The Relevance (or Irrelevance) of the 2003 Tax Act on Choice of Entity

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A. Basic fact pattern

Client forming new business – restaurant
Owned 50/50 with partner – split profits/losses equally
John and Jane each put in $25,000, the business borrows $200,000 (guaranteed by them).
Both employees of business

B. Issue - why type of entity should be formed?

GP, LP, LLC, S corporation or C corporation

C. Some non-tax distinctions

All entities except GP provide limited liability
LP arrangement requires two entities to provided full liability protection
LP must restricts participation of limited partners
LLC, GP and LP have less formalities to comply with
Special allocations allowable with LLC, LP and GP
Limited shareholders (type and number) with S corps
Better familiarity with corporations
Corporations slightly less complex to form
Equity compensation easiest with corporations
More flexibility using qualified pension plans with corporations
Generally, must be corporation to have IPO or do certain tax-free stock deals
Others:____

Applying factors to new restaurant business

Equity compensation, pensions, IPO options are not important
LLC's lax operational formalities required is benefit
Ability to do special allocations with LLC/GP/LP may be useful if add investors later

What types of businesses might you conclude differently and why?

Hi-tech companies (heard this a lot during the boom days)
Form corporations for stock options and IPO exit

- Only good reason is liberal use of stock options - If not used widely, can use LLC equity options adequately
- IPO exit really is not good reason since it is fairly easy to convert LLC to corporation before IPO/tax-free stock reorganization
- If investors require corporation

D. Tax differences between entities - finally get into impact of 2003 Tax Act

Add numbers to restaurant business example:

Year 1
Sales = $200,000
Net profit = ($100,000)
Year 2
Sales = $1 million
Net profit = $100,000
Year 3
Sales = $3 million
Net profit = $400,000

Turn to attached spreadsheet

Year 1 - loss of $100,000
a) C corporation - no tax, $100,000 NOL
b) S corporation
$100,000 loss allocated $50,000 to each shareholder
Shareholders' basis in S corporation:
$25,000 each from cash contribution
$0 from debt
Each may deduct $25,000 of loss and remaining $25,000 is suspended loss carryover
c) LLC/LP/GP
$100,000 loss allocated $50,000 to each owner
Owners' basis in entity:
$25,000 each from cash contribution
$100,000 each from debt
Each may deduct full $50,000 of loss

Years 2 and 3 profitable - see spreadsheet for tax consequences

E. Distributions from entities

Salary
Dividends

Other distributions

2003 Tax Act provides that “qualified dividends” are generally taxed at 15%
    Basically, qualified dividends must be taxed first at the entity level (C corporations)

Has analysis with C corporations changed due to 15% dividend rate?

    Before 2003 Act, incentive was to pay salary even though had payroll taxes on it since it was deductible to corporation – does 2003 Act change this?

        Divided vs. Salary

            Spreadsheet example paid as dividend not salary
                $400,000 of net income resulted in $224,400 net to shareholders

            Compare - If this instead paid out in salary - $200,000 to the shareholders/employees
                Net would be $293,858 (assuming no other income)

            Therefore, still net more if pay as salary vs. dividend even with the 15% dividend rate (with 15% rate – double taxation is still 40+% which is greater than highest individual rate)

            May prefer dividend over salary if do not own proportionate share of entity paying dividend.

Analysis determining how much to pay out as salary from LLC/GP/LP and S corps unchanged by 2003 Tax Act
    Incentive is to pay out less as salary and remainder as distribution to minimize payroll taxes
        But must pay "reasonable compensation" for services
        S corps – this issue is resolved – non-salary distributions are not subject to payroll taxes
        LLC/GP/LP – issue is not clear – payroll taxes may apply to all distributions to employees/owners even if not all designated as salary
        Result = advantage to S corporations on this issue

F. Other entity level taxes to consider (ignoring state income taxes)

California applies 1.5% tax on net income of S corporations
California applies gross receipts tax to LLC

LLC gross receipts tax not that significant until get above $5 million in sales or have to use multiple entities in organization each with sales above $250,000 (major real estate holdings)

G. Conclusion

2003 Tax Act does not appear to alter the Choice of Entity analysis

For existing business, however, 2003 Act may help in following areas:

a) May eliminate need to structure payouts as dividends if no/low basis in stock

  Example – Father, son own business (C corporation), would like to redeem stock of father (no basis in stock) over time but father will continue to participate in business

    Previously, hard to structure this and get Section 302(b) treatment (capital gains).

    Under 2003 Tax Act, as long as dividends are "qualified", no need to qualify as redemption since dividends taxed at capital gains rates

b) Distribute out accumulated E&P from S corporation

  Accumulated E&P can be problematic if S corporation has excessive passive investment income (risk termination S election)

  Consider making dividend of accumulated E&P – taxed as "qualified dividend" under 2003 Tax Act