PKF
Certified Public Accountants

Business Owner's Perspectives

Trends and Strategies for Owners of Closely Held and Family Businesses

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Should You Switch from an S Corp to a C Corp?

For decades, business owners debated the merits of switching from a C corp to an S corp, mainly for the tax advantages offered by an S corp to its owners. With the new tax act in place, the debate has flipped, and S corp owners are wondering if changing to a C corp might be advantageous.

Framing the Debate

S corps and other "pass-through" entities generally do not pay income taxes at the corporate level. Rather, S corps pass through their income to their owners, who pay tax on their S corp income at their individual tax rate.

The new tax law lowered the top corporate tax rate from 35% to 21% but kept the individual tax rates at a higher level. For some owners, a potentially lower overall tax rate might make a C corp more attractive.

To address this issue, the government established IRS Section 199A, which allows a deduction for qualified business income (QBI) for taxpayers—other than C corps—that meet certain requirements.

The deduction is limited to the greater of 50% of W-2 wages or the sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis (UBIA) of certain property used by the business. After applying various limitations, the deduction actually allowed is based on the lesser of the allowed deduction or 20% of taxable income.

When calculating QBI, "qualified" businesses do not include

specified trade or businesses (SSTBs) involved in healthcare, law, accounting, consulting, athletics, financial services, brokerage services, or any trade or business that depends on the reputation or skill of the owners or employees.

The deduction is phased out for joint filers with taxable income between $315,000 and $415,000 and for all other taxpayers with taxable income between $157,500 and $207,500.

When Does Conversion Make Sense?

With the QBI deduction, the effective tax rate is 29.6% for qualified pass-through entities, versus 21% for C corps. Also, under a C corp, stockholders are subject to double taxation on dividends issued by the company.

Does it make sense to convert to a C corp if the overall taxes are still higher when factoring in dividends, double taxation, and the possibility that tax laws may change under a new administration? Maybe.

For example, S corp shareholders who want to attract new investors and plan for ongoing operations for more than five years might benefit from IRS Section 1202, also known as the Small Business Stock Gains Exclusion.

This regulation allows capital gains from certain small business stock sales to be partially or fully excluded from federal tax. Converting to a C corp, waiting to sell newly issued shares for at least five years, and meeting certain other criteria allows new shareholders to sell their stock

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Word to the Wise

Working with Millennials—Different Is Good

Baby boomers are likely in charge at your office. They're the ones serving in executive positions, making the big decisions, and determining the business' direction.

It's also likely that your company employs a fair number of Gen-Xers and millennials. Millennials, people born from the mid-1980s to 2000 or so, tend to be the group that makes baby boomers scratch their heads. Millennials are doing things differently, which sometimes rubs baby boomers the wrong way.

How can these two generations mesh in the workplace? The key for owners is to understand millennials' experiences, desires, and world views and to appreciate how these traits can positively influence the business.

Defined by Trends

Several trends define the millennial decades:

Technology informs how millennials get their news, form opinions, communicate, and socialize. Quick response, instant information, and fear of missing out, or "FOMO," have impacted millennials' expectations. Many baby boomers see this as impatience.

Millennials grew up with school and neighborhood **violence**. Some believe that this exposure to violence has made millennials eager to make the most of every day and encounter. Baby boomers sometimes view this as short-term thinking.

Millennials have been reminded of their inherent **value** as human beings since they were children. This translates to the belief that their opinions count and that they are valuable contributors. The upside is that millennials are often willing to speak their minds and aren't cowed by authority. The downside is the expectation of "participation trophies," self-importance or neediness in the eyes of baby boomers.

What They Want

All good working relationships require respect, so managers who honor millennials' cultural, social, and behavioral experiences are sure to get more from their millennial employees. Generally speaking, millennials seek the following:

Work-life balance: Many millennials have a different expectation of work in their lives. Family often comes first in terms of scheduling and hours in the office. Money earned is often earmarked for experiences—travel, for example—and is a means to an end.

For managers, this one is simple: Find out what your employees value, and support those things to motivate and incent your team.

Authenticity: Work that matters, matters. Millennials seek meaningful work. They want "ownership" of their responsibilities. With this comes a desire to forge their own plans and strategies—which can be accomplished with the help of a hands-on mentor.

Let millennials flex their brains. Get on board with their desire to have an impact, and the results can be exciting and mutually beneficial.

Trust: For this generation, it's not about when and where they work, it's about getting their work done. So don't expect your millennial staffers to be the first ones in and the last ones to leave. This "appearance" of productivity isn't as important to them as results.

Make performance measures explicit and distinct. Trust that your millennial employees will get their work done, but maybe not when and how you would have done it.

Be Open and Encouraging

As with all employees, appreciating diverse opinions and work styles goes a long way. Learn what makes millennials tick, and they just might be your best employees.

