Choice of Entity in a Dynamic Tax Environment

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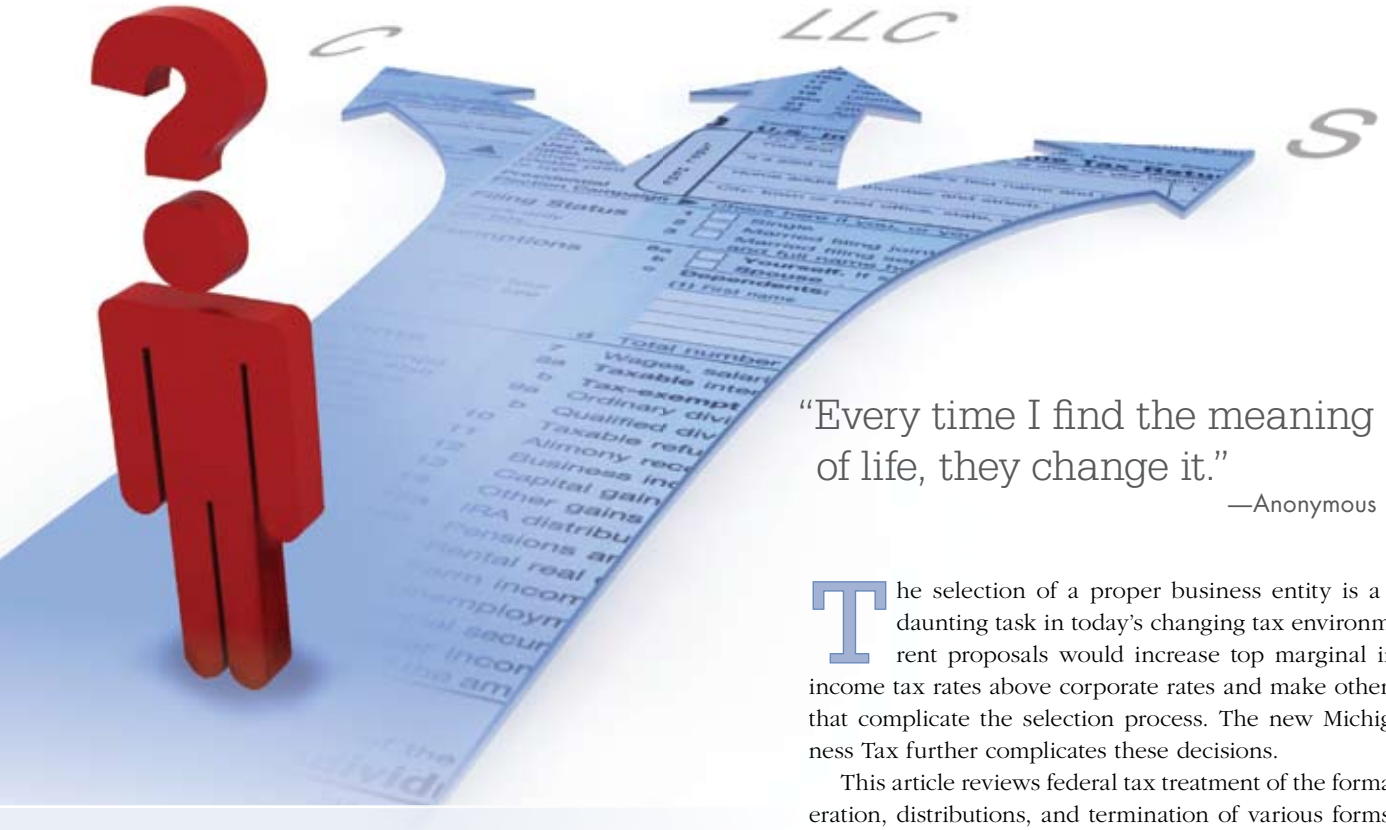

"Every time I find the meaning of life, they change it."
—Anonymous

Fast Facts:

- The expiration of the Bush tax cuts at the end of 2010 would push the top individual income tax rate above the corporate rate, and makes the decision to elect S corporation status more difficult.
- The American Recovery and Reinvestment Act of 2009 increased the gain exclusion allowed to non-corporate taxpayers on the sale of "qualified small business stock," and recent proposals would create a 100 percent exclusion, which suggests that investors should carefully review this potential opportunity.
- The Michigan Business Tax adds new complexity to the choice of entity decision.

