Small Business: The future of pass-through entities and taxes

According to the Tax Foundation (https://taxfoundation.org/pass-through-businesses-data-and-policy/), 90% of United States (US)-based businesses are pass-through entities, such as S corporations, partnerships, and sole proprietorships. These businesses employ the majority of the private-sector workforce and provide nearly half of all business income. Income from these entities is passed through to the owner's individual tax returns. With the change in leadership in Washington, several proposals will most likely change the way in which these entities are taxed, making it more advantageous to be a small business owner.

Types of Business Structures

A number of pros and cons exist for each type of business structure depending on the owner's area of expertise and personal needs. But here are the basics:

- **Sole Proprietorship** - This is the simplest business form and is not a legal entity. It is an unincorporated business owned by one individual. There is no distinction between the business and the owner, meaning the owner includes profit or loss, credits, etc., on his or her individual return and is responsible for all of the debts and liabilities of the business. A sole proprietor may register his or her businesses with his or her state as a Limited Liability Company (LLC), which generally limits the owner's liability to the business assets of the sole proprietorship. However, the Internal Revenue Service (IRS) does not recognize LLCs, so for federal purposes, it remains a sole proprietorship.

- **Partnership** - Partnerships are similar to sole proprietorships except that there are multiple owners, including individuals or other businesses. Many forms of partnerships exist, such as general, limited, publically traded, etc., each with its own set of tax and accounting rules. A partnership's income, loss, credits, etc., are passed through to each individual or entity partner via a K-1. Like sole proprietorships, partnerships may opt for LLC status for state purposes.

- **S Corporation** – An S corporation is a U.S. domestic corporation that has filed a timely S election (Form 2553) to be treated as a pass-through entity. This means the S corporation is generally exempt from federal taxes. Instead, the corporation's income or loss, credits, etc., are included on the individual shareholders' personal tax returns. An S corporation is limited to 100 individual shareholders, files its own tax return (1120-S), and distributes the results to each shareholder via a form K-1.

- **C Corporations** – A corporation is a business entity unto itself. Unlike sole proprietorships and pass-through entities, a corporation pays taxes on its income at the entity level, and shareholders receive dividends, which are again taxable on their personal tax returns.

What are the possible tax changes?

One of President Trump's goals (https://assets.donaldjtrump.com/trump-tax-reform.pdf) was to make sure that "no business of any size, from a Fortune 500 corporation to a mom and pop shop to a freelancer living job to job, will pay more than 15% of their business income in taxes." If this proposed change comes to fruition, this will reduce the top corporate rate from 25% to 15%, and the top business income tax rates for sole proprietorships and pass-through entities from 39.6% to 15%.

In Republican leader and House Speaker Paul Ryan's "A Better Way" (https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf) tax reform proposal, the tax rate for a sole proprietorship or a pass-through entity would be reduced to 25%. "A Better Way" proposals also include the ability of businesses to write-off investments in tangible and intangible property immediately.

What's next?

There is much debate on how these tax changes will affect the economy. In 2014, 28.3 million U.S. businesses (http://www.census.gov/programs-surveys/cbp/technical-documentation/methodology/universe-of-cbp.html) were pass-through entities. The most common by far, making up 69.8 percent of small businesses, are sole proprietors. So any changes in the tax code will have major repercussions in the entity choices that new startups make when establishing their businesses. Understanding the advantages of each business type can have heavy tax implications. According to the Tax Foundation, the 2016 state marginal tax rates for pass-through entities are close to 50%, with California having the highest at 51.8%. Compare this to Texas, which came in at #41 with 42.6%.

We will continue to monitor the developments in the coming months. It is imperative that you seek our advice before you decide to start a business or perhaps change your current business entity. A number of opportunities might help you to lessen your tax burden. But a careful discussion beyond just the tax issues needs to take place before any decisions are made.