FEUSA ISSUE BRIEF

# Business Structure and Its Impact on the Tax Liability of Family Firms

Family Enterprise USA

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## BUSINESS STRUCTURE & ITS IMPACT ON THE TAX LIABILITY OF FAMILY FIRMS

### Background

The United States boasts 5.5 million family firms that, collectively, generate 57% of the nation's GDP and employ 63% of our workforce, making them the backbone and primary drivers of our economy. Of the Fortune 500 companies, 35% are family owned, as are 60% of public companies. Family business owners are patient, long-term investors; making a profit is important to them, but it is not the primary motivator. They make decisions with an eye toward creating stable companies and communities. As a result, they are valuable economic engines in a community, providing long-term employment for workers and strong vendor relationships for suppliers. Research shows that the leadership tenure in family firms is 4-5 times longer than in shareholder-controlled public companies, which further bolsters stability.

Based on solid values of integrity, innovation and tenacity, family firms are intrinsically strong corporate citizens. Studies show that family businesses are committed to their employees, and are slower to shrink their workforce during tough economic times, which also makes them an important buffer against unemployment and eases the strain on social services. Family businesses are intensively engaged in living their values; FEUSA's research indicates that 95% of family firms engage in philanthropy in their community.

### Issue Overview

Of all the external uncertainties that face family firms today, there is none greater than federal tax policy. One major factor - how a family enterprise designates its tax status - S corporations, C corporations, or LLCs - can dramatically impact a business' revenue and long-term growth. Adding to the confusion, and tax exposure, some reform proposals often change the rules for partnerships, S corporations, limited liability companies or other so-called pass-through entities and require that these business structures be treated as C corporations for tax purposes.

This matters greatly with the looming "Taxmageddon"— when the extension on Bush-era income tax cuts, current estate tax law, and some $500 billion in tax breaks expire all at once on December 31, 2012.

The potential increases include $165 billion more from taxpayers as a result of expiration of the income tax cuts, which would push taxes from a bottom rate of 10% and a top rate of 35% to a bottom rate of 15% and a top rate of 39.6%. Absent action by Congress, existing rates on the estate tax, capital gains and dividends will also increase.

### Basic Taxation of Business Entities

*The following information was provided by Dori Brewer and Bryan Smith, partners of the law firm, Perkins Coie**

**C Corporations.** A C corporation is a corporation that has not elected to be taxed as an S corporation. Most public companies are C corporations, but many family-owned companies are as well. A C corporation is a taxpayer and pays tax at corporate rates on its income. Under current law, the federal tax rates applicable to C corporations range from 15% to 35%, with a flat 34% rate generally applicable to taxable income under $10 million. All of the C corporation's income is taxed at these general rates; there is no lower rate applicable to long-term capital gains, as there is for individuals in S corporations.

When a C corporation pays a dividend to shareholders who are individuals, the dividend is taxable income to the shareholders and, under current law, generally is subject to a maximum federal tax rate of 15%. This double level of tax is the principal factor that distinguishes a C corporation from an S corporation, which generally is subject to a single level of tax on its income. The impact of the double tax on C corporations is addressed in more detail below.

**S Corporations.** An S corporation is a corporation that meets certain criteria and that has made an election to be taxed as an S corporation. In order to be eligible to make an S election, a corporation must, among other things:

- have one class of stock
- have no more than 100 shareholders (with family members generally treated as one shareholder for this purpose)
- be either individuals who are U.S. citizens or residents, certain types of trusts or charities

An S corporation generally does not pay any federal income taxes. Instead, the taxable income of an S corporation is reported on its shareholders' individual tax returns and the shareholders pay tax on the S corporation's taxable income, whether or not the shareholder receives any distributions from the S corporation. That means a shareholder will pay tax on the S corporation's taxable income at the tax rates applicable to individuals. Under current law, the highest federal rate applicable to individuals is 35% and that is often the rate at which the S corporation's operating income is taxed.

The character of income (i.e. whether it's active or passive) flows through the S corporation to the individual shareholders' returns as well. So, long-term capital gains recognized by an S corporation are taxed at the rate applicable to individuals, which is currently 15%.

Finally, when an S corporation makes a distribution to its shareholders out of its taxable earnings, the shareholders generally pay no tax on the distribution because the shareholders already have paid tax on the earnings. With shareholders paying tax on the S corporation's income and no tax imposed on the equivalent of a dividend distribution to shareholders, this is the single level of tax often referred to when describing an S corporation.

