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[Q&A]

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The new act was a bundle of compromises hobbled together to fit within congressional deficit limitations. The resulting benefits are more complicated and less favorable than originally promised. However, significant benefits are available to domestic middle-market companies. We are focusing our time analyzing clients' businesses to take advantage of the opportunities, and determine ways to steer clear of new limitations under the act.

Much of the analysis for clients is around two provisions. First, the tax rate for C corporations was reduced from 35% to 21%. Second, to reduce the disparity between C corporation rates and effective tax rates for pass-through entities, a business deduction of up to 20% is available, thereby reducing the effective tax rate for pass-through income.

Consequently, clients are asking whether it's time to convert to a C corporation. While tax rates have changed, the analysis is the same. One must first determine the long-term plan for the company. Key considerations are whether it's growing rapidly with potential for dividends, or may be planning for a liquidity event. Either situation could result in a less favorable rate for C corporations. Shareholders pay tax on dividends received, while the corporation receives no deduction. For example, a corporation with net income of $100 paying out a $50 dividend will pay $21 federal tax. The shareholders pay another $10 federal tax on the dividends. The effective tax rate of this "double tax" is 31%. A C corporation selling assets will pay 21% federal tax on the gain, and shareholders pay 20% federal tax on remaining proceeds on redemption of shares. Depending on the basis of assets, that could amount to an almost 37% combined federal tax rate.

If the entity remains a pass-through, it pays no federal tax, but owners would pay graduated tax rates of up to 37% on their share of the income. Under the new act, owners of pass-throughs may be eligible for a 20% deduction.

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Complex limitations based on type of activity, wages, depreciable basis and overall income must be navigated. Assuming the same taxable income as the example above, pass-through owners may find themselves in a similar or better after-tax position. After a pass-through deduction of $20, resulting income passed through to owners of $80 would incur a tax of almost $30—an effective rate of 30% on the company's net income of $100.

Other benefits for clients include the repeal of corporate alternative minimum tax and increases to individual AMT exemptions; increased expensing of assets and first-year depreciation; relaxed accounting method rules for businesses under $25 million; and increased estate tax exclusion.

Important limitations were also contained, including on net operating loss utilization; a $10,000 cap on itemized state and property tax deductions; a net business interest expense limitation; a $500,000 limitation on use of business losses; carried interests under three years; and elimination of personal property exchanges.