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# FLYNN LAW NEWSLETTER

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This edition of the Flynn Law Newsletter focuses on certain planning opportunities for creating (or converting) new or existing entities. The first article explains (very generally) the relatively new tax deduction for pass-through entities and sole proprietorships which was passed a part of the Tax Cuts and Jobs Act of 2017.

The second article discusses a rarely used entity called a "close" corporation. A close corporation is no different from a "regular" corporation, except the traditional corporate formalities which apply to corporations (e.g., shareholder meetings, board meetings, minutes, etc.) need not be observed. Close corporations can also be structured to be run more like a partnership than a traditional corporation, which offers great flexibility for small corporations or corporations with a single owner.

The final article puts some of the first two articles together and explains how, with minimal planning, one can enjoy considerable tax savings by converting to a close corporation taxed as an S-corporation and paying the corporation's owner a reasonable salary. Compared to a professional operating as a sole proprietorship or a limited liability company, this method can result in tax savings of ten thousand dollars a year (or more).

## QUALIFIED BUSINESS INCOME DEDUCTION

*Understanding the New Tax Break for Pass-Through Entities*

Many are aware that the Tax Cuts and Jobs Act of 2017 (TCJA) significantly reduced corporate tax rates. To achieve some degree of parity for pass-through entities (like limited liability companies, S-corps and sole proprietorships), the TCJA also includes a "qualified business income deduction" (the QBID) which can, in some cases, equate to a 20% deduction against income from pass-through entities.

***The Basics***. The QBID is incredibly complex, but understanding the new deduction is not as complex from a 10,000-foot level. Under the TCJA, a deduction is allowed against "qualified business income" (meaning income from a pass-through entity or sole proprietorship) in an amount equal to *the lesser of*:

- 20% of the taxpayer's qualified business income; or
- 50% of the W-2 wages with respect to the qualified trade or business.

***An Example***. Let's take a simple example to show how this works. Suppose John runs a widget company known a Widgets, LLC. John is unmarried and is the sold member of Widgets, LLC. John has one employee whom he pays $50,000 per year. The net income from Widgets, LLC is $100,000 which passes through to John on his personal return.

Under the TCJA, John is entitled to a deduction equal to the lesser of 20% of the net income from Widgets, LLC, or 50% of the W-2 wages paid by Widgets, LLC. Here, the lesser amount is $20,000 (20% of $100,000 net income) as opposed to $25,000 (50% of $50,000 W-2 wages).

> *THE QBID ALLOWS PASS-THROUGH ENTITIES AND SOLE PROPRIETORSHIPS TO DEDUCT THE LESSER OF 20% OF NET INCOME OR 50% OF W-2 WAGES*

The deduction would reduce John's taxable income from $100,000 to $80,000 and would result in a federal tax savings of $4,750.

***Service Entities***. The situation is a bit different for certain for certain "service" entities. This includes professionals such as lawyers, accountants, brokers, financial planners and others whose income is derived primarily from the provision of services (as opposed to selling things). (Apparently the architects and engineers have a powerful lobby since they have been expressly excluded from the definition of "service" entities.)

For service entities, the ability to claim the QBID deduction is capped at certain income levels -- $157,500 for single filers and $315,000 for joint filers. If the service partner's income is below these amounts, he or she may claim the deduction in full. The deduction is phased at incomes between $157,500 and $207,500 (for single filers) and $315,000 and $415,000 (for joint filers). Above that, no deduction is allowed at all.

***Planning Opportunities***. As can be seen, the ability to claim any deduction requires the existence of W-2 wages. This may present problems for sole proprietors and single member LLC's. One way to solve this is to create (or convert into) an S-corp. The S-corp could then pay the owner a "reasonable salary" and that can be used as a basis for getting the needed W-2 wages to claim the deduction.

## STATUTORY "CLOSE" CORPORATIONS

*Understanding the Benefits of This Rarely Used Corporate Form*

Corporations are generally thought of as being less flexible than partnerships or limited liability companies. For example, all corporations are run by a board of directors who have regular meetings. The board is elected by the shareholders at an annual meeting. The board then appoints officers who run the day to day operations of the corporation under the board's direction and supervision. Corporate minutes of the shareholder and board meetings are required. The failure to follow these "corporate formalities" can lead to "piercing the veil" – i.e., exposing the shareholders to personal liability. These corporate formalities pose challenges, especially in smaller corporations (and especially in corporations with a single shareholder). For example, the sole shareholder is forced to go through the farce of holding a "shareholder meeting" to elect himself or herself to the board. The same person then holds a "board meeting" and appoints himself or herself as the president, treasurer and secretary of the corporation. And all the while, minutes of the "meetings" must be kept.

Incorporating as a partnership or a limited liability company is not always the answer. In some cases, choosing a corporation over a partnership or limited liability company makes good tax sense. In other cases, certain professions are required to be corporations. Real estate brokers in California, for example, cannot operate as a limited liability company, only a corporation.

One solution to this problem may be a statutory "close" corporation. Close corporations are not new in California, but they are used less than one might imagine.

If a corporation becomes (or converts to) a close corporation, the failure to follow the above corporate formalities cannot be used as a basis to "pierce the veil" and go after the shareholder(s) personally.

> *"IF A CORPORATION BECOMES (OR CONVERTS TO) A CLOSE CORPORATION, THE FAILURE TO FOLLOW CORPORATE FORMALITIES CANNOT BE USED AS A BASIS TO "PIERCE THE VEIL" AND GO AFTER THE SHAREHOLDER(S) PERSONALLY."*

In addition, a close corporation may enter into a "shareholder agreement" which vests management and control of the company in a "manager" (or managers) – thus virtually eliminating the need for a board of directors and corporate officers. The manager(s) takes total control of the corporation, thus allowing the close corporation to be run more like a partnership or limited liability company, as opposed to a publicly traded corporation.