The selection of a proper business entity is a similarly daunting task in today's changing tax environment. Current proposals would increase top marginal individual income tax rates above corporate rates and make other changes that complicate the selection process. The new Michigan Business Tax further complicates these decisions.

This article reviews federal tax treatment of the formation, operation, distributions, and termination of various forms of business entities; discusses current and proposed federal tax legislation affecting choice of entity decisions; and describes Michigan tax issues that influence these decisions.

Federal Tax Aspects of Formation, Operation, Distributions, and Termination

Any discussion involving choice of entity requires an overview of the federal tax differences in the treatments of the formation, operation, distributions, and termination of corporations on the one hand, and LLCs or partnerships on the other. Unless otherwise specified, the rules for corporations described below generally apply to both C corporations and S corporations. LLCs are generally treated as partnerships for tax purposes, absent an election to treat the LLC as a corporation.

Formation

Two significant issues to consider in choosing an entity are the tax treatment of contributions of appreciated property and transfers of encumbered property. Generally, shareholder contributions of appreciated property to a corporation in exchange for stock are tax free only if the contributing shareholders meet the 80 percent control requirement.[1] No corresponding control is required for tax-free contributions of appreciated property to an LLC or a partnership in exchange for an interest in the entity.[2]

A shareholder transferring encumbered property to a corporation recognizes gain to the extent that the liabilities assumed by the corporation exceed the shareholder's tax basis in the transferred assets.[3] In a transfer of encumbered property to an LLC or a partnership, the transferring member or partner is deemed to receive a cash distribution to the extent he or she is relieved of liability.[4] An LLC member or a partner must recognize gain if this deemed distribution exceeds the member's or partner's adjusted basis in the LLC or the partnership.[5]

Operation

An important issue related to the operation of an entity is the tax treatment of entity interests paid for services. A shareholder receiving corporate stock for services is not treated as receiving stock for "property." Thus, the shareholder is not counted in determining the satisfaction of the 80 percent control requirement described above.[6] This may result in a taxable contribution of appreciated property by other shareholders. The shareholder receiving stock for services generally recognizes income equal to the fair market value of the stock.[7] The corporation receives a corresponding deduction subject to the amortization requirements for start-up and organizational expenditures.[8]

The rules applicable to transfers of corporate stock for services also apply to an LLC member or a partner contributing services in return for an interest in partnership capital.[9] However, an LLC member or partner contributing *services* for a right to share in future profits, with no right to current capital, generally does not recognize income when receiving the interest in future profits.[10]

An owner's tax basis in an S corporation, LLC, or partnership generally determines the owner's ability to deduct losses and shelter distributions. S corporation shareholders may not include their share of corporate debt in determining basis.[11] By contrast, LLC members and partners may include their share of LLC or partnership debt in determining basis.[12] Treasury regulations indicate that in a partnership, recourse debt is allocated to general partners, who bear the risk of loss, while nonrecourse debt is allocated among the general and limited partners in accordance with their respective interests in partnership profits.[13] As for LLCs, since all members of an LLC enjoy limited liability, they are allocated their ratable shares of LLC debt for basis purposes.

Shareholder loans to an S corporation provide the shareholder with additional amounts against which loss pass-throughs may be taken.[14] However, such loans do not directly affect the shareholder's tax basis in the S corporation stock and, therefore, do not shelter cash distributions.[15] In contrast, loans by an LLC member or a partner generally increase the member's or partner's basis in the LLC or the partnership by the full amount of the loan unless the other owners guarantee the obligation.[16]

Another consideration that does not affect corporations but is important to partners and LLC members is self-employment tax. The self-employment tax consists of two taxes: a 12.40 percent tax for old-age, survivor, and disability insurance, which for 2009 and 2010 applies to the first $106,800 of net self-employment earnings; and a 2.9 percent tax for hospital insurance, which applies to all net self-employment earnings.[17]

The distributive share of income or loss of a general partner is normally included in net earnings from self-employment subject to self-employment tax.[18] The distributive share of income or loss of a limited partner is normally excluded in the computation of net earnings from self-employment and is not subject to self-employment tax.[19] In general, guaranteed payments made to partners for rendering services to a partnership are included in a partner's net earnings from self-employment.[20]

