THE DEVIL IN THE DETAIL: CHOOSING A U.S. BUSINESS STRUCTURE POST-TAX REFORM

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INTRODUCTION

Prior to 2017 U.S. tax reform legislation (the "T.C.J.A."), the higher corporate income tax rate made it much easier to decide whether to operate in the U.S. market through a corporate entity (*i.e.*, a C-corporation) or a pass-thru entity (*i.e.*, a partnership or limited liability company ("L.L.C."), or a corporation that has elected S-corporation status). With a Federal corporate income tax rate of up to 35%, a Federal qualified dividend rate of up to 20%, and a Federal net investment income tax on the distribution of 3.8%, the effective post-distribution tax rate was 50.47% pre-T.C.J.A. This did not include potential state and local taxes. In contrast, assuming an active business, a pass-thru entity would have resulted in only one level of Federal tax of up to 39.6% for individual owners.

With the post-tax reform corporate income tax rate of 21% and the introduction of the qualified business income ("Q.B.I.") and foreign derived intangible income ("F.D.I.I.") deductions, this choice is no longer apparent. This is even more true when taking into account the net investment income tax ("N.I.I.T."), self-employment tax, and state and local tax exposures.

This article looks into some important tax considerations for an individual planning to start a U.S. business. While this article does not attempt to look at all relevant provisions in detail, it highlights potential points of friction. It does not focus on non-Federal tax issues or non-tax considerations, such as limits on the number or types of shareholders.

PROS AND CONS

Now, more than ever, and as shown below, pro-forma tax returns and short- and long-term investment goals are key to structuring the most tax-efficient entity.

Taxpayers must weigh the positives associated with C-corporation status:

- A 21% flat Federal rate of tax
- In certain cases, the ability to qualify for the qualified small business stock ("Q.S.B.S.") exemption for capital gains on a sale (or potentially no tax in the case of a foreign investor)
- A special reduced tax rate on export activities

And they must consider the negatives:

- A second level of tax upon distribution

- The N.I.I.T. on dividends
- The possibility of the accumulated earnings tax ("A.E.T.") or personal holding company tax

On the pass-thru entity side, there are also numerous positives:

- One single level of tax
- The possibility of a reduced rate of tax if the entity is eligible for the 20% Q.B.I. deduction
- The ability to pass losses on to equity holders
- The ability to increase tax basis for undistributed earnings
- Avoidance of the A.E.T.

And these must be compared with the disadvantages:

- The possible imposition of self-employment tax on all earnings (except in the case of an S-corporation, where self-employment tax may be limited to wages)
- The possibility of the N.I.I.T. on passive income
- The possibility of facing the highest individual tax rates
- The possible recognition of ordinary income on the sale of a partnership or L.L.C. interest and, in the case of a foreign investor, possible tax on capital gain income on the sale of a partnership or L.L.C. interest

THE N.I.I.T.

U.S. individuals, trusts, and estates are subject to the 3.8% N.I.I.T. on the lesser of (i) their net investment income or (ii) the excess of (a) their modified adjusted gross income over (b) $250,000 (for married taxpayers filing jointly).

U.S. and foreign corporations, foreign trusts, and nonresident alien individuals are not subject to the N.I.I.T.

For this purpose, net investment income is defined as the excess of the following over appropriately allocable deductions:[1]

- Gross income from interest, dividends, annuities, royalties, and rents derived in a trade or business of trading in financial instruments or commodities, or in a trade or business in which the taxpayer does not materially participate
- Gross income from interest, dividends, annuities, royalties, and rents derived in a for-profit activity that is not a trade or business

[1] Code §1411(c)(1).

- Net gain from the disposition of property held in a trade or business of trading in financial instruments or commodities, or in a trade or business in which the taxpayer does not materially participate
- Net gain from the disposition of property held in a for-profit activity that is not a trade or business

A special rule exists for the disposition of partnership and S-corporation interests. The capital gain generated from such a sale is subject to the N.I.I.T. only to the extent of the net gain that the transferor would take into account as net investment income if all property of the partnership or S-corporation was sold for fair market value immediately before the disposition of the interest. Otherwise, to the extent the partnership or S-corporation's activity is not passive and constitutes a trade or business, the income flowing up to the partner or shareholder is not subject to the N.I.I.T.[2]

Thus, one important aspect in comparing C-corporation investments with pass-thru entity investments is whether the underlying activity constitutes an active or passive trade or business. If the activity constitutes a passive activity, the N.I.I.T. will apply in either case.[3]

SELF-EMPLOYMENT TAX

A U.S. individual is subject to self-employment tax on his or her net income from any trade or business he or she carries out.[4] In addition, an individual is also subject to self-employment tax on his or her share of trade and business income of a partnership in which he or she is a partner.

