CORPORATE TAX UPDATE
AND
ENTITY FORMATION ISSUES

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This outline should be viewed only as a summary of the law and proposed laws, and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.

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1. Tax Rules to Force C Corp Dividends

"If the corporate rate is significantly below the individual's marginal rate (for example, because of the graduated corporate income tax rate structure), the value of deferring shareholder-level tax by not distributing corporate income can more than offset the extra burden of the corporate income tax. Present law provides a disincentive to the accumulation of undistributed income at lower corporate rates by imposing accumulated earnings tax or personal holding company tax on a corporation that does not distribute its income in certain limited circumstances, as discussed in section II of this document. If these taxes apply, they are payable in addition to the regular corporate tax and are imposed at the maximum rate applicable to an individual's receipt of a dividend. Such taxes are intended to compensate for the shareholder level deferral that may occur when corporate income is not distributed."[1]

"Taxes at a rate of 15 percent (the top rate generally applicable to dividend income of individuals) may be imposed upon the accumulated earnings or personal holding company income of a corporation. The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs. The personal holding company tax may be imposed upon the excessive passive income of a closely held corporation. The accumulated earnings tax and the personal holding company tax, when they apply, in effect impose the shareholder level tax in addition to the corporate level tax on accumulated earnings or undistributed personal holding company income."[2]

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[1] Staff of the Joint Committee on Taxation, SELECTED ISSUES RELATING TO CHOICE OF BUSINESS ENTITY, IV.A. (August 1, 2012).

[2] *Id.* at II.B.2.

"If the rate differential became very substantial again – let us say for illustration 40 percent maximum individual rate and 28 percent maximum corporate rate, tax planning for the closely held business would change substantially, reverting in many ways back to a setting like [the 1070s and early 1980s]. Use of the [C corp] as, in part, an "incorporated pocketbook" would again become part of the tax planning scene, as wealthy closely-held business owners might want to hold more of their portfolio assets at the corporate level and benefit from lower rates at that level. I would undoubtedly start teaching the accumulated earnings tax and personal holding provisions again after a 25 year hiatus."[3]

2. Personal Holding Company Tax

2.1. Rate changes on the horizon

In addition to the regular corporate income tax, the Internal Revenue Code provides for taxes designed to prevent retention of corporate earnings so as to avoid individual income tax in dividends received.

The personal holding company tax is imposed on certain undistributed personal holding company income, generally where the corporation meets certain closely held stock requirements and more than 60 percent of the adjusted ordinary gross income (as defined) consists of certain passive-type income such as dividends, interest, and similar items.[4]

"If the corporate rate is significantly below the individual's marginal rate (for example, because of the graduated corporate income tax rate structure), the value of deferring shareholder-level tax by not distributing corporate income can more than offset the extra burden of the corporate income tax. Present law provides a disincentive to the accumulation of undistributed income at lower corporate rates by imposing **accumulated earnings tax** or **personal holding company tax** on a [C] corporation that does not

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[3] Dana Trier, University of Miami School of Law and Columbia Law School, Statement for Senate Finance Committee Aug. 1 Hearing on Tax Reform, Taxation of Business Entities, II.B.2., August 1, 2012.

[4] I.R.C. §§ 541-547.

distribute its income in certain limited circumstances.... If these taxes apply, they are payable in addition to the regular corporate tax and are imposed *at the maximum rate applicable to an individual's receipt of a dividend*. Such taxes are intended to compensate for the shareholder level deferral that may occur when corporate income is not distributed."[5]

2.2. Checking the wrong box

PLR 2012-01-011, October 3, 2011. LLC holds intellectual property and licenses it to affiliates and others in exchange for royalty payments. LLC is a second-tier subsidiary. A great way to isolate the IP from claims against the operating company. If the operating company goes down in flames, the IP LLC still owns the brands and the owners of the brands can start over or sell the brands. If the LLC is a single-member LLC, it is disregarded and the consolidated return rules do not apply. The risks of terminating QSub status are avoided. If the operating company is a disregarded or pass-through entity, the fact that the LLC's receipts are all passive royalties are no problem, because the "regarded" parent corporation has plenty of active income.

Unless ... the LLC is taxed as a C corporation. And a new accounting firm comes in and concludes that the LLC classified as a C corp is a ... personal holding company its income consists solely of royalties.