In contrast, distributions paid to S corporation shareholders are not treated as net earnings from self-employment for self-employment tax purposes. If an S corporation shareholder is also an employee of the corporation, compensation paid to the shareholder is treated as wage income for employment tax purposes. The IRS can attempt to re-characterize a portion of the dividends paid to a shareholder-employee as wage income for FICA, FUTA, and income tax withholding purposes if it believes an S corporation has inadequately compensated the shareholder-employee to minimize payroll taxes.[21]

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The self-employment tax treatment of distributions paid to LLC members is less than clear. In 1997, the IRS proposed regulations that sought to address this issue. The proposed regulations provide that an investor in a pass-through entity (including an LLC) will be treated as a limited partner for self-employment tax purposes unless that individual:

- Is personally liable for entity debts by reason of being a partner or member;
- Has authority to contract on behalf of the entity under state law or the governing instrument; or
- Participates for more than 500 hours during the taxable year in the entity's trade or business.[22]

However, "guaranteed payments…made to the individual for services actually rendered to or on behalf of the [entity]…are included in the individual's net earnings from self-employment."[23] In addition, the exclusion for limited partners does not apply to partners or LLC members if the entity is involved in a service profession "in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting."[24] A partner or LLC member may bifurcate the distributive share of partnership or LLC income between "active" and "passive" classes for self-employment tax purposes.[25]

Distributions

The tax treatment of distributions is another important consideration when choosing an entity. In general, corporations recognize gain upon the distribution of appreciated assets.[26] In the case of LLCs and partnerships, gain is generally not recognized upon the distribution of appreciated assets.[27] Further, a corporation's distribution of an asset with pre-contribution gain or loss not recognized by the contributing shareholder does not result in a special allocation of the gain or loss. Mandatory allocation of pre-contribution gain or loss to members of LLCs and partners of partnerships occurs if an asset is distributed within seven years of contribution, however.[28]

The S corporation provisions contain "one class of stock" rules, which require that all stock receive similar distribution and liquidation rights.[29] These rules generally prevent the special allocation of tax attributes. However, LLCs and partnerships may provide special tax allocations if the allocations have "substantial economic effect."[30] In general, special allocations will have "substantial economic effect" if they are reflected in the members' or partners' capital accounts and will affect the economic distributions to and liabilities of the members or partners upon liquidation of the entity.[31]

Termination

The last basic consideration for federal tax purposes is the tax treatment when an individual's interest in an entity ends. In most cases, this occurs on the sale of the individual's interest in the entity. The sale of appreciated stock of a corporation generally results in capital gains or losses to the individual.[32] The sale of stock at a loss may be eligible for ordinary loss treatment under the "small business stock" rules.[33] While the sale of an LLC or partnership interest also generally results in capital gain or loss to the individual,[34] some of the gain may be recharacterized as ordinary income[35] if the entity holds unrealized receivables[36] or substantially appreciated inventory.[37]

Federal Tax Legislation Influencing Choice of Entity

American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (ARRA) did not affect choice of entity decisions to a large extent. However, ARRA did reduce the 10-year asset holding period required for a former C corporation that makes an S corporation election to avoid the "built-in gains" tax. In general, the "built-in gains" rules prevent a C corporation from making an S corporation election to avoid the double tax on the sale of the corporation's assets by requiring that a sale of assets within 10 years of such an election results in a corporate-level tax equal to 35 percent of the corporation's "built-in gain" at the time of the election.[38] For C corporations that make an S corporation election in the 2009 and 2010 tax years, the holding period is only seven years.[39] If a C corporation converts to an LLC or a partnership, there will be an actual or deemed liquidation of the corporation, and gain on the deemed sale of assets will be recognized immediately.[40]

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Another provision of ARRA allows non-corporate taxpayers to exclude 75 percent (up from 50 percent)[41] of the gain they receive from the sale or exchange of "qualified small business stock"[42] that is held for five years.[43] This provision applies to stock acquired after the enactment of ARRA and before January 1, 2011.[44] Additionally, President Obama has proposed raising the exclusion to 100 percent for "qualified small business stock" issued after February 17, 2009.[45]