"If the activity constitutes a passive activity, the N.I.I.T. will apply in either case."

S-corporations, although transparent for Federal income tax purposes, are not transparent for Federal self-employment tax purposes.[5] Shareholders of S-corporations are generally only subject to self-employment taxes on their wages and not on their part of the S-corporation's income.

Q.S.B.S.

Under the Q.S.B.S. regime, a U.S. resident investing in Q.S.B.S. could be partially or totally exempt from U.S. capital gains tax upon a sale, assuming that a statutory five-year holding period has been met.[6] Further, and depending upon the residence of the individual, the capital gain could also benefit from an exemption at the state and local levels. Finally, the excludable gain is not subject to N.I.I.T.

The following cumulative requirements must be met for the issuing entity to be a qualified small business on the date of the issuance (the "Q.S.B. Test"):

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2 Code §1411(c)(4)(A).

3 On dividend distributions received by the individual from the C-corporation and on the individual's share of partnership income.

4 Code §1402(a).

5 Code §1402(a); Rev. Rul. 59-221.

6 Corporate investors are excluded from this provision (Code §1202(a)(1)). Please refer to "Qualified Small Business Stock & the EB-5 Visa Program – An Attractive Combination for Potential Investors" for more details on this regime.

- The issuing entity is a U.S. C-corporation.[7]
- The aggregate gross assets of the corporation (or a predecessor) do not exceed $50,000,000 from August 10, 1993, until immediately after the issuance of the stock for which preferential treatment is sought.[8]
- The issuing corporation submits reports to its shareholders and the I.R.S. as the I.R.S. may require.[9] (Although the Secretary has authority to require certain reporting obligations, no such regulations have been published yet.)
- During substantially all of the taxpayer's holding period for the stock, at least 80% of the corporation's assets have been used in the active conduct of a trade or business that is in a category *other than* any of the following:
  - Professional services (such as health, law, engineering, architecture, and brokerage services)
  - Banking, insurance, financing, leasing, or similar businesses
  - Farming
  - Mining or natural resource production or extraction
  - Operating a hotel, motel, restaurant, or similar business

For the purpose of the gross asset requirement, cash and the adjusted bases of property held by the corporation constitute "aggregate gross assets."[10] As a result, the post-issuance growth of a start-up does not disqualify such corporation from meeting the Q.S.B. Test.

All corporations that are part of the same parent-subsidiary controlled group will be treated as one person.[11] A parent-subsidiary controlled group is constituted by one or more chains of corporations connected through ownership with a common parent.[12] A 50% ownership test (by vote or value) must be met for the corporations to be part of said controlled group.

Foreign corporations that are only subject to U.S. tax pursuant to Code §881 are excluded from the definition of a member of a controlled group. Thus, absent effectively connected income ("E.C.I."), a foreign corporation is excluded from the definition of a controlled group.

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[7] Code §1202(d)(1).

[8] Code §§1202(d)(1)(A), (B).

[9] Code §1202(d)(1)(C).

[10] Code §1202(d)(2). For assets contributed to the corporation, the basis is the fair market value of the contributed assets immediately after the contribution.

[11] Code §1202(d)(3)(A).

[12] Code §1202(d)(3)(B). Direct ownership and constructive ownership rules under Code §§1563(e)(1), (2), and (3) apply.

PERSONAL HOLDING COMPANY REGIME

A personal holding company is any corporation meeting both of the following requirements:[13]

- Items of personal holding company income comprise at least 60% of adjusted ordinary gross income for the taxable year.
- At any time during the last half of the taxable year, more than 50% of the outstanding stock, measured by reference to value, is owned, directly or indirectly, by or for not more than five individuals. In broad terms, family groups are treated as a single shareholder. Consequently, shares of stock owned directly or indirectly by an individual's brothers, sisters, spouse, ancestors, and lineal descendants are attributed to that individual.[14] Also, stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is attributed proportionately to shareholders, partners, or beneficiaries.[15]

Foreign corporations[16] are excluded from personal holding company status.

"The A.E.T. was enacted in order to incentivize corporations to distribute dividends to shareholders."

Personal holding company income includes dividends, interest, and adjusted income from rents.[17]

When a corporation is a personal holding corporation, it is subject to the regular corporate income tax and to an additional 20% tax on the undistributed personal holding company income.[18] Undistributed personal holding company income is the income determined for regular income tax purposes, with certain adjustments.

A.E.T.