A consent dividend is one made after the year closes but before the tax return is filed. It is treated as if it was made during the prior year, so it reduces or eliminates the income subject to the PHC penalty tax.[6] The LLC that filed the ruling request was years late, but the IRS allowed the late consent dividends.

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[5] Staff of the Joint Committee on Taxation, SELECTED ISSUES RELATING TO CHOICE OF BUSINESS ENTITY, IV.A. (Augist 1, 2012).

[6] I.R.C. § 561, 565(a); Treas. Reg. § 1.565-1(a).

3. Accumulated Earnings Tax

3.1. "The accumulated earnings tax can be imposed on certain earnings in excess of $250,000 ($150,000 for certain service corporations in certain fields) accumulated beyond the reasonable needs of the business. However, the rate is 15 percent.[7]

4. PHC and AET Penalty Tax Rates

4.1. "Reduced rates under accumulated earnings tax and personal holding company tax (secs. 531 and 541 and sec. 901 of Pub. L. No. 107-16)

- "In addition to the regular corporate level income tax, tax at the highest individual rate on dividends (currently 15 percent) is imposed on a corporation with respect to certain undistributed taxable income. The 15-percent accumulated earnings tax is imposed on certain income that is accumulated beyond the reasonable needs of the corporate business (but does not apply to a personal holding company). The 15-percent personal holding company tax is imposed on certain taxable income of a personal holding company (generally, a closely held corporation that receives at least 60 percent of its taxable income from certain investments treated as passive).

- "The 15-percent rate for the accumulated earnings tax and personal holding company tax was adopted, *repealing the former Code reference to the highest individual tax rate*, in 2003 in the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, in connection with adoption of the special rule for qualified dividends of individuals, which taxed such dividends at the same rate as capital gains and reduced the rate for both to 15 percent. The repeal of the reference to the highest individual tax was originally scheduled to expire on December 31, 2008.

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[7] I.R.C. §§ 531-537.

- "The 15-percent rate provisions were extended through December 31, 2010 in the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222.

- "The 15-percent rate provisions were most recently extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, through December 31, 2012."[8]

4.2. **New 39.6% AET and PHC tax rate**

The rates are scheduled to revert to the pre-2003 rates for tax years beginning in 2013, as individual income tax rates are scheduled to rise substantially above the maximum 35% tax rates on C corp income.

5. S Corp Developments

5.1. **ObamaCare taxes**

5.1(a) Non-Deductible 0.9% additional employment tax on wages over $250,000 Will encourage more S corp shareholders to reduce salaries below that amount.

5.1(b) A new 3.8% tax on passive investments will apply in 2013.

- S corp shareholders who are *active* in the business can avoid this tax on their flow-through income.

5.2. **Increased California individual income tax rates**

5.2(a) California Proposition 30 PASSED to increase maximum nominal tax rates on individuals from 9.3% and 10.3% (on income over $1M) to 10.3%, 11.3%, 12.3% and 13.3% (for income over $1M).

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[8] Staff of the Joint Tax Committee, LEGISLATIVE BACKGROUND OF EXPIRING FEDERAL TAX PROVISIONS 2011-2022, I.A.38., January 27, 2012 (emphasis added).

- With the California 6% itemized deduction cutback, the maximum effective California income tax rate is 14.1%.[9]

- Proposition 30 is effective as of January 1, *2012*.

5.2(b) California Proposition 38 DEFEATED, would have increased the maximum individual income tax rates to 11.5% and 12.5%.

- With the 6% itemized deduction cutback, the effective maximum marginal tax rate on individual income over $1M would have been 13.25%.

- These rates would have become effective in 2013.

5.2(c) If both Propositions 30 and 38 passed, only the one with the most votes will go into effect.[10]

5.3. "**Base Broadening**"

5.3(a) A consensus is building to reduce the maximum corporate income tax rates (34% and 35% -- maybe even the 25% rate), possibly achieving "revenue neutrality" by "broadening the base" -- eliminating or scaling back business deductions and credits.

5.3(b) Pass-through entities won't benefit by reducing the maximum corporate tax.

- But they will be affected by base broadening.