**Limited Liability Companies and Partnerships.** Limited liability companies ("**LLCs**") and partnerships are flow-through entities for federal income tax purposes, taxed in many ways similarly to S corporations, but without the ownership and other requirements imposed on S corporations. For example, there is no limit on the type or number of owners of an LLC or the classes of equity issued by an LLC. Although many new businesses are formed as LLCs, many legacy companies are corporations because LLCs have not been available or appropriate for operating businesses until relatively recently. The same is true for partnerships, which historically did not provide the same liability protection as corporations. Because the tax treatment of LLCs and partnerships is very similar to S corporations, except as specifically noted below, the remainder of this paper does not distinguish between them.

## How Tax Rates Differ and What the Future Holds

**Current Income Tax Treatment and Projected Increases.** To illustrate the difference between the two types of corporations, assume a business has taxable income of $10 million and distributes all of its after tax income to its shareholders in 2012. Assuming that the income is taxed at a corporate rate of 34% and the highest individual rate of 35%, here is how taxes affect those businesses under current law. See Figure 1.

Figure 1

| 2012 | C Corp | S Corp |
|---|---|---|
| Taxable Income | $10,000,000 | $10,000,000 |
| Tax paid by corporation (34%) | $3,400,000 | $0 |
| Remainder distributed to shareholders | $6,600,000 | $10,000,000 |
| Tax paid by shareholders on business income (35%) | $0 | $3,500,000 |
| Tax paid by shareholders on distribution (15%) | $990,000 | $0 |
| Total taxes paid | $4,390,000 | $3,500,000 |
| **Effective tax rate** | **44%** | **35%** |

Figure 2

| 2013 | C Corp | S Corp |
|---|---|---|
| Taxable Income | $10,000,000 | $10,000,000 |
| Tax paid by corporation (34%) | $3,400,000 | $0 |
| Remainder distributed to shareholders | $6,600,000 | $10,000,000 |
| Tax paid by shareholders on business income (39.6%) | $0 | $3,960,000 |
| Tax paid by shareholders on distribution (39.6%) | $2,613,600 | $0 |
| Medicare tax (3.8%) | $250,800 | $380,000 |
| Total taxes paid | $6,264,400 | $4,340,000 |
| **Effective tax rate** | **63%** | **43%** |

If no legislation is enacted to prevent it, tax rates are scheduled to increase in 2013 as follows:

- The highest individual rate will increase from 35% to 39.6%
- The tax rate applicable to dividends will increase from 15% to 39.6%
- The long-term capital gains rate will increase from 15% to 20%
- Passive income, including dividends, capital gains and income of a passive owner from flow-through entities like S corporations, will be subject to an additional Medicare tax of 3.8%. This additional tax generally will not apply to operating income and gain that flows through to those shareholders of an S corporation who are active in the business.

If the business described above has taxable operating income of $10 million in 2013 rather than in 2012, the income will be taxed as follows (assuming that none of the shareholders is active in the business). See Figure 2.

In the Figure 2 example, if any shareholders are active in the business, the Medicare tax will not apply to their share of the S corporation's income (but will continue to apply to passive shareholders).

The effective federal tax rate on a C corporation that distributes all of its operating income after paying taxes increases from 44% to 63% and the effective tax rate on an S corporation increases from 35% to 43%.

**Current Capital Gains Tax Treatment and Projected Increases.** The difference between C corporations and S corporations becomes more significant in connection with the sale of one of the corporation's entities. Assume the business described above has a capital gain of $10 million from the sale of one of its assets and distributes all the proceeds to its shareholders in 2012. Assuming that the corporation's gain is taxed at a corporate rate of 34% and the maximum individual rate applicable to long-term capital gains of 15%, here is how a sale of that business would be taxed under current law. See Figure 3.

Figure 3

| 2012 | C Corp | S Corp |
|---|---|---|
| Taxable gain from sale of assets | $10,000,000 | $10,000,000 |
| Tax paid by corporation (34%) | $3,400,000 | $0 |
| Remainder distributed to shareholders | $6,600,000 | $10,000,000 |
| Tax paid by shareholders on long-term capital gain (15%) | $0 | $1,500,000 |
| Tax paid by shareholders on distribution (15%) | $990,000 | $0 |
| Total taxes paid | $4,390,000 | $1,500,000 |
| **Effective tax rate** | **44%** | **15%** |

Figure 4

| 2013 | C Corp | S Corp |
|---|---|---|
| Taxable gain from sale of assets | $10,000,000 | $10,000,000 |
| Tax paid by corporation (34%) | $3,400,000 | $0 |
| Remainder distributed to shareholders | $6,600,000 | $10,000,000 |
| Tax paid by shareholders on long-term capital gain (20%) | $0 | $2,000,000 |
| Tax paid by shareholders on distribution (20%) | $1,320,000 | $0 |
| Medicare tax (3.8%) | $250,800 | $380,000 |
| Total taxes paid | $4,970,800 | $2,380,000 |
| **Effective tax rate** | **50%** | **24%** |

If the business described in Figure 3 had a capital gain of $10 million and were to distribute all the proceeds in liquidation to its shareholders in 2013, that gain would be taxed as follows in 2013. See figure 4.

