"The newfound advantages of a C corporation are clear: the top federal rate dropped to 21% and the cash method of accounting is now available until average gross receipts exceed $25 million. Add to these benefits 100% asset expensing and the ability to provide tax-free fringe benefits to shareholder/employees, and it is easy to see why C corporations are going to be more attractive at all stages of the business life cycle."

Ryan C. Gaglio
Shareholder

Stradling
Attorneys at Law

The Topsy-Turvy World of Post-Tax Cuts and Jobs Act Planning

As a tax lawyer, I've gotten used to a lot of things, but cocktail-hour popularity isn't usually one of them.

However, beginning just in time for last year's holiday parties and continuing through to today, I've found myself in the unusual position of at least *appearing* to be popular, and I've got the Tax Cuts and Jobs Act (TCJA) to thank for it. The TCJA has renewed everyone's focus on taxes and tax planning – in many cases upending decades of bedrock tax advice.

What type of entity should I use to operate my business?
My answer was almost always the same: S corporation or partnership (technically, an LLC taxed as a partnership). Why? Simple: The "double tax" inherent in operating as a C corporation was just too punitive for most profitable businesses.

Pre-TCJA law meant that a C corporation paid taxes on corporate-level income at a rate of nearly 35%. A subsequent distribution of cash is then taxed to shareholders at a top rate of 23.8%. Distributions of appreciated assets are treated as if the corporation sold those assets for their fair market value, which means that selling shareholders of C corporations are always going to sell stock and thus unable to negotiate higher selling prices based on buyers' basis step-up because buyers won't get one.

Meanwhile, owners of S corporations and LLCs taxed as partnerships pay taxes on the income earned by the business only once – at the owner level – at a top federal tax rate of 39.6% under pre-TCJA law. Compare this to the two-level tax rate on owners of C corporations and throw into the mix the ability of buyers to obtain a basis step-up in the assets and thus a potential willingness to pay higher prices in sales of flow-through businesses, and it's easy to see why C corporations have long been relegated to the entity choice of last resort for most of my clients.

But in the topsy-turvy world of post-TCJA planning, C corporations are going to be more popular than ever.

The newfound advantages of a C corporation are clear: the top federal rate dropped to 21% and the cash method of accounting is now available until average gross receipts exceed $25 million. Add to these benefits 100% asset expensing and the ability to provide tax-free fringe benefits to shareholder/employees, and it is easy to see why C corporations are going to be more attractive at all stages of the business life cycle.

Don't forget about Section 1202.
Because C corporations are going to enjoy a post-TCJA jump in popularity, you'll also want a refresher on the benefits of Section 1202, which is exclusively available to C corporations and their shareholders.

Section 1202 provides an exclusion from gains upon the sale of stock in a "qualified small business" (QSB). This is nothing new; it's just that until fairly recently, the benefits weren't all that great. Before 2010, if you sold QSB stock, 50% of the gain was excluded. As attractive as that sounds, the remaining 50% of the gain was taxed at 28%, meaning the federal tax rate on the total gain was 14%, which was a one percent benefit over the long-term capital gain rate of 15% at the time. Also, seven percent of the gain was treated as a preference under the Alternative Minimum Tax, thereby rendering Section 1202 mostly useless.

In 2010, Section 1202 was amended to provide that QSB stock acquired after September 27, 2010 would be eligible for a 100% exclusion when sold. In the world of taxes, that's about as good as it gets.

To qualify, the corporation and its shareholders have to jump through a handful of hoops – many of which they were probably going to sail through anyway:

- The stock must be originally issued by a business that does not have aggregate assets in excess of $50 million and is engaged in an active trade or business that isn't a service business, such as health, law or engineering, or a financial business, *i.e.*, banking, insurance or financing.
- The shareholder must acquire the stock at its "original issuance" in exchange for money, property or services.
- At least 80% of the corporation's assets must be used in the active conduct of one or more qualified businesses.
- The corporation must not have engaged in certain redemptions from the shareholder or other shareholders during various periods of time beginning two years before the issuance of stock to the shareholder and ending two years after the issuance.

If you meet these along with a few additional requirements, and hold the stock for at least five years before selling, then upon sale you can exclude 100% of the gain up to the greater of $10 million or 10 times the basis of the stock.

By now the popularity of C corporations should start to make sense. If the new federal corporate rate is 21%, and there is the potential to sell C corporation stock after five years without paying tax, then C corporations – and perhaps their tax lawyer advisers – start looking a lot better than they used to. Sure, C corporations still have to deal with two levels of tax, and so on a year-by-year and cash-flow basis, a flow-through entity may still come out ahead (and TCJA includes some added benefits for businesses structured as flow-throughs). However, the benefits of Section 1202 in a sale of a C corporation can potentially overwhelm the year-by-year benefits of a flow-through entity. With some prior planning, it may even be possible to multiply the $10 million exclusion for trust beneficiaries by gifting QSB stock to one or more irrevocable trusts sufficiently in advance of a sale.

The popularity of tax lawyers following the enactment of TCJA won't last long. The resurgence of C corporations, however, will likely prove to be one of TCJA's more enduring legacies.

Ryan C. Gaglio
Ryan Charles Gaglio is a shareholder in Stradling's Corporate and Tax practice groups. Ryan focuses on tax planning, tax controversy and transactional matters. He advises clients on the federal, state and local tax consequences of mergers and acquisitions, bankruptcies and workouts, and executive compensation, as well as on sales, use and property tax matters. Contact him at 949-725-4042 or rgaglio@sycr.com.