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9 13.3% + (6% x 13.3%) = 14.098%

10 *See:* http://www.sos.ca.gov/elections/ballot-measures/qualified-ballot-measures.htm

- To avoid a tax increase on pass-throughs as a result of base broadening, a special rule will be needed to "neutralize" the effect of base broadening on them.

6. C Corp Developments

6.1. Federal tax rate on dividends to jump from 15% to 39.6% + 3.8% + 1.2% on passive income over $250,000 = 44.6% -- tripling.

6.2. AET and PHC penalty tax rates to increase to 39.6%.

6.3. Possibility of lower rates and base broadening

7. Tax Rates in 2013

7.1. Proposition 30 (effective in 2012) or 38 (effective in 2013)

7.2. ObamaCare taxes Tax (effective in 2013)

7.3. Federal individual tax rates scheduled to increase in 2013

7.4. Federal 3% itemized deduction cut-back returns in 2013 -- adds another 1.2% to the marginal tax rate

7.5. **Top effective combined California and federal rates**

7.5(a) Long-term capital gain – 33% to 39% (depending on how much of the California tax can be deducted against ordinary income).[11]

7.5(b) Ordinary income (not passive investments or wages) – 49%.[12]

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[11] 14.1% + 20% + 1.2% + 3.8% = 39.1% (assumes no ordinary income to absorb a federal deduction for state taxes). 14.1% + 20% + 1.2% + 3.8% - (14.1% x (39.6% + 1.2% + 3.8%) = 32.8% (assumes enough ordinary income to absorb a federal deduction for all state taxes).

7.5(c) Ordinary income through an S corp (active) – 50%.[13]

7.5(d) Ordinary income through an S corp (passive) – 53%.[14]

7.5(e) C corp dividends – 51%.[15]

7.5(f) C corp income (undistributed) – 40% to 41%.[16]

7.5(g) C corp income (distributed as dividend) -- 71%.[17]

7.5(h) C corp income (distributed as capital gain) – 60% to 63%.[18]

7.5(i) C corp income subject to AET or PHC tax – 76% to 77%.[19]

7.5(j) C corp income subject to AET or PHC tax and distributed in a later year – 88% to 89%.[20]

(..continued)

12 14.1% + 39.6% + 1.2% - (14.1% x (39.6% +1.2%)) = 49.15%

13 14.1% + 1.5% + 39.6% + 1.2% - ((14.1% + 1.5%) x (39.6% +1.2%)) = 50.03%.

14 14.1% + 1.5% + 39.6% + 1.2% + 3.8% -
((14.1% + 1.5%) x (39.6% +1.2% + 3.8%)) = 53.24%.

15 14.1% + 44.6% - (14.1% x (1- 44.6%)) = 50.88%.

16 8.84% + **34**% - (8.84% x **34**%) = 39.83% (over $335,000 taxable income);
8.84% + **35**% - (8.84% x **35**%) = 40.75% (over $10M of taxable income).

17 40% + ((1-40%) x 51%) = 70.6%.

18 40% + ((1-40%) x 33%) = 59.8%;
40% + ((1-40%) x 39%) = 63.4%.

19 8.84% + **34**% +39.6% - (8.84% x (**34**% + 39.6%)) = 75.93%;
8.84% + **35**% +39.6% - (8.84% x (**35**% + 39.6%)) = 76.87%

20 **76**% +((1 - **76**%) x 51%) = 88.24%;
77% +((1 - **77**%) x 51%) = 88.73%.

8. Personal Service Corporations

8.1. Certain personal service corporations are not entitled to use the graduated corporate rates below the 35-percent rate.[21]

- Such a corporation is one in which substantially all the activities involve the performance of services in certain fields, and substantially all the stock of which is held directly or indirectly by employees performing services for such corporation, retirees, or certain estates or heirs of such persons.[22]

- A separate provision allows the Secretary of the Treasury to reallocate income, deductions, and other items between a differently defined personal service corporation and its owners, to prevent the avoidance of Federal income tax.[23]

8.2. If the base-broadening/rate-reducing effort is successful, the maximum corporate tax rate will drop. The tax rate on personal service corporations might also drop.

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[21] I.R.C. §§ 11(b)(2), 448(d)(2). PSCs are entitled to use the cash method of accounting.

