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Current Trends in LLC and Partnership Tax Planning

Leading Lawyers on Understanding the Implications of Recent Legislation and Developing Effective Client Strategies

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ATRA and ACA Complicate Partnership Tax Planning

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Introduction

The American Tax Relief Act of 2012 (ATRA) and the Patient Protection and Affordable Care Act (ACA) impact tax planning for choice of entity decisions in 2013 and beyond. Because of the new top federal individual income tax rate of 39.6 percent after the enactment of ATRA, in certain situations, a taxpayer may want to consider choosing a C corporation as the vehicle to conduct business. But even after ATRA and ACA, in most cases, a C corporation is the least favorable alternative from a tax-planning standpoint for a closely held business.

S corporations, which allow for one level of federal income taxation of business income, thereby avoiding the potential double taxation associated with C corporations, may provide certain tax planning benefits with respect to self-employment taxes and the 3.8 percent tax on net investment income, which went into effect on January 1, 2013, under ACA. Although generally less favorable than S corporations with respect to planning for taxes on self-employment income and net investment income, partnerships and limited liability companies (LLCs) often provide taxpayers with significantly greater flexibility and additional tax-planning opportunities, as compared to S corporations, in structuring the ownership of their businesses.

Effects of ATRA and ACA

Effect of Tax Rate Changes and New Tax on Net Investment Income on Tax Strategies

ATRA[1] was enacted in January 2013. A significant aspect of ATRA was the increase of federal income tax rates on individuals from a top marginal rate of 35 percent to a top marginal rate of 39.6 percent, which became effective January 1, 2013.[2] While the higher rates do not have a direct impact on partnerships or LLCs, since those entities do not pay federal income taxes at the entity level, the higher rates do impact individuals who hold ownership interests in LLCs or partnerships because the income passed

[1] Pub. L. No. 112-240, 126 Stat. 2313 (2013).

[2] For 2014, the 39.6 percent rate applies to the taxable income of single individuals over $406,750 and the taxable income of married individuals filing joint returns over $457,600. There are six additional brackets for lower levels of taxable income with tax rates ranging from 10 percent to 35 percent. Under Section 1(f) of the Internal Revenue Code of 1986 (referred to herein as the IRC or the Code), these dollar thresholds are adjusted annually for inflation.

through to them from the partnership or LLC will generally be taxed at those higher rates in 2013 and later years.[3] Although the highest marginal individual federal rates are now 39.6 percent, federal tax rates for C corporations were unaffected by ATRA and generally continue to top out at 35 percent.[4]

Now that corporate tax rates are lower than the top rates on individuals, in certain limited circumstances, federal income tax savings might be realized by forming a business entity as a C corporation, rather than an LLC or partnership, if the owners of the entity are individuals who expect to be in the top 39.6 percent federal bracket. However, the number of situations where it makes sense to choose a C corporation for a privately held business over a pass-through entity, such as an S corporation, partnership or LLC, still appears to be quite limited. If an individual in the top 39.6 percent federal income tax bracket is a partner in a partnership conducting a profitable business or activity, that individual will pay federal income tax on the individual's share of the partnership's taxable income at a marginal rate of 39.6 percent (regardless of the amount of cash distributed, if any, by the partnership to the partner), and the partnership will not pay federal income tax at the partnership level.[5] If, however, that same business were conducted by a C corporation instead of a partnership or LLC, the corporation's income would not be taxed to the shareholders unless dividends were paid by the corporation.[6] Undistributed corporate income is taxed to the corporation at a maximum federal rate of 35 percent,[7]

[3] Unless it elects to be taxed as a C corporation under Treas. Reg. § 301.7701-3(a), an LLC or a general or limited partnership is a treated as a partnership for federal income tax purposes. A partnership does not pay federal income tax at the partnership level but is required to file an annual information return with the Internal Revenue Service (IRS) on Form 1065 to report the partnership's items of income, gain, loss, deductions, and credits, which are then passed through to the partners and reported on Form K-1 filed by partnership for the partners. Each partner is generally required to report such partner's share of the partnership's tax items (as reported by the partnership to the partner on Form K-1) on the partner's own federal income tax return, regardless of the amount of cash distributed, if any, by the partnership to the partner. I.R.C. §§ 702 & 6222(a).

[4] *See* I.R.C. § 11 (West).

[5] I.R.C. §§ 701-02.

[6] *See* I.R.C. § 11 (imposing tax on a corporation on the corporation's taxable income) and §§ 301 & 331 (generally including corporate dividends and liquidating distributions in a shareholder's taxable income).

[7] I.R.C. § 11. Under § 11, the 35 percent corporate tax rate applies only to corporate taxable income in excess of $10,000,000. The portion of a corporation's taxable income up to $50,000

compared to a top rate of 39.6 percent for individuals, a potential savings of 4.6 percent on the undistributed income of a C corporation. As explained in note 7, a corporation's taxable income less than $335,000 is subject to an effective rate of less than 34 percent, so for a corporation with modest taxable income, the initial tax savings of operating as a C corporation instead of a partnership or LLC could be greater than 4.6 percent.