Obama Tax Proposals

President Obama's tax proposal to allow the Bush tax cuts to expire at the end of 2010 has important implications for choice of entity issues. In particular, the expiration of the Bush tax cuts would allow the top two individual income tax brackets to return to 36 percent and 39.6 percent from their current levels of 33 percent and 35 percent, respectively.[46] This will affect single filers making over "$200,000 less the standard deduction and one personal exemption, indexed from 2009" or "$250,000 less the standard deduction and two personal exemptions, indexed from 2009" for joint filers.[47] In addition, the capital gains rate and dividends rate will increase from 15 percent to 20 percent for the same top two income brackets.[48] President Obama also proposes to reinstate the personal exemption phaseout and the limitation on itemized deductions and to "limit the value of all itemized deductions by limiting the tax value of those deductions to 28 percent" for single filers with adjusted gross income over $200,000 or $250,000 for joint filers.[49]

Although the increase in the top individual income tax rate above the top corporate income tax rate is a factor favoring C corporations over "pass-through" entities in which income is taxed at the shareholder level at individual tax rates, business owners must carefully consider the potential C corporation "double tax" on the sale of assets followed by a liquidation when choosing the form of business entity.

Michigan Tax Treatment of Corporations, LLCs, and Partnerships

Michigan Business Tax

The Michigan Business Tax Act (MBT) imposes a 4.95 percent tax on the business income tax base of an entity.[50] The business income tax applies to all entities that have business activity in Michigan.[51] One distinction the MBT makes with regard to entity types is that in calculating the business income tax base, LLCs and partnerships are allowed to deduct self-employment income.[52] Corporate income, including S corporations' pass-through income, is not treated as self-employment income for federal purposes, and the MBT includes no self-employment income deduction for corporations.[53] Corporations may deduct compensation paid to shareholders in computing business income. This means that the S corporation strategy of paying relatively "low" compensation to shareholders to minimize payroll taxes, as described above, may have the effect of increasing MBT tax liability.

The MBT also imposes a 0.8 percent tax on the modified gross receipts tax base.[54] The modified gross receipts tax also applies to all entities with a substantial nexus in Michigan.[55] Both the business income tax and modified gross receipts taxes under the MBT are subject to a 21.99 percent surtax.[56]

An important consideration when choosing an entity is the MBT Small Business Alternative Credit. This credit is equal to "the amount by which the tax imposed under [the MBT] exceeds 1.8 percent of adjusted business income."[57] This credit is similar to the Small Business Credit available under the now-repealed Michigan Single Business Tax, except that the distributive share disqualifier has been raised under the MBT from $115,000 to $180,000, as described below.

The Small Business Alternative Credit "is available to any taxpayer with gross receipts that do not exceed $20,000,000.00 and with adjusted business income minus the loss adjustment that does not exceed $1,300,000.00," adjusted annually for inflation.[58] In addition, an individual, partnership, LLC, or S corporation is disqualified if an owner "receives more than $180,000.00 as a distributive share of the adjusted business income minus the loss adjustment…."[59] In the case of C corporations, the "[c]ompensation and directors' fees of a shareholder or officer [cannot] exceed $180,000.00," nor can the sum of the "[c]ompensation and directors' fees of a shareholder" and that shareholder's share of the C corporation's business income exceed $180,000.[60]

The Small Business Alternative Credit begins to phase out when an owner's distributive share/income is over $160,000.[61] The phaseout occurs at 20 percent increments for each $5,000 over $160,000.[62] Additionally, the credit is gradually phased out to the extent gross receipts exceed $19,000,000.[63] This reduction is based on "a fraction, the numerator of which is the amount of gross receipts over $19,000,000.00 and the denominator of which is $1,000,000.00."[64]

Under the MBT, members of a "unitary business group" must generally determine qualification for the Small Business Alternative Credit on a unitary basis. This means that the gross receipts and adjusted business income thresholds described above apply to the combined gross receipts and adjusted business income of the group. However, the distributive share of income, compensation, and director fees received by individuals, partners, members, shareholders, and officers from a member of a unitary business group are not combined with similar amounts received from other members of the group for purposes of the disqualifiers and reduction percentages described above.[65]

Michigan Income Tax

Shareholders of S corporations, partners of partnerships, and members of LLCs are subject to Michigan income tax for the flow-through income allocated to Michigan that they receive from entities subject to the MBT.[66] The MBT Small Business Alternative Credit described above is designed in part to reduce this "double tax" on owners of these entities.