The effective federal tax rate on capital gains of a C corporation that distributes all of its proceeds in liquidation increases from 44% to 50% and the effective tax rate on an S corporation increases from 15% to 24%.

### Why Family Firms Need an Alternative

As the examples above show, the form of entity is a significant factor in the tax rate that applies to a business. S corporations were created to encourage the creation and growth of small and family-owned businesses. However, there are a number of requirements to qualify to be an S corporation and many family businesses do not meet those requirements. Moreover, even when a family business can qualify as an S corporation, the requirement that an S corporation have only one class of stock can present a significant issue, in particular for a business that wishes to reinvest in the company for growth or retain earnings for financial stability.

For example, because the shareholders of an S corporation pay tax on its income, most S corporations distribute sufficient cash to their shareholders to pay this tax. Where an S corporation has shareholders who are subject to different tax rates, the S corporation is essentially required to make tax distributions to all shareholders at the highest of these rates (because all distributions must be made pro rata), which prevents this extra cash from being used in the business. This problem becomes more significant when shareholders reside in different states, or, starting in 2013, if some shareholders will be subject to the Medicare tax and some will not.

A new business can be formed as a limited liability company and receive the benefits of being a flow-through entity like an S corporation but without the restrictions imposed on S corporations. For example, an LLC may make tax distributions to its members based on their particular tax rate, because distributions from an LLC need not be made pro rata. However, while the election by a C corporation to be an S corporation generally is not a taxable event, the conversion of a C corporation to a limited liability company generally is taxable to both the corporation and its shareholders. Thus, a family-owned business that is a C corporation and that does not qualify to make an S election cannot achieve the benefits of being a flow-though entity without either changing its ownership structure to enable qualification as an S corporation or incurring what is most likely a significant tax. As a result, the current status of the tax laws applicable to business entities could be viewed as unfairly penalizing long standing family-owned businesses.

**Family Attribution and Related Party Rules.** There are a number of rules under the federal income tax code where individuals are deemed to own corporate stock or other equity interests that are owned by their family members and related entities. This "attribution" of ownership can sometimes cause negative and unanticipated tax consequences. For example, if a family business that operates in the form of a C corporation redeems shares from a family member shareholder, that transaction could be treated as a dividend for tax purposes rather than as a sale of shares. As a result, they would not qualify for the preferential long-term capital gain rate if the shareholder is "deemed" to own shares owned by other family members.

Similar problems can arise where family members or entities owned by them engage in transactions with other family members or entities, and the regular and anticipated tax consequences of the transaction are modified by related party rules under the tax code (generally to the detriment of the family members or family business). Examples of these rules include the disallowance of losses or deductions relating to assets sold between family members or entities or the conversion of capital gain into ordinary income in such a sale.

Although the purpose of the attribution and related party rules is generally to prevent abuse, in many situations they affect non-abusive transactions that simply happen to be occurring between related parties (i.e. family firms).

## Conclusion

With "Taxmaggedon" on the horizon and tax reform as a center stage issue in Washington, D.C. and the presidential election, there's never been a more important time for family firms to be informed and engaged on potential changes that will impact their bottom line.

It is important for family business leaders to communicate through FEUSA to our Washington leaders that strong family businesses make for a strong economy and strong communities. We should have a receptive audience since over one-third of the members of the current Congress have a direct or indirect tie to a family-owned business (see FEUSA's Faces of Family Business Report). Contact FEUSA if you are interested in supporting our efforts to create a favorable environment for America's job creators and community stabilizers to continue for generations.

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*Footnote: Dori Brewer and Bryan Smith, partners of the law firm, Perkins Coie, have more than 25 years of experience in the areas of corporate governance, mergers and acquisitions, strategic business transactions, joint ventures, partnerships, limited liability companies, and advising closely-held companies and family-owned businesses. They can be reached at (206) 359-8000 or at dbrewer@perkinscoie.com or bsmith@perkinscoie.com, respectively.*

*Family Enterprise USA is a non-profit 501(C)(3) organization that educates the general public, policymakers and the media about the collective issues facing family enterprises and publicly promotes their contributions to the common good.*

Disclaimer: As all business owners are aware, nothing is simple when it comes to taxes. This paper contains many general statements and simplifies complex concepts. There are many nuances in the issues discussed in this paper and exceptions to the general rules. A tax advisor should be consulted before taking any action with respect to a particular business or situation.