qualified business income ("QBI") deduction reduces pass-through income by 20% (not a tax rate reduction)
Pass-through tax deduction

- QBI deduction requirements at entity level
  - Qualified trade or business
  - Specified service business
  - Qualified income by activity (and foreign sourced income excluded)
  - Limitation based on 50% x W-2 wages
  - Alternative limitation based on 25% x W-2 wages + 2.5% x capex

- QBI deduction requirements at owner level
  - Taxable income threshold limitations
  - Taxable income generally
  - Aggregation and segregation of activities
# Comparison of rates

<table>
<thead>
<tr>
<th>Type of income</th>
<th>2017</th>
<th>2018</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>C corporation</td>
<td>35%</td>
<td>21%</td>
<td>-14%</td>
</tr>
<tr>
<td>Individual non-business income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Earned income</td>
<td>43.4%</td>
<td>40.8%</td>
<td>-2.6%</td>
</tr>
<tr>
<td>• Capital gains and dividends</td>
<td>23.8%</td>
<td>23.8%</td>
<td>0%</td>
</tr>
<tr>
<td>• Interest, rents, royalties</td>
<td>43.4%</td>
<td>40.8%</td>
<td>-2.6%</td>
</tr>
<tr>
<td>Individual pass-through income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Active business not subject to SE tax (qualified)</td>
<td>39.6%</td>
<td>29.6%</td>
<td>-10.0%</td>
</tr>
<tr>
<td>• Active business subject to SE tax (qualified)</td>
<td>43.4%</td>
<td>33.4%</td>
<td>-10.0%</td>
</tr>
<tr>
<td>• Active business not subject to SE tax (non-qualified)</td>
<td>39.6%</td>
<td>37%</td>
<td>-2.6%</td>
</tr>
<tr>
<td>• Active business subject to SE tax (non-qualified)</td>
<td>43.4%</td>
<td>40.8%</td>
<td>-2.6%</td>
</tr>
<tr>
<td>• Passive income</td>
<td>43.4%</td>
<td>33.4%</td>
<td>-10.0%</td>
</tr>
</tbody>
</table>

Includes 3.8% Medicare tax on investment income and combined employer and employee Medicare rate on earned income. Assumes 20% deduction in qualified business not otherwise limited. Assumes no C corporation dividends.
Comparison of rates

<table>
<thead>
<tr>
<th>Type of business income</th>
<th>2018 Top rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Pass-through: Active (qualified)</td>
<td>29.6%*/**</td>
</tr>
<tr>
<td>• Pass-through: Passive (qualified)</td>
<td>33.4%*/**</td>
</tr>
<tr>
<td>• C corporation: Distribute all earnings</td>
<td>39.8%*</td>
</tr>
<tr>
<td>• C corporation: Distribute ½ of earnings</td>
<td>30.4%*</td>
</tr>
<tr>
<td>• C corporation: Retain all earnings</td>
<td>21%</td>
</tr>
</tbody>
</table>

*Includes 3.8% Medicare tax on passive income, but not FICA nor SE tax on earned income. Also assumes no AAA available after conversion to C.  
**Assumes 20% deduction not otherwise limited
Net operating loss changes

• C corporations
  – Limits NOL deduction to 80% of taxable income for new NOLs (post-12/31/2017) under section 172
  – Carrybacks repealed, but carryforwards unlimited for new NOLs
  – Old NOLs now usable without AMT issues
  – Section 163(j) interest expense limitations treated like NOLs for section 382 purposes

• Pass-through entities
  – Business losses recognized by individuals can no longer be used to reduce nonbusiness income without limitation, limited to available business income times 80%
  – $500,000 annual limitation on utilization of individual NOL carryforwards
  – Exit gains generally can free up NOLs
New international provisions

• Foreign derived intangible income ("FDII") provisions:
  – Benefit of new 37.5% deduction for intangible income generated by relevant transactions with non-U.S. customers available only to U.S. corporations

• Global intangible low tax income ("GILTI") provisions:
  – Non-corporate (including S corporation) shareholders get taxed on GILTI income at their normal rates
  – C corporation shareholders receive a GILTI deduction (50%), resulting in a nominal rate on GILTI of 10.5%

• Dividends received deduction:
  – New section 245A allows a C Corporation that is a 10% shareholder of a foreign corporation a 100% "dividends received deduction" from the foreign corporation
  – No such deduction available to pass-through entities or individuals
# New international provisions

## C-Corp vs. Pass-through – Incongruity

<table>
<thead>
<tr>
<th>Issue</th>
<th>C-Corp</th>
<th>Pass-through/Individual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend received deduction (10% or more owned foreign corps)</td>
<td>100% dividends received deduction for most dividends</td>
<td>N/A – Subject to statutory rates*</td>
</tr>
<tr>
<td>Foreign branch income</td>
<td>Subject to 21% corporate rate</td>
<td>Subject to statutory rates (generally 37%)*</td>
</tr>
<tr>
<td>50% deduction allowed to offset new global minimum tax</td>
<td>Available to C-Corp</td>
<td>N/A</td>
</tr>
<tr>
<td>37.5% deduction allowed to offset &quot;foreign-derived intangible income&quot;</td>
<td>Available to C-Corp</td>
<td>N/A</td>
</tr>
</tbody>
</table>
# New international provisions

