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Choice of Business Entity after JGTRRA and AJCA, Part 1

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The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) and the American Jobs Creation Act of 2004 (AJCA) made substantial changes in tax rates affecting the choice of entity decision—between a regular corporation and a flow-through entity—that companies have to make regarding how they will conduct business. After the JGTRRA went into effect, corporate dividends paid to noncorporate taxpayers changed—they now are taxed at a 15% or 5% rate, depending on the taxpayer's marginal tax bracket. Dividends received by most individual taxpayers are taxed at the 15% rate; taxpayers whose marginal tax bracket for ordinary income is 15% or less, however, are taxed at a 5% rate on their dividends.

Also, the JGTRRA changes the rates at which capital gains are taxed. The former 20% and 10% rates are now 15% and 5%, consistent with the changed dividend rates. Differences between the tax treatment of dividends and capital gains, however, still remain. Dividends generally are taxed in the amount received, but proceeds of capital gains are reduced by the taxpayer's basis in the property sold, thus subjecting only the net gain to tax. Also, capital gains can be offset by capital losses incurred by the taxpayer. Dividends usually can't be offset by capital losses and thus are taxed fully to the extent of the distributing corporation's earnings and profits.

The JGTRRA accelerated the reduction in tax rates for individuals that had been established by earlier tax legislation. This acceleration is favorable for individuals who are owners in a partnership, Limited Liability Partnership (LLP), S Corporation, or Limited Liability Company (LLC). We will discuss the changes affecting these flow-through entities along with relevant changes made in the AJCA next month in Part 2 of this column.

Typically, the biggest drawback to using the corporate business form has been the problem of double taxation. Unlike for a pass-through entity, corporate income is taxed directly to the corporation when it earns the income. If the earnings are later distributed to shareholders, the income is taxed again as a dividend to the shareholders with no offsetting tax deduction to the corporation. This rule has discouraged many small and some medium-sized businesses from operating as a corporation. The JGTRRA alleviates this problem to a substantial degree. Now the dividend tax will be at a lower rate than prior to the Act. The reduced dividend rate should encourage the formation of more

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corporations (due to the nontax advantages that a corporation has over other types of entities, which we'll discuss later).

One basic tax advantage of the corporate form should be mentioned. Partnership earnings are taxed to partners and LLC members treated as partners whether they receive them or not. The earnings are taxed at the partners' and members' marginal tax rate. With a corporation, earnings are taxed to the owners only if and when distributed. Consequently, if a corporation has limited net income and doesn't want to distribute it, the corporation and its shareholders may pay a smaller combined tax on earnings than the total tax paid by the owners of a pass-through entity. If the corporation only has to pay tax in the 15% and 25% corporate tax brackets, these rates often may be lower than the rate that would have applied to its shareholders had the earnings passed through to them from a partnership or LLC.

Reasonable earnings may also pass through to the shareholders as salary for services performed. The corporation receives a tax deduction for the earnings, effectively splitting the earnings between the corporation and the shareholders. If done with care, this strategy has always been a popular planning technique. Now the consequences of having the salary reclassified as a disguised dividend aren't as onerous. The corporation will lose the deduction as a result of the reclassification, as before, but now the shareholder/employee will be taxed at a lower rate than if the distribution remained classified as salary.

When nontax differences are considered, the corporate form usually shines. It is well established that corporate shareholders have limited liability for their investments. The shareholder may lose out if the stock declines in value, but the loss is limited to the amount of the shareholder's investment. Corporate creditors can't go to the shareholders to collect debts. A sole proprietor and a general partner don't have this protection. They and the entity itself are personally responsible for the entity's debts. Thus, limited liability is still an important characteristic of a corporation. LLCs and LLPs have reduced or eliminated this exposure for many owners of pass-through entities, but the law is less settled for them.

Corporate stock is also easier to transfer than interests in partnerships and LLCs. In fact, courts will not enforce substantial restrictions on transferring corporate interests. Also, in many cases, an established market may exist for these shares. For LLCs and partnerships, restrictions on transferability are more common. Many partnerships permit partners a great deal of flexibility in controlling who new partners will be. It isn't unusual for a partnership agreement to require that a partner who is thinking of selling his or her partnership interest must first get permission from the nonselling partners.

For larger enterprises, centralized management and the ease of running a business in a corporate form are important. Corporations also have been around a long time, and it's generally known how they and their owners will be treated under federal and state law. There's often more consistency here than with other forms of ownership, particularly LLCs and LLPs. Setting up a corporation may require some paperwork and fees, but a road map exists and, again, we usually know how the corporation will be treated once it is formed.

With their freely transferable shares, established markets in some situations, and their ability to establish different types of shares, corporations generally find it easier to obtain financing than other business forms, especially if large amounts are needed. Similarly, the ability to merge with other corporations helps build up the enterprise and can be an inexpensive way (e.g., using the corporation's own stock to acquire other companies) to grow the business(es). Finally, most corporations have the ability to operate freely outside their state of domicile and in foreign countries. While LLCs and LLPs also enjoy the flexibility of operating across borders, the law governing these firms is less settled, making both their operation and the rules regulating their governance less predictable. ■

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