Introduction to Entity Classification

State Bar of Michigan Taxation Section
Fundamentals of Taxation Program
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Presenters

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Objectives

- Learn the different types of business entities
- Recognize the different taxes applicable to different business entities and their owners/shareholders
- Learn how the entity classification rules affect the taxation of businesses
- Understand the tax consequences of converting one business entity type to another
- Learn possible transaction structures for selling a business

Taxation of Different Business Entities

C Corporation Structure

- Shareholders can be a natural person, trusts, corporations or any other type of organization
- Unlimited number of shareholders
- Multiple classes of stock permitted

C Corporation Taxation Considerations

- Two levels of taxation
  - (1) First at the corporate level when earnings are generated
    - Taxable at corporate rate, max 35%
  - (2) Again at shareholder level when earnings are distributed
    - Distributions are taxable at 23.8%
- Shareholder is permitted to be an employee and participate in benefit plans
- Shareholders can not use C Corporation losses to offset other income
  - C Corporation itself can carryback losses two years or carryforward losses 20 years

S Corporation Structure

- Classification requirements
  - 100 or fewer “eligible” shareholders
  - Distributions to shareholders must be pro-rata
  - Single class of stock (exception for voting/nonvoting distinction)
- Eligible shareholders must be:
  - US citizens or resident aliens and
  - Individuals, estates, certain types of exempt organizations, and certain types of trusts

S Corporation Taxation Considerations

- Generally, one level of tax at the shareholder level
- Distributions are not taxable to the extent of basis
    - Basis includes amounts *directly* loaned to the corporation
- Shareholder is permitted to be an employee and participate in benefit plans
- Self-employment taxes do not apply to allocations of income to shareholders
- Generally permitted to use losses to offset other income
    - Losses subject to basis, at-risk and passive activity loss limitations

Partnership Structure

- Partners generally can be any type of owners
- Unlimited number of partners
- Multiple classes of interest permitted
- More flexible than S corporations
  - Capital interests and profits interests allowed
  - Distributions do not have to be pro rata
  - Property can be contributed and distributed on a tax-free basis

Partnership Taxation Considerations

- Generally, one level of tax at the partner level
- Distributions are not taxable to the extent of basis
  - Unlike in an S corporation, basis includes share of *all* liabilities
- Partner cannot also be an employee of the company and cannot participate in some employee benefit arrangements
- Self-employment taxes on allocations of income to service partners
- Generally permitted to use losses to offset other income
  - Losses subject to basis, at-risk and passive activity loss limitations

Disregarded Entities

- Disregarded entities include:
  - Single-member LLCs (SMLLCs)
  - Qualified subchapter S subsidiaries (QSUBs)
  - Qualified REIT subsidiaries
  - Grantor trusts
- All of the entity’s assets, liabilities, and items of income and loss are treated as those of the owner and reported on owner’s tax return
- All activities between entity and owner are disregarded
- Not disregarded for payroll and excise taxes

Illustration - Single vs. Double Taxation

	C Corporation	Flow-Through
Entity Level Taxes		
Net Income	$100,000	$ 100,000
Federal Tax	$ 34,000	N/A
State Tax (net of federal tax benefit)*	$ 3,960	N/A
Total Entity Income Taxes	$ 37,960	N/A
Individual Level Taxes		
Individual Income	$ 62,040	$ 100,000
Federal Tax	$ 12,408	$ 39,600
NIIT	$ 2,358	$ 3,800
State Tax (net of federal tax benefit)*	$ 1,492	$ 2,406
Total Individual Income Taxes	$ 16,258	$ 45,806
Total Taxes	$ 54,218	$ 45,806
Effective Tax Rate	54.22%	45.81%