Conclusion

Practitioners asked to recommend the proper form of business entity must understand the client's specific plans and goals for the business and should mesh these objectives with the federal and state tax rules governing the formation, operation, distributions, and termination of the entity. This planning should also consider recent and proposed tax legislation, including the Obama tax proposals and the Michigan Business Tax. ■

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FOOTNOTES

1. 26 USC 351(a); 26 USC 368(c).
2. 26 USC 721(a).
3. 26 USC 357(c).
4. 26 USC 752(b).
5. 26 USC 731(a)(1).
6. 26 USC 351(d).
7. 26 USC 83(a).
8. 26 USC 83(h).
9. Treas Reg § 1.721-1(b)(1).
10. See Treas Reg § 1.721-1(b)(1); Rev Proc 93-27, 1993-2 CB 343; Rev Proc 2001-43, 2001-2 CB 191; see also IRS Notice 2005-43, 2005-1 CB 1221, May 20, 2005 (proposed revenue procedure regarding partnership interests transferred in connection with the performance of service).
11. *Brown v CIR*, 706 F2d 755 (CA 6, 1983).
12. 26 USC 752; 26 USC 722.
13. See Regulations under 26 USC 752.
14. 26 USC 465(b)(1).
15. 26 USC 1367(a)(1).
16. 26 USC 752(c); Treas Reg § 1.752-2(c)(1).
17. 26 USC 1401(a) and (b).
18. 26 USC 1402(a).
19. 26 USC 1402(a)(13).
20. See *id.*
21. See Rev Rule 74-44, 1974-1 CB 287.
22. IRS Prop Reg § 1.1402(a)-2(h)(2).
23. IRS Prop Reg § 1.1402(a)-2(g).
24. IRS Prop Reg § 1.1402(a)-2(h)(5) and (6)(iii).
25. IRS Prop Reg § 1.1402(a)-2(h)(3).
26. 26 USC 311(b); 26 USC 336(a).
27. 26 USC 731(b); 26 USC 736(b).
28. 26 USC 704(c)(1).
29. 26 USC 1361(b)(1)(D); Treas Reg § 1.1361-1(l)(1).
30. 26 USC 704(b); Treas Reg § 1.704-1(b)(2).
31. Treas Reg § 1.704-1(b)(2)(ii) and (iii).
32. 26 USC 1221; 26 USC 1222.
33. 26 USC 1244.
34. 26 USC 741.
35. 26 USC 751(a).
36. 26 USC 751(c).
37. 26 USC 751(d).
38. See 26 USC 1374.
39. PL 111-5, § 1251, 123 Stat 115.
40. 26 USC 336(a).
41. 26 USC 1202(a).
42. See 26 USC 1202(c).
43. PL 111-5, § 1241, 123 Stat 115.
44. *Id.*
45. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (May 2009), pp 13–14, available at <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>. All websites cited in this article were accessed November 19, 2009.
46. *Id.* at 73–74.
47. *Id.* at 74.
48. *Id.* at 77.
49. *Id.* at 75–76, 88.
50. MCL 208.1201(1).
51. *Id.*
52. MCL 208.1201(2)(h).
53. State of Michigan, Michigan Taxes: Michigan Business Tax, *Frequently Asked Question B3* <http://www.michigan.gov/taxes/0,1607,7-238-47449-176055--F,00.html>.
54. MCL 208.1203(1).
55. MCL 208.1200.
56. MCL 208.1281(1).
57. MCL 208.1417(4).
58. MCL 208.1417(1).
59. MCL 208.1417(1)(a).
60. MCL 208.1417(1)(b).
61. MCL 208.1417(1)(c).
62. *Id.*
63. MCL 208.1417(5).
64. *Id.*
65. State of Michigan, Michigan Taxes: Michigan Business Tax, *Frequently Asked Question C41* <http://www.michigan.gov/taxes/0,1607,7-238-47449-200163--F,00.html>.
66. State of Michigan, Michigan Taxes: Michigan Business Tax, *Frequently Asked Question B1* <http://www.michigan.gov/taxes/0,1607,7-238-47449-173875--F,00.html>.