The A.E.T. was enacted in order to incentivize corporations to distribute dividends to shareholders. It does this by imposing a tax on unreasonable accumulations of earnings. The tax is imposed when a corporation allows earnings to accumulate instead of being distributed.[19] Only C-corporations are subject to this additional tax. The tax does not apply if the personal holding company tax already applies. The now-reduced corporate tax rates have breathed new life into this provision.

The fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business is determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation, by the

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13 Code §542.

14 Code §544(a)(2).

15 Code §544(a)(1).

16 Code §542(c)(5).

17 Code §543(a)(1). It also includes certain income from mineral, oil, and gas royalties; certain copyright royalties; certain produced film rents; rents from 25% shareholders; and certain personal service contracts (Code §543(a)(2)).

18 Code §541.

19 Code §532(a).

preponderance of the evidence, proves otherwise.[20] The fact that any corporation is a mere holding or investment company is *prima facie* evidence of the purpose to avoid the income tax with respect to shareholders.[21]

For most other corporations, whether a tax avoidance purpose exists depends on the facts and circumstances of each case.[22] Factors indicative of a tax avoidance purpose include the following:

- Dealings between the corporation and its shareholders, such as personal loans to the shareholders or expenditures by the corporation for the personal benefit of its shareholders[23]
- Investment of undistributed earnings in assets having no reasonable connection with the business of the corporation[24]
- The dividend history of the corporation[25]
- Whether shareholder-employees are undercompensated[26]

If the A.E.T. applies, it is imposed in addition to the income tax. The rate is 20% of the accumulated taxable income.[27]

Reasonable needs of the business include the following:

- The reasonably anticipated needs of the business, such as plant expansion, market expansion, expansion, or product line[28]
- Accumulations that will be used to make distributions in redemption of stock to pay death taxes of a shareholder[29]
- Accumulations to retire *bona fide debt*[30]

The A.E.T. can be easily avoided if distributions are made regularly or the corporation's earnings are used for business.

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20 Code §533; Treas. Reg. §1.533-1(a)(1).

21 Code §533.

22 Treas. Reg. §1.533-1(a)(2).

23 Treas. Reg. §1.533-1(a)(2)(i). *See also, e.g.*, *Herzog Miniature Lamp Works, Inc. v. Comr., 481 F.2d 857 (2d Cir. 1973).*

24 Treas. Reg. §1.533-1(a)(2)(ii).

25 Treas. Reg. §1.533-1(a)(2)(iii). See also*, e.g., Doug-Long, Inc. v. Comr., 72 T.C. 158 (1979).*

26 *Herzog,* 481 F.2d 857.

27 Code §531.

28 Treas. Reg. §1.537-1(a). A prudent-businessperson standard is used for this purpose, and the retention must be for *bona fide* business purposes.

29 Code §§535(c)(3). When the corporation is a mere holding or investment company, the credit is limited to the amount (if any) by which $250,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

30 Treas. Regs. §1.537-2(b)(3).

SALE OF A PARTNERSHIP INTEREST

As a general rule, the sale of a partnership interest results in capital gains treatment, with the exception of amounts attributable to inventory items and unrealized receivables of the partnership.[31] Since non-U.S. taxpayers are generally exempt from U.S.-source capital gains, a sale by a foreign partner of his or her partnership interest should logically be exempt from U.S. tax.

"An individual investor who may leave the U.S. in the long-term and wishes to ultimately exit the investment may be better advised to invest through a C-corporation."

However, new Code §864(c)(8) provides that gains or losses realized upon the direct or indirect disposition of a U.S. partnership interest by a non-U.S. partner generally constitute E.C.I. to the extent that a fair-market-value sale by the partnership of all its assets would have generated effectively connected gain or loss in the hands of the transferor partner.[32]

Code §1446(f) provides that if any gain on the disposition of a partnership interest is treated as E.C.I. pursuant to Code §864(c)(8), the transferee must withhold 10% of the amount realized on the sale. Here is the problem. The amount realized includes not only payments made by the purchaser but also the amount of the seller's distributive share of partnership debt. That share provided the selling partner with basis in the partnership interest at the time of acquisition or refinance. When that share of debt is eliminated as a result of the sale, the partner is considered to realize additional amounts in the sale.

As a result of the above, an individual investor who may leave the U.S. in the long-term and wishes to ultimately exit the investment may be better advised to invest through a C-corporation.

Q.B.I.

Taxpayers other than corporations may be allowed a deduction of up to 20% of the excess of the taxpayer's taxable income over the taxpayer's net capital gain.[33] This deduction can be less if the taxpayer's combined qualified business income amount ("C.Q.B.I.A.") is less. As a result, and to the extent the taxpayer has C.Q.B.I.A., the allowable deduction is capped at 20% of the excess of the taxpayer's taxable income over the taxpayer's net capital gain.