* This is for illustrative purposes, state rates vary

Illustration - Potential Tax Reform

	C Corporation	Flow-Through
Entity Level Taxes		
Net Income	$100,000	$ 100,000
Federal Tax	$ 20,000	N/A
State Tax (net of federal tax benefit)*	$ 4,800	N/A
Total Entity Income Taxes	$ 24,800	N/A
Individual Level Taxes		
Individual Income	$ 75,200	$ 100,000
Federal Tax	$ 15,040	$ 25,000
NIIT	$ 2,858	$ 3,800
State Tax (net of federal tax benefit)*	$ 1,809	$ 2,406
Total Individual Income Taxes	$ 19,707	$ 31,206
Total Taxes	$ 44,507	$ 31,206
Effective Tax Rate	44.51%	31.21%

* This is for illustrative purposes, state rates vary

Types of Federal Taxes

Corporate Income Tax

- Progressive rate schedule depending on level of taxable income
  - Current maximum federal rate 35%
  - Tax reform could lower this to around 20%
- Same tax rate applies to ordinary income, capital gain, and dividends
  - Capital losses can only offset capital gains
  - Dividends received deduction reduces multiple layers of C corporation tax
- Not applicable to S corporations and partnerships

Built-in Gains Tax

- 35% tax on gains recognized by S corporation on assets that had built-in gain in the hand of the C corporation
- Applies when within the last five years:
  - C corporation made S election or
  - S corporation received assets from a C corporation in a carryover basis transaction
- Triggered in an asset sale (or deemed asset sale under 338(h)(10))
- Not triggered in the case of a stock sale or tax-free exchange

Personal Income Tax

- Maximum federal income tax on ordinary income 39.6%
    - Progressive rate schedule
    - Rates change based on filing status
    - Tax reform could lower to a max of 35%
- Maximum federal rate on long-term capital gains and qualified dividends 20%
- Investment and passive income subject to 3.8% Net Investment Income Tax
- Maximum 15.3% self employment tax

Capital Gains Tax

- 20% tax on long-term capital gain recognized by non-corporate taxpayers
  - Sale of a capital asset or
  - Section 1231 asset held for more than 1 year
- Section 1202 gain exclusion for individuals
- C corporations do not benefit from a rate preference on long-term capital gains
  - All C corporation income taxed at ordinary rates (max 35%)

Qualified Dividends

- 20% tax on qualified dividends recognized by non-corporate taxpayers
- Qualified dividends
  - Received from domestic corporation or qualified foreign corporation
  - Stock must be held for more than 60 days during the period that surrounds the dividend
- C corporations do not benefit from a rate preference on qualified dividends
  - Generally a corporation may deduct 70% of dividends received from other corporations

Net Investment Income Tax (NIIT)

- 3.8% tax on most investment income and passive activities
  - Applicable if AGI is over $250K (joint) or $200K (single)
- Applies to individuals, estates, and trusts
- NIIT is not applicable income from “active” S corporations or partnerships
  - Sale of “active” S Corporation or partnership is also generally excluded
- Sale of C corporation stock and dividends received from a corporation will always be subject to NIIT

Payroll Taxes

- Company must pay for all employees
  - Including employee-shareholders of corporations
  - Not applicable to partners receiving guaranteed payments
- Social Security tax of 6.2% is imposed on each employer and employee on the first $127,200 of wages
- Medicare hospital insurance tax of 1.45% imposed on employer and employee on all employee wages with no cap
  - Employee portion increased by additional 0.9% on wages received in excess of $250K (joint) or $200K (single)

Self Employment Taxes

- 15.3% tax on first $127,200 of self employment income
- 2.9% tax on amounts over $127,500 of self employment income
    - Increased by additional 0.9% on wages received in excess of $250K (joint) or $200K (single)
- Self employment income includes a partner or member's distribution share of earnings
    - Does not apply to shareholders of corporations
- Deduction for half of self employment tax

Other Taxes

- Accumulated Earnings Tax
  - 20% tax on C corporations that accumulate earnings and profits for purposes of avoiding shareholder individual income tax
- Personal Holding Company Tax
  - 20% tax on closely held C corporations with substantial passive income
- Sting Tax
  - 35% tax on S corporations with excessive passive income and C corporation and earnings and profits

Entity Classification Basics

Default Classifications

- Classification determines how the entity and its owners are taxed
- Taxation of business entity is based on its “default” classification
  - Per se corporation – C Corporation
  - Other – Partnership or SMLLC