[22] I.R.C. § 448(d)(2). The fields are health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

[23] I.R.C. §Sec. 269A. A personal service corporation for this purpose is a corporation the principal activity of which is the performance of personal services and such services are substantially performed by employee-owners (persons who own, or by attribution are deemed to own, more than 10 percent of the stock of the corporation). If substantially all the services of a personal service corporation are performed for or on behalf of one other entity, and the principal purpose of forming or availing of such personal service corporation is the avoidance or evasion of federal income tax, the IRS may reallocate items of income or deduction. T he provision is in addition to the general provision of Section 482 that permits reallocation of income, deductions, or other items among related parties. See also I.R.C. § 1551.

8.3. Cat breeding and IT consulting biz is not a PSC[24]

8.3(a) 2,000 to 2,200 hours on IT consulting and 800 hours on "cattery activity," so less than 95% PSC services – not a PSC.

8.4. Revenue procedure regarding the nonaccrual experience method

8.4(a) The Rev. Proc. outlined a book safe harbor method of accounting for taxpayers using the nonaccrual experience ("NAE") method of accounting.[25]

9. Pass-Throughs and SECA Taxes

9.1. The New York State Bar Association offered recommendations on how to define "limited partners" for purposes of the self-employment tax rules:[26]

9.1(a) Use a material participation standard to define "limited partners for purposes IRC Section 1402.

9.1(b) Distinguish between "service partnerships" (like an accounting firm) and "investment partnerships" (like a private equity group, a real estate deal or a hedge fund).

9.1(c) Define "service partners" of "service partnerships," and treat all of their income as SE income.

9.1(d) For investment partnerships, allow a partner with more than one class of ownership to treat one class as a service class subject to SECA and another as an investment class subject to the 3.8% ObamaCare tax.

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24 DKD Enterprises v Comm'r, 2011-29 T.C.M. (January 31, 2011)

25 Rev. Proc. 2011-46, I.R.B. 2011-42 at 518 (9-29-11).

26 New York State Bar Association Tax Section, *Comments On The Application Of Employment Taxes To Partners And On The Interaction Of The Section 1401 Tax With The New Section 1411*, Report 1247, DAILY TAX REPORT (BNA), November 16, 2011.

9.1(e) Treat all "carried interests" in an investment partnership as subject to the 3.8% tax, not SECA.

10. New California LLC Act

10.1. Beverly-Killea Limited Liability Company Act

10.1(a) Enacted and became effective in 1994.

10.1(b) Ceases to be effective on 1-1-14.[27]

10.2. California Revised Uniform Limited Liability Company Act

10.2(a) Enacted 9-21-12.[28]

10.2(b) Becomes effective on 1-1-14.

10.2(c) Entirely replaces the 1994 Act.

10.2(d) Does *not* permit series LLCs to be formed under California law.

10.2(e) Does *not* permit LLCs to engage in activity licensed under the Business and Professions Code ("BPC"), *even if* the applicable licensing provisions of the BPC allow it.[29]

10.2(f) Specifies that a transfer in violation of a transfer restriction in the operating agreement "is *ineffective* as to a person having notice of the restriction at the time

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27 Cal. Corp. Code § 17657(b).

28 SB 323, Chapter 419.

29 Cal. Corp. Code § 17701.04(b) (allowing it), (e) (not allowing it and superseding (b). *Compare* Cal. Corp. Code § 17002(c) and 17375 (permission to operate as LLC given in BPC supersedes prohibition in 1994 LLC Act).

of transfer" – even a transfer of only the right to receive distributions and tax allocations.[30]

- The 1994 Act was not this specific, so there was always the danger that a court would refuse to enforce a transfer restriction that it viewed as an "unreasonable restraint of alienation of property."

10.2(g) *Does* permit a single-member LLC.[31]

10.2(h) *Does* permit charging orders as the sole method by which a creditor of a member can tap the distributions to the member.[32]

- Does *not* address whether a charging order is the creditor's sole remedy if there is no other member of the LLC.

[End of outline.]

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[30] Cal. Corp. Code § 17705.02(f). *Compare* Cal. Corp. Code §§ 17005, 17301.

[31] Cal. Corp. Code § 17701.02(s). The 1994 law was amended in 1996 to permit single-member LLCs. Cal. Corp. Code § 17001(t).

[32] Cal. Corp. Code § 17705.03