The problem with that strategy is that when the earnings of the corporation are eventually distributed to the shareholders as dividends or liquidating distributions, the shareholders pay a second tax on the dividends and liquidating distributions, which are paid out of the corporation's earnings after reduction by corporate-level income taxes, and a corporation is not entitled to a federal income tax deduction for dividends or liquidating distributions paid to shareholders.[8] Dividends paid by a C corporation are taxed to individual shareholders at a federal income tax rate of 20 percent if the income constitutes "qualified dividend income."[9] Since January 1, 2013, individuals receiving dividends from a C corporation are also subject to a "net investment income tax" at the rate of 3.8 percent on the taxable amount of the dividend.[10] This 3.8 percent tax on net investment income was introduced as part of the ACA[11] and applies to certain investment income earned by individuals with modified adjusted gross income in excess of $250,000 (for married couples filing jointly) and $200,000 (for single individuals).[12] In addition, if the sale of the business of a C corporation is structured as an asset sale by the corporation rather than a stock sale by the corporation's shareholders, two levels of federal income tax will potentially

is taxed at a rate of 15 percent; a 25 percent rate applies to the portion of corporate taxable income greater than $50,000 but not in excess of $75,000; a 34 percent rate applies to the portion of corporate taxable income greater than $75,000 but not in excess of $10,000,000. However, for corporations with taxable income over $100,000 or over $15,000,000, the benefits of the lower brackets are phased out by applying an additional 5 percent rate or 3 percent rate to taxable income in excess of $100,000 and $15,000,000, respectively, until the benefits of the lower brackets are fully phased out. *See* I.R.C. § 11(b). As a result, corporate taxable income under $335,000 is taxed at an effective tax rate of 34 percent or less. Unlike federal income tax brackets for individuals (as discussed in note 2 above), these dollar thresholds for the corporate income tax are not periodically adjusted for inflation.

[8] I.R.C. §§ 301 & 331.

[9] I.R.C. § 1(h)(11).

[10] I.R.C. § 1411.

[11] Pub. L. No. 111-148, 124 Stat. 119 (2010) (to be codified in scattered sections of 42 U.S.C.).

[12] I.R.C. §§ 1411(a)(1) & 1411(b). "Modified adjusted gross income" is defined in I.R.C. §1411(d).

be imposed—one at the corporate level on the corporation's gain, if any, on the sale of its assets, and a second level of tax on a shareholder's receipt of liquidating distributions from the corporation, to the extent such distributions exceed the basis of the shareholder's shares in the corporation.[13] In limited circumstances, such as a C corporation that does not pay significant (or any) dividends,[14] has significant shareholders in the 39.6 percent tax bracket, and will not likely sell its business for a long time, it might be possible, considering the time value of the deferral of the additional 4.6 percent tax on the corporation's operating profits, to save some amount of federal income tax by using a C corporation, rather than a partnership or LLC. However, for most businesses, the double taxation associated with a C corporation will result in significantly more federal income tax being paid by the entity and its owners than a partnership or LLC, particularly on the sale of a C corporation's assets, followed by liquidating distributions to its shareholders. For these reasons, a partnership or LLC is generally a more tax-efficient entity than a C corporation for privately held businesses, even after ACA and ATRA.

The new 3.8 percent tax on net investment income enacted by the ACA, as well as Federal Insurance Contributions Act (FICA) and Medicare taxes, is also an important part of the tax analysis in choosing the form of entity for a privately held business. The 3.8 percent tax is intended to assist in funding programs instituted under the ACA, and in some ways is a mirror image of the self-employment tax that self-employed individuals pay on earned income.[15] A self-employed individual, including an individual who is a partner in a partnership (other than a limited partner) that conducts a trade or business, pays federal self-employment tax at a rate of 15.3 percent on

[13] I.R.C. § 331. In addition, a buyer of a business operated in corporate form will often prefer to structure the transaction as an asset purchase, rather than a stock purchase, because the buyer will take a stepped-up basis in the purchased assets equal to the purchase price paid by the buyer, and the buyer generally will be able to depreciate or amortize that new asset basis for income tax purposes in tax years following the purchase. A buyer of corporate stock does not obtain a stepped-up basis in the corporation's assets, so a stock purchase is often less desirable for a buyer from a tax standpoint than an asset purchase. *See* discussion in Martin A. Culhane III, *S Corporation Owners Likely to Benefit From New Intangibles Legislation*, J. S CORP. TAX (summer 1994). Although the Culhane article compares stock sales and assets sales in the context of an S corporation, many of the same issues are relevant for C corporation sales.

[14] Note that a C corporation that accumulates significant earnings beyond its reasonable business needs, rather than distributing them to its shareholders as taxable dividends, may be subject to the accumulated earnings tax at the corporate level under I.R.C. §§ 531-37.