Classification Elections

- Form 8832 filed for business entity to elect a different classification (if eligible)
    - Also known as "checking the box"
- Form 2553 filed for business entity to be classified as an S corporation (Form 8832 is not necessary)
- Form 8832 & Form 2553 due 75 days after formation

Eligible Entities

- An “eligible” entity is an entity other than an entity that is ineligible
- Ineligible entities include:
  - Insurance companies and banks
  - Most publicly traded partnerships
  - Certain foreign entities (listed in instructions to Form 8832)
  - Exempt organizations and government entities
  - Special types of entities such as RICs and REITs

Terminating the Election

- Terminating S Election
  - No official form to terminate
  - Revocation letter to IRS stating company is terminating the election
  - Generally, once terminated, cannot reelect for five years
- "Unchecking" the Box
  - Cannot "uncheck" the box for five years unless election was made at formation
  - If eligible, file Form 8832 and elect new entity classification

Questions to Determine Entity Classification

- Is it a registered corporation or other?
- Is it an "eligible" entity?
- If it is an eligible entity, what is its "default" classification?
- Has an election been made to classify the entity as something other than its default classification?
    - Form 8832 or Form 2553

Entity Conversions

Methods of Entity Conversion

- Merger
- Formless state law conversion
- Tax election
- Transfer of assets or equity interests to new entity

Nontaxable Conversions

- C corporation to S corporation
  - Potentially subject to built-in gains tax
- S corporation to C corporation
- Disregarded entity to disregarded entity
  - Qsub to LLC
  - Redomicile to a new state

Taxable Conversions

- C corporation to partnership
- C corporation to disregarded entity
  - Unless corporation is solvent and a wholly-owned subsidiary of corporate parent
- S corporation to partnership or disregarded entity

Possible Taxable Conversions

- Partnership to C corporation or S corporation
- Partnership to disregarded entity
- Disregarded entity to C corporation or S corporation
- Disregarded entity to partnership

Transaction Structures for Sale of a Business

Transaction Structures

- Equity sale
- Asset sale
- Section 338(h)(10)
- Section 336(e)
- Deemed asset sales
- F Reorganization Transactions

Equity Sale

- Typically desired by Seller
- Includes sale of stock, partnership interest, or membership units
- Seller Considerations:
  - C & S Corporations – capital gain to selling shareholders
  - Partnership – capital gain and/or ordinary income
- Buyer Considerations:
  - C & S Corporations – no step up in basis for stock purchase
  - Partnership – step up available

Asset Sale

- Typically desired by Buyer
- Seller Considerations:
  - C Corporation – two layers of taxation
  - S Corporation & Partnership – character of gain determined by underlying assets
- Buyer Considerations:
  - Step up in basis regardless of Seller structure
- Planning Considerations
  - Purchase price allocation can help minimize ordinary gain
  - Gross up from Buyer can make Seller whole

Section 338(h)(10) – Deemed Asset Sale

- Stock acquisition treated as purchase of assets for tax purposes
- Election is made jointly by Buyer and Seller
- Requirements:
  - Purchaser must be a C or S corporation
  - Target entity must be a corporate subsidiary of a consolidated/affiliated group or an S corporation
  - Purchaser must buy at least 80% of the total voting power and value of stock of target entity over a 12-month period

