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How the Tax Proposals May Impact Your Business:

Flow-Through versus Corporate Structure

If you've been following the U.S. tax reform process, you are probably aware of some of the tax rules that have been targeted for modification. The House of Representatives passed the Tax Cuts and Jobs Act on November 16, 2017. This Act provides for significant changes to the US taxation of both individuals and businesses. Some of the proposed changes are as follows:

- Reduction of individual tax brackets from 7 to 4;
- Increase of standard deductions, while eliminating many individual tax deductions currently allowed;
- Reduction of the corporate tax rate from 35% to 20%;
- Creates a 25% maximum tax rate on pass-through business income (for non-active partners or members), and (for active partners or members) assumes 70% of business income is compensation subject to ordinary rates while 30% is business income subject to the 25% rate;
- Extends Net Operating Loss carryover to an indefinite time period, while restricting the NOL carryover deduction to 90% of current taxable income; it eliminates the 2 year carryback rule;
- Eliminates the Section 199 manufacturing deduction;
- Eliminates Alternative Minimum Tax for individuals and corporations;
- Moves to a "quasi" territorial tax system;
- Allows full expensing of certain capital assets for five years; and
- Provides for deemed repatriation of currently deferred foreign earnings and profits at a rate of 14% for cash and cash-equivalent profits and 7% for illiquid holdings of reinvested foreign earnings.

It is important for business owners to not only understand the impact these proposed changes could have on them and their businesses, but to determine if they should implement any changes to their business operations or structure as a result of the U.S. tax reform. It should be noted that the Senate version passed by the Senate Finance Committee has some differences from the version passed by the House.

Flow-through vs. Corporate Structure

As mentioned above, the proposed Act creates a 25% maximum tax rate on pass-through business income, but only for partners and members who are not actively involved in the business. Unfortunately, it provides a presumption that 70% of income derived from a flow-through business that is earned by an active partner or member of the business should be treated as compensation and taxed at ordinary rates (up to 39.6%). The remaining 30% of business income would be treated as income for active owners, and taxed at the 25% rate. Passive flow-through income (e.g., investment of passive assets) would not be subject to this 70/30 split. Rather, 100% of passive flow-through income would be taxed at a rate up to 39.6%. Service businesses would also not receive any of the favorable 25% rate.

This will mean that the effective rate for partners and members of flow-through entities that are not service businesses would pay an effective tax rate of approximately 35.22%. Since corporations will be taxed at a 20% rate, the effective tax rate after distributions as qualified dividends will be approximately 39% (at the maximum rate). The second layer of tax on the distribution would not be paid until distributions are actually made.

A U.S. individual that currently operates a flow-through business overseas may want to consider making an entity classification election to treat the foreign business as a corporation. Under the proposed rules, as written, business income from overseas operations for an active partner or member of the business would be subject to a blended rate of 35.22% (70% of income at 39.6% + 30% of income at 25%) as a flow-through business. If the overseas business is operated through a foreign corporation, it would be subject to the rate in the foreign location (which might be less than 20% in certain situations).

Distributions from the foreign corporation would then be taxed at the qualified dividend rate of 20% plus the 3.8% net investment income tax. If the foreign tax rate is 20%, the effective tax rate might be 39%. However, the additional tax is deferred until repatriated. At a low enough foreign rate, it might even be less than for the flow through situation.

If a tax bill becomes law with an effective date of January 1, 2018, taxpayers may have until March 16, 2018 to make an entity classification election effective back to this date.

The above is just one example of actions taxpayers should consider in anticipation of, or because of, the passing of the proposed Tax Act by the House. The international tax consultants at Moore Stephens Doeren Mayhew are available to discuss the proposed tax law changes, how they may impact your business, and actions you may want to consider in light of the upcoming tax reform.