For this purpose, C.Q.B.I.A. is the sum of the following:

- The taxpayer's deductible amount for each trade or business carried on by the taxpayer
- 20% of the aggregate amount of the qualified real estate investment trust ("R.E.I.T.") dividends and qualified publicly traded partnership income of the taxpayer

The taxpayer's deductible amount for each trade or business is the lesser of the following:

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31 Code §§741; 751(a).

32 For more on this topic, see "Foreign Investor in a U.S. L.L.C. – How to Minimize Withholding Tax on Sale of L.L.C. Interest" and "Proposed Code §864(C)(8) Regulations Codify Tax on Gain from Sale of Partnership Interest."

33 Code §199A.

- 20% of the taxpayer's Q.B.I. with respect to the qualified trade or business
- The greater of (i) 50% of the W-2 wages with respect to the qualified trade or business, or (ii) the sum of 25% of the W-2 wages and 2.5% of the unadjusted basis immediately after acquisition of all qualified property

Q.B.I. is the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Several items are excluded from the definition of Q.B.I. including, in relevant part the following:[34]

- Reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business
- Any guaranteed payment described in Code §707(c) paid to a partner for services rendered with respect to the trade or business
- To the extent provided in regulations, any payment described in Code §707(a) to a partner for services rendered with respect to the trade or business
- A specified service trade or business ("S.S.T.B.")
- The trade or business of performing services as an employee

An S.S.T.B. is any of the following:

- Any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services
- Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners
- Any trade or business involving the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in Code §475(c)(2)), partnership interests, or commodities (as defined in Code §475(e)(2))

The benefit of the deduction may still be partially available to certain taxpayers having an S.S.T.B. with taxable income not exceeding $207,500 ($415,000 for joint filers).[35]

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[34] Code §§199A(c)(4), (d). Also excluded from the definition are qualified R.E.I.T. dividends, qualified publicly traded partnership income, short-term capital gains, short-term capital losses, long-term capital gains, long-term capital losses, dividends, certain dividend equivalents, payments in lieu of dividends, interest income not allocable to a trade or business, certain commodities transaction related income, certain foreign currency gains, certain income from notional principal contracts, and certain amounts received from an annuity. See Code §§199A(c)(1), (3)(B).

[35] Code §199A(d)(3).

Further, in the case of a partnership or S-corporation, the above determinations must be made at the partner or shareholder level and each of the above described items must be allocated to the partner or shareholder.[36]

As a result of the above, if the investor wishes to invest in a qualified business that is capital or wage loaded, it may make sense to invest through a U.S. partnership or single member L.L.C. to take advantage of the Q.B.I. deduction.

F.D.I.I.

F.D.I.I. constitutes a taxable U.S. corporation's income from specified export activities.[37] More precisely, the F.D.I.I. regime allows for a reduced corporate tax on hypothetical intangible income used in a U.S. business in exploiting foreign markets. Under the F.D.I.I. rules, the hypothetical intangible income is reduced by a 37.5% deduction, which is intended to result in an effective Federal corporate income tax rate of 13.125% for a U.S. corporation.[38] It is important to note that, due to the way F.D.I.I. is computed, the effective rate on export income is generally higher than 13.125% under this rule.

As a result, if an investor wishes to conduct an active business in the U.S. that will service both the U.S. and foreign markets, *pro-rata* tax returns should be run to compare the benefits of the Q.B.I. regime for pass through entities and the F.D.I.I. regime for C-corporations. Another option may be to start by operating through an L.L.C. and, at a later date, when F.D.I.I. appears more beneficial than Q.B.I., have the L.L.C. elect to be treated as a corporation for U.S. tax purposes. Here again, careful consideration must be given to the additional income tax on dividend distributions, increased by the N.I.I.T. on such distributions.

CONCLUSION

More than before, planning for U.S. businesses owned by individuals requires a careful analysis of the pros and cons of each structure. As is often stated, "The devil is in the detail." Among important factors to be taken into consideration are the nature of the business, the target market, and the long-term goal of the investor. "Detail," such as the N.I.I.T., the personal holding company tax, or the A.E.T., can tip the balance one way or the other for the individual investor.

36 Code §199A(f).

37 For further discussion of the F.D.I.I. regime, see "Proposed F.D.I.I. Regulations: Deductions, Sales, and Services."

38 For tax years beginning after December 31, 2025, the allowable deduction is decreased, and the effective tax rate will be 16.406% (Code §250(a)(3)(A)).