## C-Corp vs. Pass-through – Global intangible low taxed income

<table>
<thead>
<tr>
<th></th>
<th>C Corp</th>
<th>Pass-through</th>
</tr>
</thead>
<tbody>
<tr>
<td>GILTI Inclusion</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Sec. 78 Gross-up</td>
<td>$200</td>
<td>N/A</td>
</tr>
<tr>
<td>Less: 50% GILTI Deduction*</td>
<td>$600</td>
<td>N/A</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$600</td>
<td>$1,000</td>
</tr>
<tr>
<td>U.S. Tax (21% for C Corp, 37% for Pass-through individual owner)</td>
<td>$126</td>
<td>$370</td>
</tr>
<tr>
<td>Less: Foreign Tax Credit (subject to 80% limitation)</td>
<td>$160</td>
<td>N/A</td>
</tr>
<tr>
<td>Net U.S. Tax Due</td>
<td>$0</td>
<td>$370</td>
</tr>
</tbody>
</table>

**Global Effective Tax Rate on Inclusion**

|                                      | 20%     | 57%          |
## New international provisions

<table>
<thead>
<tr>
<th>C-Corp vs. Pass-Through – Foreign derived intangible income deduction</th>
<th>C Corp</th>
<th>Pass-through</th>
</tr>
</thead>
<tbody>
<tr>
<td>FDII Income</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Less: 37.5% FDII Deduction*</td>
<td>$375</td>
<td>N/A</td>
</tr>
<tr>
<td>Less: Pass-through Deduction</td>
<td>N/A</td>
<td>$200</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$625</td>
<td>$800</td>
</tr>
<tr>
<td>U.S. Tax (21% for C Corp, 37% for Pass-through individual owner)</td>
<td>$131.25</td>
<td>$296</td>
</tr>
</tbody>
</table>

**Global Effective Tax Rate on Income**

<table>
<thead>
<tr>
<th>C Corp</th>
<th>13.125%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pass-through</td>
<td>29.6%</td>
</tr>
</tbody>
</table>
State Taxation Differences
State taxation differences

- Corporations - deductibility of SALT
- LLCs, LPs - limit on SALT deductibility by owners
- Effect of state tax rates.
Exit Strategies Impact on Entity Choice
Structural/Process

- Stock sale vs. asset sale
- Tax
- Process - liability issues, 3rd party issues
- IPO - corporate structure favored except in certain industries
- Licensing - tech company exit
Exit Strategies Impact on Entity Choice

- S corporations converting to C corporation cannot go back and escape taxation on asset sale for 10 years
  - 5 years to convert back plus
  - 5 years to run off section 1374 built-in-gains period
- Partnerships appreciating in value cannot convert back (from C corporation to partnership) without incurring double-taxation on gain
- Near-term sale generally a good reason not to convert
- Estate planning strategies may be best implemented as pass-through entity
- Significant distributions to fund owners liquidity needs or estate planning strategy generally a good reason not to convert
- Political uncertainty regarding tax rates and phase-out of QBI deduction
Exit Strategies Impact on Entity Choice

• **C corporation**
  - Gain on exit likely higher, however, all capital gains
  - All owners pay net investment income tax on sale
  - No tax basis step-up to buyer, trade at lesser value
  - Significant difference between stock sale and asset sale; carve outs attract double taxation unless all proceeds reinvested

• **Pass-through entity**
  - Gain on exit likely lower due to increased tax basis; may attract some ordinary income (beware section 1245, 751, section 1221(a)(3))
  - Active owners pay no net investment income tax on sale
  - Higher value proposition to buyer due to step-up availability and full expensing
  - One layer of tax on stock, asset or deemed asset sales including carve out deals
Conversion of Legal Entity Form
Execution and operational issues regarding conversion

- State law process
  - Delaware - separate process for mergers of domestic, foreign corporations and LLCs
- By acquisition
- Transition of form of equity/equity rights
- Transition of governance structures
Tax issues regarding conversion

• Partnership & LLC issues
  – Section 351 qualification
    – Solvency (asset FMV > liabilities FMV) - section 351
    – Business purpose - section 351
  – Built-in-gain (tax basis in assets < FMV assets) - section 362(e)
  – Excess liabilities (tax basis in assets > liabilities) - section 357(c)
  – Tax avoidance purpose (example where shareholders keep cash; loan is assumed by corporation) - section 357(b)
  – Negative tax capital - section 731
  – Decrease in partner's share of liabilities is deemed distribution - section 752(b)
Tax issues regarding conversion

- S corporation issues
  - AAA transition rules
  - QSub section 351 testing and "springing debt"
  - Bailing assets out prior to conversion - sections 311(a) and (b)
- Section 269 and 269A anti-avoidance regimes - does form of transaction matter, e.g. hybrid structures?
- Accumulated earnings tax - section 531
- Personal holding company tax - section 541
- Personal service corporation - section 448
Tax issues regarding conversion

- Accounting method issues
  - C corporations with average annual gross receipts > $25M over three years must use accrual method, except personal service corps
  - Change from cash to accrual for S corporation requires Form 3115 and section 481(a) adjustment (over 4 or 6 years)
  - Change from cash to accrual for partnerships and LLCs is handled prospectively (e.g. A/R is picked up as collected)
  - All new elections must be established for C corporation converting from partnership, except for depreciation
  - For partnerships, all revenue deferred under Rev. Proc. 2004-34 is accelerated upon conversion
  - LIFO layers collapse if LIFO is re-elected by partnership