[15] The tax on self-employment income is imposed by I.R.C. § 1402 (West).

self-employment income (as defined in IRC §§ 1402(a) and (b)) up to a specified dollar amount,[16] 2.9 percent on an unlimited annual amount of self-employment income above that amount, and, beginning January 1, 2013, an additional 0.9 percent on self-employment income in excess of $250,000 for married individuals filing a joint return, or in excess of $200,000 for single individuals.[17] Before the enactment of IRC § 1411, individuals who sold assets (other than inventory or dealer property) at a gain or earned passive investment income, such as dividends, rents, royalties, and interest, did not have to pay any such additional taxes on that income because passive investment income is excluded from the definition of "self-employment income."[18]

This new tax on passive-type investment income has taxpayers and their advisors trying to devise ways to avoid or minimize it. However, a partnership or LLC is not a good solution in most cases. If a business is conducted through a partnership or LLC, a partner's or member's share of partnership or LLC active business income is considered net earnings from self-employment, unless the partner is a limited partner.[19] Except for limited partners, a partner's or member's entire share of the partnership's or LLC's taxable income is typically subject to self-employment tax at a rate of 15.3 percent on self-employment income up to a specified amount—$117,000 in 2014, subject to adjustment in later years—plus a 3.8 percent tax on income over the specified amount.[20] Thus, a partnership or LLC does not generally avoid self-employment tax. Shareholders of a C corporation are not subject to self-employment tax on the corporation's income, but compensation paid by the corporation to an individual shareholder-employee who works in the corporation's business is subject to FICA tax and Medicare tax at the same tax rates as self-employment tax.[21]

[16] For 2014, this specified amount is $117,000.

[17] ACA increased this rate from 2.9 percent to 3.8 percent, effective January 1, 2013. *See* I.R.C. § 1401(b)(2).

[18] *See, e.g.*, I.R.C. §§ 1401(a)(1), (2) & (3).

[19] I.R.C. §§ 1402(a) & 1402(a)(13).

[20] *Id.*

[21] The taxes are imposed on both the employee and the employer. The tax rates imposed on the employee are 6.2 percent on an employee's annual wages up to a specified amount ($117,000 in 2014, subject to adjustment in later years), plus 1.45 percent on the employee's wages without limit, and beginning January 1, 2013, an additional 0.9 percent tax is imposed on the annual wages of employees exceeding $250,000 for joint returns and $200,000 for single employees. I.R.C. §§ 3101(a) & (b). The employer is required to withhold the employee's

The FICA and Medicare taxes, however, are imposed on the individual's W-2 compensation only (e.g., salaries, wages, and bonuses). So, for example, if a business earns $1 million in taxable income before deductions for shareholder-employee compensation, and the shareholder-employee is paid a salary of $300,000, the shareholder-employee and the corporation will be subject to FICA and Medicare taxes only on the $300,000 salary, not the entire $1 million of taxable income. Neither the shareholder-employee nor the corporation will pay self-employment tax or net investment income tax on the additional $700,000 of taxable income over the $300,000 salary.[22]

A C corporation and its shareholders, however, are subject to two levels of taxation, as discussed above. An S corporation may be a good alternative because it is generally not subject to federal income tax at the corporate level.[23] The income of an S corporation passes through, and is taxed, to its shareholders, similar to a partnership or an LLC.[24] As with a C corporation, if a shareholder works for an S corporation as an employee, the employee and the S corporation pay FICA and Medicare taxes only on the employee's actual salary.[25] However, if the employee's salary is unreasonably low, the IRS may attempt to impose FICA and Medicare taxes on what it considers to be a higher reasonable level of compensation based on all of the facts and circumstances.[26] S corporation taxable income that passes through to the shareholder-employee above a reasonable salary is not subject to the self-employment tax, and if the individual shareholder-employee materially participates in the business

share of the taxes from the employee's wages. IRC § 3102. Except for the new 0.9 percent tax, the same taxes are imposed on the employer based on the same rates and annual limit. I.R.C. §§ 3111(a) & (b).

[22] *See* discussion in WILLIAM CHRISTIAN & IRVING GRANT SUBCHAPTER S TAXATION ¶ 1.10 (McGraw-Hill 1990).

[23] I.R.C. § 1363(a) (West). An S corporation that was formerly a C corporation, however, may be subject to corporate-level built-in gain taxes and corporate-level taxes on excess passive investment income under I.R.C. §§ 1374-75 (West). An S corporation is subject to several restrictions concerning the types of shareholders eligible to own S corporation stock. (For example, foreign persons and most types of legal entities cannot own stock in an S corporation, and allocations of income, losses, dividends, and liquidating distributions among shareholders must be made strictly on a pro-rata basis based on the number of shares held by each shareholder.) *See* I.R.C. § 1361 (West).

[24] I.R.C. § 1366 (West).

[25] *See* CHRISTIAN & GRANT *supra* n. 22.

[26] Alan Bruce Clements, *A New Look at Subchapter S Compensation Strategies*, 15 WG&L BUS. ENTITIES 24 (2013).