Becoming a close corporation (or converting an existing corporation into a close corporation) is a fairly easy process. A close corporation does have some limitations – namely, the corporation cannot have more than 35 shareholders. For most small corporations, this is not an issue (and even if it became one, you can covert back to a regular corporation).

Two other items are worth noting. First, a close corporation is – for all intents and purposes – the same as a "regular" corporation. The only difference is the fact corporate formalities need not be observed and the corporation can enter into agreements with its shareholders which alter how the company is operated and managed. Second, a close corporation is not the same as an S-corp (although many close corporations will elect to be taxed as an S-corp). If you incorporate as a close corporation, you will still need to elect to be taxed as an S-Corp. If you convert to a close corporation and are already an S-corp, you do not need to do anything.

## PUTTING IT ALL TOGETHER

*Using an S-Corp and the QBID to Save Upwards of $1,500 Per Month*

We've talked about the QBID deduction and the advantages of forming a "close" corporation. The fun part comes in strategically combining this with an S-corporation to save a lot of money.

***Consider Joe***. Joe is a consultant. He operates his business as a sole proprietorship. Joe does not have any employees. Joe makes a good living, taking home $300,000 per year. Joe files a joint return with his wife, a stay at home mother. For purposes of simplicity, Joe takes a standard (non-itemized deduction).

***Let's consider Joe's tax situation***. As a sole proprietor, Joe has to pay federal income taxes, state income taxes and payroll taxes. As a sole proprietor, all of Joe's income is subject to payroll tax. In addition, because Joe has no employees he is unable to take advantage of the new tax rules which allow up to a 20% deduction against the income of sole proprietorships and other "pass through entities."

*How does this play out for Joe?* Joe pays $24,658 in payroll taxes since all of his $300,000 income is subject to payroll tax. Joe pays $54,819 in federal income taxes and $21,597 in California income taxes. All totaled, Joe pays $101,075 in taxes – more than 1/3rd of his total income.

***What can Joe doe?*** Under the above facts, Joe can save approximately $21,358 in taxes by incorporating and hiring himself.

***How does this work?*** First, Joe creates a statutory "close" corporation called Joe, Inc. Close corporations can be run more like a partnership or sole proprietorship without the need for messy corporate formalities, such as shareholder meetings, board meetings, officers, and the keeping of minutes. Second, Joe elects S-Corp status for Joe, Inc. This avoids the double layer of taxation for C-Corporations. Third, Joe, Inc. employs Joe for a reasonable salary of $100,000.

***What are the results?*** First, Joe saves a considerable amount on payroll taxes. Because Joe is now a W-2 employee, only $100,000 is subject to payroll tax. The delta between Joe's income and Joe Inc.'s net income is passed through as profit to Joe and is not subject to payroll tax. Total payroll taxes are just $15,300, saving $9,358 right off the bat.

> *BY CHANGING FROM AN LLC OR A SOLE PROPRIETORSHIP TO AN S-CORP, CERTAIN PROFESSIONALS MIGHT BE ABLE TO SAVE TEN THOUSAND DOLLARS A YEAR, OR MORE, IN TAXES*

Second, under the 2018 federal tax reform bill, the IRS (not California, unfortunately) allows qualified businesses (including S-Corps, limited liability companies and sole proprietorships) to deduct the *lesser of* 20% of their income or 50% of all W-2 wages. Here, Joe, Inc. is paying Joe $100,000 per year. The lesser of the two amounts is $50,000 (50% of $100,000, as opposed to $60,000 which is 20% of $300,000). This deduction lowers Joe's taxable income to $250,000. The net result is $42,819 in federal income taxes, a savings of $12,000.

By incorporating and paying himself a reasonable salary, Joe pays just $79,716 in taxes, a savings of $21,358.

***Costs of Running an S-Corp.*** Against these savings, there are some added costs. California imposes a $800 per year tax on S-Corps. In addition, California imposes a 1.5% tax on the net income of an S-Corp, which in Joe, Inc.'s case would be 1.5% of $200,000, or $3,000. After accounting for the increased cost of $3,800, Joe's net tax savings by incorporating is $17,558 or $1,463 per month.

***Why can't Joe set up an LLC?*** Certain professionals (including real estate brokers) can only be organized as a corporation, not a limited liability company. However, even for those professions which allow limited liability companies, the above strategy only works with a corporation. This is because members of LLC's cannot, by definition, be employees of the same LLC. The only entity which can employ its owner is a corporation (including an S-Corp). Employing Joe is the only way to reduce payroll taxes and get an entitlement to the new deduction for pass-through entities.

***Caveats.*** The payroll tax savings in this analysis can be achieved by incorporating and hiring the owner as an employee for a reasonable salary. What is "reasonable" depends on the facts and circumstances.

However, for purposes of federal income taxes, for most "service providers" (i.e., accountants, lawyers, brokers, advisers, consultants, etc.) the ability to deduct upwards of 20% of income under the new tax law gets limited and then eliminated as one's income rises. The current limit for joint filers is $315,000 (and $157,500 for single filers). Between $315,001 and $415,000 (for joint filers) and $157,501 and $207,500 (for single filers) the deduction gets reduced under a very complex calculus. Over those amounts, the deduction, unfortunately, goes away entirely.

***How to do this?*** (1) Create close corporation by filing articles of incorporation with the Secretary of State; (2) Draft bylaws and initial corporate resolutions; (3) Draft shareholder agreement between the shareholder and the company; (4) File election to be taxed as an S-Corp; (5) Apply for and obtain a federal tax identification number; and (6) Set up payroll and pay the owner a "reasonable salary."

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