Our firm works with many multigenerational businesses. We are happy to share best practices with you.

How to Navigate the New Revenue Recognition Rules

You've been hearing about the new revenue recognition rules for customer contracts since 2014. The time has finally come to implement them. For privately held companies, ASC 606 is now in effect.

A Quick Recap

As a reminder, ASC 606 requires a five-step model of revenue recognition for all entities that enter into contracts with customers for the transfer of goods, services, or real estate. The five steps apply to each customer contract:

1. Identify all customer contracts. A contract is defined as having the following conditions: It identifies the rights of the parties, has payment terms and commercial value, has been approved by the parties, and payment is likely collectible.

2. Identify performance obligations. The standard requires identification of "distinct" obligations. If the customer can use a deliverable on its own, it is considered a distinct performance obligation. If the deliverable is dependent on other pieces included in the contract, it is not considered to be distinct.

3. Determine transaction price. If a contract includes discounts, rebates, or refunds, what are you actually going to get paid? What about other factors impacting the price, like market volatility or weather? How does the time value of money figure in if a customer pays early or late?

4. Allocate transaction price. If the contract includes separate performance obligations, you must recognize revenue as each is complete. This means you must calculate a standalone price for each obligation.

The same goes for discounts, which must be allocated against the price of each performance obligation or allocated proportionately as revenue is recognized.

5. Recognize revenue. Revenue must be recognized as each performance obligation is completed and control of the goods or services is transferred to the customer.

Lessons Learned

Some companies have already implemented the new rules, and it's wise to learn from their experience. For example:

Judgment is key. Every company is different. Even companies in the same industry may arrive at different answers relative to the five steps. With this in mind, be sure to document your contract evaluation process.

Prepare for earlier income. For many companies, the standard results in advanced income recognition. If this is the case for your business, you will need to work with your finance and accounting team to determine the impact of the earlier timing.

Expect enhanced disclosures. The standard requires more significant disclosures on financial statements. What used to be explained in one or two sentences will now likely take one or two pages.

Dig into complicated contracts. If your company has master service agreements or long-term, complicated contracts, you must evaluate them as soon as possible. The process is time-consuming.

Get Going

The extent and scale of this accounting change can't be overstated. Indeed, the standard and its related interpretations and implementation guidance total more than 1,000 pages. Expect to invest a significant amount of time and effort to meet the new requirements.

Our team is familiar with the new standard and is ready to help you understand and implement the new rules.

S Corp or C Corp?

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tax-free, up to the greater of $10 million or 10 times the adjusted basis of their stock.

Note that not all small business stocks qualify for this tax break, and it applies only to new shareholders after conversion.

Talk to Your Tax Advisor

There may be other circumstances where conversion to a C corp would make sense, but the most prudent way to proceed is to discuss your situation with your CPA.

Let's talk about your entity status. Call us now to explore your options.

PKF
Certified Public Accountants

99 Summer Street, Suite 1660
Boston, MA 02110
617-PKF-9985

300 Crown Colony Drive, Suite 400
Quincy, MA 02169
617-422-0007

www.pkfboston.com

Changes to Business Auto Depreciation and Deductions

The Tax Cuts and Jobs Act changed the rules for business autos. Here are a few highlights:

Luxury autos: The law changed depreciation limits for luxury passenger vehicles placed in service after Dec. 31, 2017. If you don't claim bonus depreciation, the greatest allowable deduction is $10,000 for the first year, $16,000 for the second year, $9,600 for the third year, and $5,760 for each later taxable year in the recovery period.

If you claim 100% bonus depreciation, the greatest allowable depreciation is $18,000 for the first year, $16,000 for the second year, $9,600 for the third year, and $5,760 for each later taxable year in the recovery period.

Note that under the IRS definition, most cars qualify as "luxury" vehicles, regardless of cost.

SUVs: Under prior law, most SUVs used for business were eligible for a $25,000 deduction under IRS Section 179, as well as 50% bonus depreciation on the balance of the purchase price.

The new tax law retains the $25,000 Section 179 expense, but most SUVs are also now eligible for 100% bonus depreciation, which means you can immediately expense the full cost in the first year.

Leased autos: If the leased vehicle is used 100% for business, the full lease cost is deductible. However, to prevent taxpayers from avoiding the luxury car depreciation limits that apply to purchased vehicles, the IRS requires a certain amount of the leased vehicle's fair market value to be included as income during each year of the lease.

This income exclusion amount varies with the initial fair market value of the leased auto and the year of the lease.

Trade-ins: Prior to the new law, business auto trade-ins yielded neither gains nor losses. Now, taxpayers recognize a gain or loss on a trade-in—its trade value minus the remaining depreciable basis.

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