CLIENT ALERT (see disclaimer at the end of the article)

Change Your S-Corp to a Partnership to Take More Advantage of the Pass-Through Tax Deduction

The Tax Cuts and Jobs Act of 2017, signed into law by President Trump on December 22nd, 2017 (the “Tax Cuts and Jobs Act”), added Code Section 199A to the Internal Revenue, which provides for up to a 20% deduction applicable to pass-through income, including income from S-Corps, partnerships, and sole proprietorships. Given this new deduction, it is within an owner of a pass-through’s interest to maximize what the IRS refers to as Qualified Business Income (“QBI”) which is defined as income net of any deductions or losses from a qualified business or trade, including any wages paid by the pass-through entity. The IRS requires that shareholders of S-Corps who perform services for the S-Corp must have a portion of their distributive share from the S-Corp and other payments be classified and treated as wages so that the amounts are reasonable compensation for services rendered. Consequently, all S-Corp shareholders who perform services for the S-Corp must receive reasonable wages which will necessarily reduce the amount of QBI available for the 20% deduction provided by §199A.

In order to remedy this potentially disadvantageous side-effect of being organized or treated as an S-Corp, it might be advisable, depending on taxable income, for entities to consider changing their taxable form to partnerships or sole proprietorships, as these types of entities are not required to compensate service providing shareholders with reasonable wages. Such a switch will affect many other tax elements, such as self-employment tax and Medicare tax liability. Furthermore, various states tax law regimes have laws specific to pass-through entities that may or may not be applicable depending on the structure of the entity. Because such a structural change will affect how income to individual shareholders is taxed at a statewide level, as well as at a federal level, it is highly recommended that tax advisors and counsel be consulted to determine the most tax efficient manner for taking full advantage of the §199A 20% income deduction.

Take Advantage of Accelerated Depreciation and Expensing of Certain Business Related Assets.

Under the Tax Cuts and Jobs Act, more business assets may be immediately expensed under Sections 179 and 168(k) of the Internal Revenue Code (the “Code”). As such, taxpayers may wish to make certain acquisitions or improvements before year- end. Although there is some overlap between what assets would be eligible for expensing under Sections 168(k) and 179 of the Code, a taxpayer is entitled to take advantage of both provisions, even for the same assets.

Section 179 permits a taxpayer to elect to take an immediate expense deduction of all or part of the cost of certain business assets (“Section 179 Property”) placed in service during a given tax year, without capitalization. The maximum expense deduction is $1 million for the 2018 tax year (up from $500,000), reduced dollar by dollar to the extent the cost of Section 179 Property placed in service during the taxable year exceeds $2.5 million (up from $2 million; and such that the expense deduction is completely phased out once such cost equals or exceeds $3.5 million).The expense deduction is further limited to the amount of taxable income derived from the active conduct of any trade or business, provided, however, that a disallowed deduction due to income may be carried over under certain conditions.

Section 179 Property is defined as property which is (i) tangible property subject to cost recovery depreciation deductions or certain computer software subject to depreciation under the Code, (ii) certain personal or other property specified under the Code or, at the election of the taxpayer, “qualified real property” which includes (a) "qualified improvement property", defined as expenditures for interior improvement work (including leasehold improvements) to non-residential buildings, other than expenditures for building enlargement, elevators or escalators, or the internal structural framework of a building and (b) new roofs, HVAC systems, fire protection and alarm systems, and security systems; and (iii) acquired by purchase for use in the active conduct of a trade or business (but not from a related party and the basis of the property must not be determined by reference to the adjusted basis of the seller). Although an expensing deduction may be taken for certain passenger vehicles used for the business, there are certain limitations and exclusions.

Under Section 168(k), a first-year 100% bonus depreciation (up from 50%) applies to wide range of qualified new and used business assets acquired after September 27, 2017 and placed in service before January 1, 2023 (from 2023 to 2026, the available bonus depreciation is phased out). The original use of the asset must begin with the taxpayer or, if already used, must not have been used by the taxpayer prior to acquisition. Qualified assets include property with a recovery period of 20 years or or less (which, due to a technical error under the law, would not include "qualified improvement property" as such property has a longer recovery period), certain computer software, water utility property, qualified film or television production, qualified live theatrical production, vehicles used for business (subject to certain limitations), and certain other property. However, qualified assets do not include any assets to which the alternative depreciation system applies (such as may be required when electing to avoid interest limitation rules). Additionally, the assets cannot be acquired from a related party and the basis of the of the property must not be determined by reference to the adjusted basis of the seller.

The attorneys of DarrowEverett have experience and expertise in both personal and business tax areas, providing our clients with a full range of services. The attorneys of DarrowEveret's Tax Practice Group understand that tax is an ever evolving practice and strive to stay on top of all current developments that may affect our clients' interests. Should you have any questions regarding tax deductions, please do not hesitate to contact any member of the DarrowEverett Tax Practice Group.

*Article written by Kevin P. Gildea, Esq., of DarrowEverett's New York City office and Eric J. Rietveld, Esq., of DarrowEverett's Providence office.

CONTACT US

If you would like to learn more about how to take more advantage of the Pass-Through Tax Deduction or think our legal team can assist you with an upcoming project, please contact an office near you or visit our website, **www.darroweverett.com** for more information.

PROVIDENCE OFFICE
One Turks Head Place
Suite 1200
Providence, RI 02903
tel: (401) 453-1200
fax: (401) 453-1201

NEW YORK OFFICE
450 Seventh Avenue
Suite 1802
New York, NY 10123
tel: (212) 335-2090
fax:(212) 335-2091

FLORIDA OFFICE
101 NE Third Avenue
Suite 1500
Ft. Lauderdale, FL 33301
tel: (954) 278-8355

BOSTON OFFICE
One Boston Place
Suite 2600
Boston, MA 02108
tel: (617) 443-4500
fax: (617) 933-1400

WORCESTER OFFICE
11 Pleasant Street
4th Floor
Worcester, MA 01609
tel: (508) 757-3300

SOUTH COAST OFFICE
10 North Main Street
3rd Floor
Fall River, MA 02720
tel: (508) 675-1576
fax: (508) 672-6196