

*Choice of Entity Revisited  
After the 2003 Tax Act*

The upheaval in taxation of various classes of individual income under the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub L No 108-27, 117 Stat 752 (2003) (2003 Tax Act), necessitates a reevaluation of the old choice-of-entity debate for both new and existing enterprises. While the nuances of any such discussion exceed the space available here, I will proffer some thoughts on this critical decision.

**Planning for New Entities  
(and to Consider With  
Existing Businesses)**

As a general rule, the most tax-advantageous entity, both before and after the 2003 Tax Act, is a pass-through entity such as an S corporation or LLC, absent unusual securities law restrictions, marketing of securities concerns, or other special circumstances. Three key points of the 2003 Tax Act are as follows:

1. Ordinary income rates were reduced. The top marginal individual rate declined from 38.6 percent to 35 percent, effective January 1, 2003.
2. "Qualified dividend income" to individuals, effective January 1, 2003, is now taxed at a maximum of 15 percent rather than up to 38.6 percent.
3. Individual long-term capital gain, including such gain from pass-through entities, is likewise taxed at a maximum 15 percent rate. The effective date is generally for transactions on or after May 6, 2003.

You may have heard the question, why should anyone choose an entity other than a C corporation, when C corporation dividends are now taxed at a 15 percent rate and ordinary operational profits from an S corporation or LLC are taxed to individual owners at up to 35 per-

cent? Setting aside employment and self-employment tax issues, figure 1 exposes the "15 percent is less" fallacy.

Figure 1 simply illustrates one mathematically undeniable fact. In a C corporation, the 35 percent corporate tax followed by a 15 percent individual level tax on what is left is more costly to the individual taxpayer than one 35 percent tax. Many commentators that have touted a move to the C corporate form may have lost sight of the fact that the 2003 Tax Act did not change the law that dividend distributions are non-deductible.

If profits are not distributed to owners, then the maximum tax rate, 35 percent, is the same for C and S corporations and individually owned LLCs. Before the 2003 Tax Act, the C corporation rate had been lower than the higher individual rate.

Tax-wise, the second major concern is that someday most entities will be sold or exchanged in a taxable transaction. When an enterprise is sold, the purchaser usually strongly prefers to purchase assets rather than stock for two reasons. The first is a very expensive tax-driven rationale. If a purchaser acquires stock, it is effectively saddled with the "old basis" of the target for its assets, commonly known as the "inside basis." A stock sale generally is advantageous to the purchaser in the rare factual setting where the fair market value of

the assets is less than the inside basis. For even a modestly prosperous business, the value of the corporate assets usually substantially exceeds the inside basis, and the purchaser seeks an asset sale to obtain an elevated inside basis. The purchaser then begins depreciation and amortization against the higher inside basis. Even most intangible assets, such as goodwill and going concern value, can be amortized by an asset purchaser. The second reason purchasers generally prefer an asset purchase is that the purchaser may be able to contractually limit its liability by excluding specific known liabilities as well as by not taking subject to many (but not all) unknown and contingent liabilities. Figure 2 presumes that assets have a fair market value of \$100, the corporation's inside basis is \$20, and the shareholder's stock basis is \$10. What are the consequences on sale? A multimember LLC taxed as a partnership and an S corporation, in general, have similar taxation with exceptions beyond the scope of this article. The one difference that must be noted is that an election to increase basis under IRC 754 on sale or the death of an owner is available only to partnerships and LLCs taxed as partnerships, but not to S corporations. However, for the purpose of the following examples, assume that an S corporation as well as an LLC taxed as a partnership would be taxed similarly.

As figure 2 demonstrates, because of the corporate level tax it is far less expensive on an asset sale to operate as an S corporation. Let us assume that because of the substantial benefit

Figure 1  
\$100 Current Distribution Example

	<i>C Corporation</i>	<i>LLC/Partnership</i>
Gross profit	\$100.00	\$100.00
Less entity level tax	-35.00	0.00
Owner distribution	65.00	100.00
Individual tax	-9.75	-35.00
Net to owner	55.25	65.00
Percent of tax	44.75%	35.00%

Figure 2  
Asset Sale Under C Corporation vs. S Corporation Scenarios

	<i>C Corporation</i>	<i>LLC/Partnership</i>
Sales price	\$100.00	\$100.00
Entity level gain	80.00	80.00
Entity level tax	28.00	0.00
Available to owners	72.00	100.00
Shareholder level tax*	-9.30	-13.50
Net to owners	62.70	86.50
<b>Tax savings with pass through</b>		<b>23.80</b>

\*The S corporation asset sale produces an \$80 flow through of capital gain and thus increases stock basis from \$10 to \$90. On the corporate distribution of \$100, the shareholder recognizes a gain of (\$100 less \$90) \$10. The combined gain of \$90 is subject to a 15 percent tax equaling \$13.50.

of a stepped-up basis on an asset sale, a purchaser who agrees to buy stock will only pay \$80 rather than \$100. This is a very realistic assumption in many situations. The federal income tax consequences of the sale are shown in figure 3.

### Dealing With Existing C Corporations

There are some opportunities for C corporations with available cash to now start distributing dividends at the 15 percent rate because the 15 percent dividend rate is scheduled to sunset after 2008. Presidential and Congressional elections between now and then will determine how long the 15 percent rate lasts. An example of a post-2003 Tax Act opportunity is for C corporations that now have substantial passive income (i.e., over 25 percent) to elect S corpo-

ration status and minimize the impediment to thousands of C corporations in that situation. If a C corporation elects S status and if it has C corporation earnings and profits for three consecutive years, then the S election is automatically terminated at the beginning of the fourth year. By distributing out the C corporation's earnings and profits as dividends taxed at the 15 percent rate, such entities can now elect S status at a far cheaper top dividend rate of 15 percent, as opposed to 38.6 percent before the 2003 Tax Act, and can avoid the automatic termination rule.

### Action Steps

We have repeatedly found it helpful to meet with clients and their accountants, whatever type of entity they may be, to explore planning opportunities arising out of the

2003 Tax Act. Highly beneficial action steps have resulted from such meetings.



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Figure 3  
C Corporation Stock Sale at \$80 vs. S Corporation Asset Sale at \$100

	<i>C Corporation</i>	<i>Pass Through</i>
Sales price	\$80.00	\$100.00
Entity level gain	N/A	80.00
Entity level tax	0.00	0.00
Available to owners	80.00	100.00
Shareholder level tax	-10.50	-13.50
Net to owners	69.50	86.50
<b>Pass through savings</b>		<b>17.00</b>