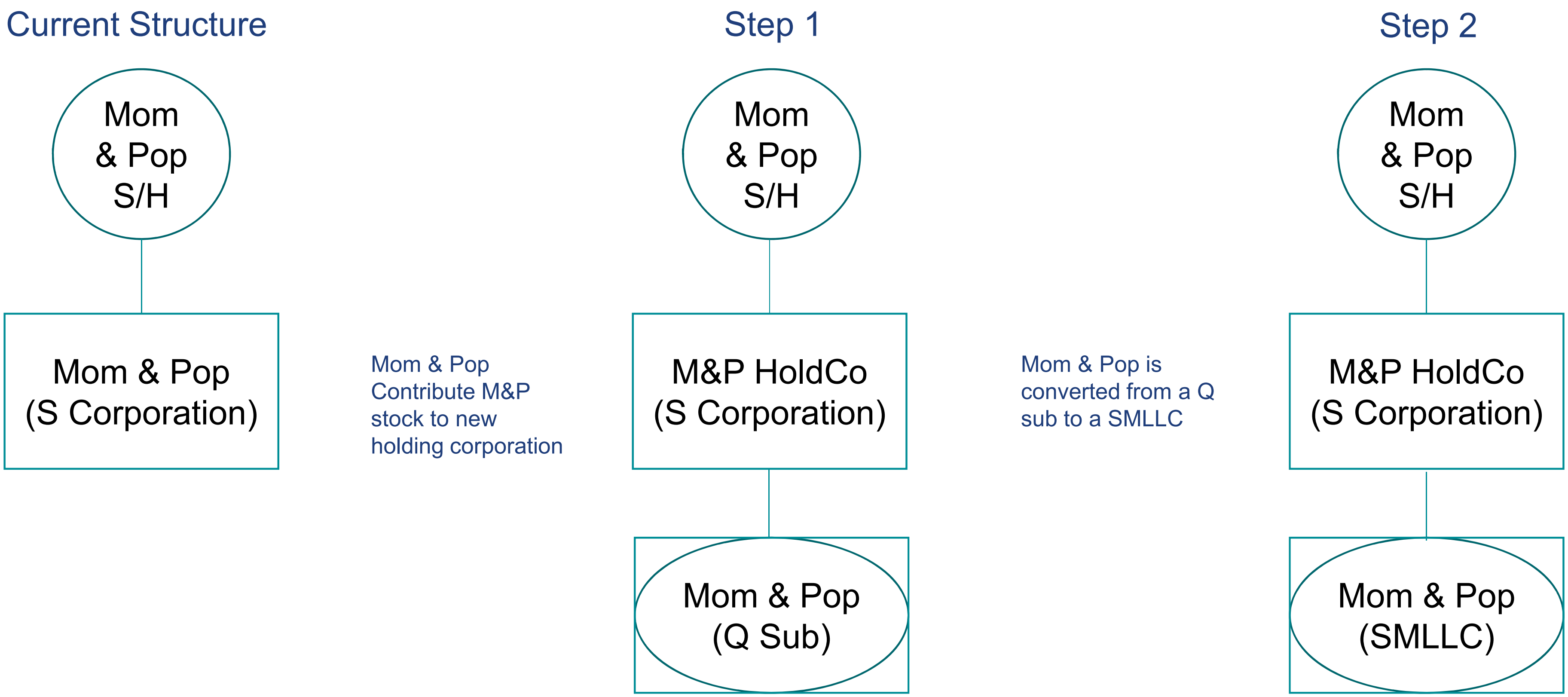
Section 336(e) - Deemed Asset Sale

- Same as a Section 338(h)(10) except:
  - Election is made by seller and target
  - Purchaser(s) can be any entity, individual, or group

