GROWERTALKS

Features

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Should You Switch?

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Pass-through business entities—commercial growers and retailers operating as partnerships, limited liability companies (LLCs), S corporations and sole proprietorships—have long been extremely popular. In fact, one form of pass-through business entity, S corporation, is currently
the most-used business entity. Limited liability companies (LLCs) are the pass-through entities most frequently chosen today.

Unfortunately, thanks to the recently enacted reforms under the Tax Cuts and Jobs Act (TCJA), the owners of many small businesses operating as pass-through entities will face personal tax rates as high as 29.6%—far above the new 21% corporate tax rate. Little wonder that many have begun considering switching to the basic C corporation for their greenhouse operations.

Passing through businesses

In addition to profits being taxed only once—not at the business level, but rather only when passed onto the owner's tax returns—many growers and retailers choose to operate as "pass-through" business entities because of the protection from personal liability.

As mentioned, under the recently passed TCJA, the tax rate for incorporated growing businesses has been reduced from the former 35% rate to 21% for the 2018 tax year and thereafter. And, although the individual tax cuts are only temporary—expiring in 2026—the business tax cuts are, for the most part, permanent.

Pass-throughs

A grower electing to incorporate as an S corporation or choosing to be treated as another type of pass-through entity has its business income taxed only once, similar to the manner in which sole proprietorships and partnerships are taxed. By electing to operate as a pass-through entity, a grower or retailer can benefit from the legal advantages available to businesses with a corporate structure, as well as the tax advantages available to partnerships.

One of the best features of a pass-through entity, such as an S corporation, was the tax savings for both the business and its shareholders. While "members" of an LLC are subject to employment tax on the entire net income of the business, only the wages of the S corp. shareholder, who's an employee, are subject to employment tax. The remaining income is paid to the owner as a "distribution," which is taxed at a lower rate, if at all.

An S corporation designation allows a business to have an independent life, separate from its shareholders. If a shareholder leaves the business, or sells his or her shares, the S corporation can continue doing business relatively undisturbed. Similar rules now apply to partnerships. Maintaining the business as a distinct, separate entity defines clear lines between the shareholders and the business and greatly improves shareholder protection.

A Limited Liability Company (LLC) is, on the other hand, a business structure that combines the pass-through taxation of a partnership or sole proprietorship with the limited liability of a corporation. As is the case with growers and retailers in partnerships or sole proprietorships, LLC “members” report business profits or losses on their personal income tax returns; the LLC itself is not a separate taxable entity.

While pass-through entities are generally not subject to federal income tax, they may be liable for and required to make estimated tax payments based on a number of entity-level taxes, such as “built-in gains” or BIG taxes, LIFO inventory recapture, passive income tax, and voluntary and involuntary terminations, as well as the accumulated earnings tax.

Other pass-through taxes

As a general rule, losses incurred by a pass-through entity cannot be claimed by the shareholder, member or partner in excess of the amount they’ve invested—their “basis.” And not too surprisingly, there are several tax issues pass-through businesses must consider.

Partners, for example, are considered to be self-employed, not employees, and required to file a Schedule SE with their Form 1040 and pay self-employment taxes. Because of this self-employed status, each partner is also responsible for paying his or her share of Social Security taxes and Medicare.

Partners are responsible for paying double what a regular employee would pay (because employers normally match employees' contributions). Of course, the partners’ tax burden is reduced by an allowance for one-half of the self-employment tax that can be deducted from taxable income.

TCJA pass-through businesses

Pass-through businesses pass their income to their owners who pay tax at their individual rate. The TCJA created a 20% deduction that applies to the first $315,000 of income (half that for single taxpayers) earned by growers and retailers operating as S corporations, partnerships, LLCs and sole proprietorships.

All businesses under the income thresholds, regardless of whether they’re considered service professionals or not, can take advantage of the 20% deduction. However, the TCJA limits who can qualify for the pass-through deduction with strong safeguards to ensure that “wage income” doesn’t receive the lower marginal tax rates for business income.

For pass-through income above the threshold amount, the new law also provides a deduction for up to 20%, but only for “business profits.” In other words, that 20% deduction applies only to business income that’s been reduced by the amount of “reasonable compensation” paid the owner. That reasonable compensation hasn’t been defined by our lawmakers as yet.

Those operating a pass-through business, such as an S corporation, lose things like fringe benefits, plus being required to pay themselves reasonable compensation and deal with the other restrictions. And then there’s the elimination of a number of itemized, personal deductions.

Today, the vast majority of pass-through business owners will no longer be able to deduct state and local income taxes and permitted to write off only $10,000 of their property taxes. A regular C corporation faces no similar deduction restrictions.

Switching to corporate form

In the eyes of many experts, there’s no longer a reason to operate a growing business as an S corporation or other pass-through entity. However, converting from a pass-through entity to a regular C corporation can be a complicated process requiring quite a few adjustments.

Going the other way, a sale of assets by an S corporation that was formerly a C corporation during the "recognition period" is subject to a built-in-gains tax. A built-in-gain tax is imposed on the incorporated business at the highest corporate tax rate, based on the appreciation in asset value that existed on the date the corporation became an S corporation. The shareholders may then be subject to a second tax on distribution of the sale proceeds.

This "double tax" created by imposition of the built-in-gain rules can be eliminated if the corporation holds and sells assets only AFTER the 10-year recognition period has expired. Naturally, the longer the recognition period is, the tougher that is to do.

Under the former rules, distributions made by an S corporation converting to a regular C corporation during the post-termination transition period (PTTP) can be tax-free to the shareholders. Distributed funds from those accumulated adjustment accounts can also reduce the adjusted basis of the owner's stock.

Under the new TCJA rules, adjustment of a terminated S corporation (even if only changing accounting methods) is taken into account ratably during a six-year period beginning with the year of change.

Decisions, decisions

The annual tax return provides an opportunity to reconsider the options available for many growers and retailers. Entities with more than one shareholder or member can elect corporate status on their annual tax returns. Thus, an entity that's a partnership under state laws may elect to be taxed as a C corporation or S corporation for federal taxes by using Form 8832 (Entity Classification Election). Unfortunately, under those "check-the-box" regulations, entities formed under a state's corporate laws are automatically classified corporations and may not elect to be treated as any other type of entity.

Changing business entities

Changing circumstances, changes in the tax laws and even the success of the growing operation might prompt a re-assessment of the entity used for the operation or business. And best of all, the annual tax return isn't the only option when selecting the entity that makes the most economic sense.

Although many of the tax law's provisions apply to all business entities, some areas of the law specifically target each entity. Obviously, choosing among the various entities can result in significant differences in federal income tax treatment. However, there's more to choosing the right structure for a commercial growing business than taxes.

Not only will the decision to change the business' entity have an impact on how much is paid in taxes, it will also affect the amount of paperwork required for the business, the personal liability faced by the principals and, especially important in today's economy, the operation's ability to raise money.

To switch or not to switch? If previous tax law changes are any indication, provisions should be made for switching entities without a penalty. Since every situation is different, the best approach might be to choose the entity for your retail or growing operation based on the current, "reformed" tax law. To help in this decision-making process, professional advice is strongly recommended. **GT**

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