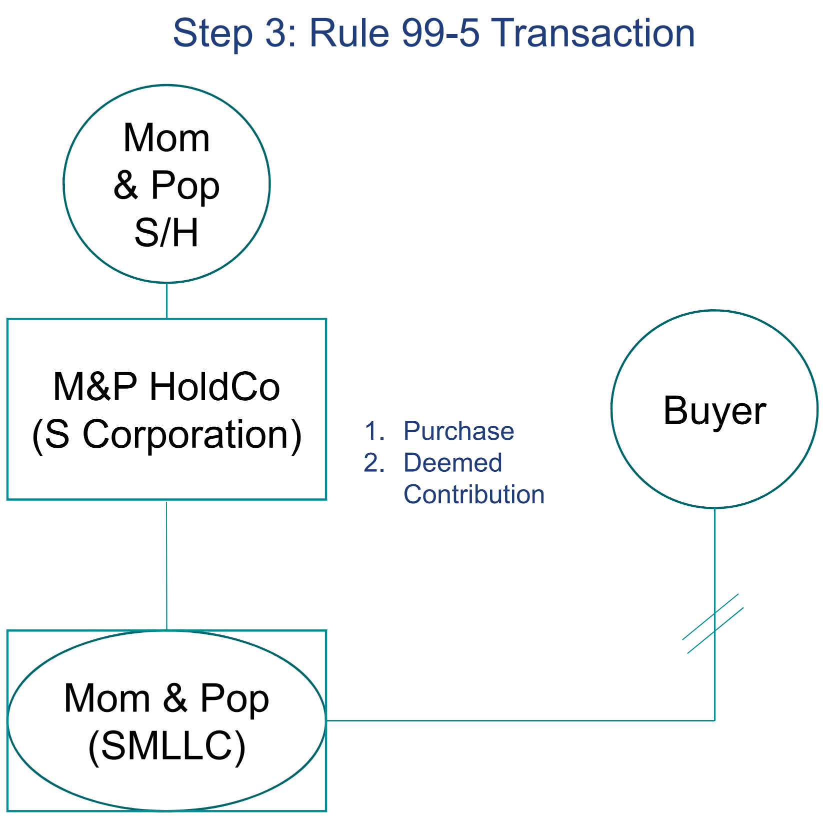
S Corporation Partial Sale Case Study

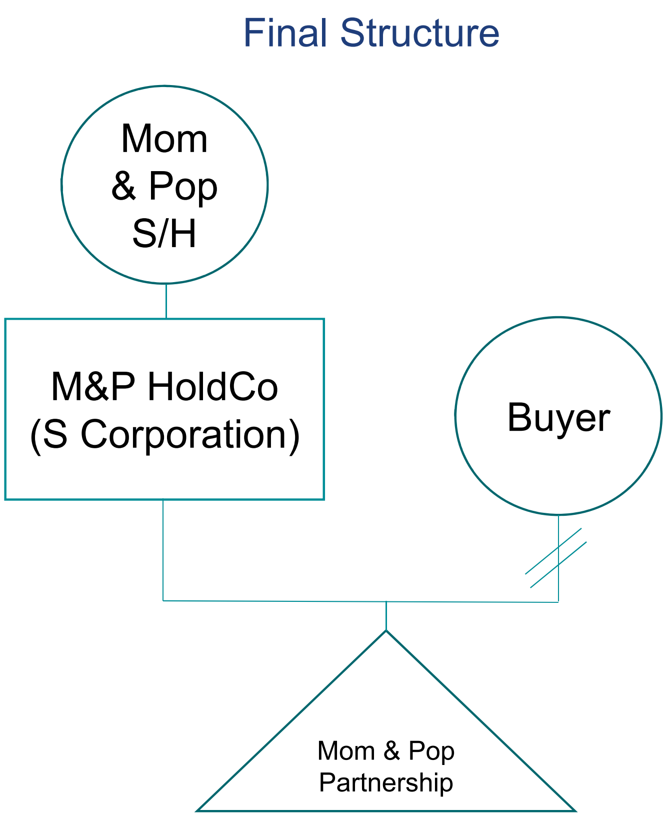
- Mom & Pop own a S corporation (Mom & Pop S Corp) formed in 2000
- Buyer – prefers asset purchase (for step up in basis)
- Seller – prefers equity sale
- Seller to have a 30% rollover interest
    - Rules out a Section 338(h)(10) election
- Solution – Complete an F Reorganization and sell 70% of SMLLC units to the buyer
- Result – a partnership owned 70% by Buyer (who received a step up) and 30% owned by Seller through an S corporation

S Corporation Partial Sale Case Study



S Corporation Partial Sale Case Study





Summary

- There is no single answer for all businesses
- Choice must be evaluated based on all considerations:
  - Legal issues
  - Employment issues
  - Federal & state taxes
  - Eventual exit or conversion
- Any evaluation involves significant amount of projects & assumptions
- It is still not clear what future tax rates are going to be so even the best laid plans may be derailed based on future Congressional (in)action

Questions?

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