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Choice of Business Entity after JGTRRA and AJCA, Part 2

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Last month we discussed how changes to tax rates in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) and the American Jobs Creation Act of 2004 (AJCA) affect a business's choice of entity decision—focusing primarily on corporations. In part 2, we examine the recent tax law changes that affect owners in a partnership, a Limited Liability Partnership (LLP), an S Corporation, and a Limited Liability Company (LLC).

An LLC with two or more members is automatically treated as a partnership under the federal income tax law unless the LLC elects corporate treatment. Like an LLP, an LLC treated as a partnership never pays federal income tax. As a pass-through entity, the LLC or LLP passes its ordinary income—and other items of income, gain, deduction, or loss—separately to its owners, who include the items on their individual tax returns.

When one owner sells his or her partnership interest (including an LLP or LLC interest), a tax issue arises as to how any gain or loss on the sale will be treated. Generally, the gain or loss is capital. If the partnership has unrealized receivables, recapture items, or inventories, however, there could be ordinary income when one sells a partnership interest. The 18.6% gap between the top ordinary rate (38.6%) and the top capital gain rate (20%) that existed before the 2003 tax law goes to 20% after the JGTRRA (35% vs. 15%), so the impact of the characterization of gain when an owner sells his or her partnership interest hasn't been changed greatly by the JGTRRA.

The reduction in the dividend tax rate to 15% or 5% should expand the use of the special bypass election for S Corporations. An S Corporation that had been a regular C Corporation previously or that acquired another C Corporation's earnings and profits in a tax-free reorganization, may have accumulated C Corporation earnings and profits. The existence of earnings and profits exposes the S Corporation to a potential penalty tax if it has excessive passive investment income or could subject the corporation to the loss of its S election. If the S Corporation distributes its earnings and profits to its shareholders, the potential exposure to the penalty tax or loss of the S election is eliminated. After the JGTRRA, high-income-tax S Corporation owners pay tax on dividends at a 15% rate only. The substantial reduction in the dividend tax rate

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makes it more likely that an S Corporation may be willing to distribute its earnings and profits first to avoid the tax or loss of election penalties.

Income still passes through to the owners of a partnership, LLP, LLC, or an S Corporation. Losses also pass through as well but are subject to loss limitation provisions. The entity's owners may only deduct current losses if they satisfy the basis, at-risk, and passive activity loss rules, in that specific order. The ability to pass through losses remains a plus in several situations, especially during the formative years of many businesses. For example, it may be wise in some circumstances to begin business as an LLC (or LLP) and consider a later switch to the corporate form if and when circumstances dictate.

Generally, the impact of the JGTRRA on LLCs treated as partnerships is minimal. The impact of the JGTRRA on corporations is more pronounced and generally favorable. Tax-wise, the entity-choice decision between using a corporate or pass-through entity is more complex than before the JGTRRA. Of course, the entity-choice decision must turn on the anticipated facts and circumstances that will characterize the new business.

An LLC treated as a partnership may desire limited liability but also want to avoid the self-employment tax liability for an LLC owner. These goals are achieved by an LLC that elects to be treated as an S Corporation. Procedurally, the LLC in this case would file Form 8832, elect to be treated as a corporation, and then file Form 2553 and elect to be treated as an S Corporation. Recent taxpayer-friendly rulings have been issued by the IRS that permit an LLC to simply file Form 2553 to be treated as an S Corporation.

The American Jobs Creation Act of 2004 included several provisions that affect S Corporations and partnerships. With respect to S Corporations, the AJCA added the following key provisions: (1) an S Corporation can now have up to 100 owners, 25 more than the permitted number prior to the AJCA; (2) certain family members who are S Corporation owners may elect to be treated as one owner, thus further increasing the post-AJCA number of owners that an S Corporation may have; (3) in the case of married shareholders who divorce, the AJCA permits the spouse to whom S Corporation shares are transferred to use the suspended losses that the transferring spouse had in the shares that are transferred; and (4) a bank S Corporation now may have an IRA (Roth or traditional) as an owner.

There were some partnership changes in the AJCA that also affect LLCs treated as partnerships and LLPs. One provision in the AJCA requires that if a partner transfers loss property to a partnership and later sells his or her interest while the loss property is still in the partnership, then the loss property must be adjusted downward to what its fair market value was when the partner contributed it to the partnership.

Another provision in the AJCA requires that, with respect to certain loss partnerships, the partnership must adjust the basis of partnership assets in the case of certain distributions (where there would be a downward adjustment of more than $250,000 to the partnership's assets) and certain transfers by a partner of his or her partnership interest (where the partnership's net assets have a loss of at least $250,000 in them) even though the partnership doesn't have a Section 754 election at the time of the distribution or transfer. In certain cases, this AJCA provision could create a recordkeeping burden for loss partnerships.

Finally, the AJCA establishes a new deduction for domestic manufacturers. The deduction will be 3% of qualified domestic production gross receipts in 2005 and 2006, 6% in 2007 through 2009, and 9% in 2010. The deduction is permitted for regular tax and alternative minimum tax purposes. Although complex, this provision appears to apply to all entities. But since the deduction generally is limited to 50% of W-2 wages paid, partnerships, LLPs, and LLCs treated as partnerships could be at a disadvantage because owners of these entities aren't considered employees (generating W-2 wages)—in contrast to an owner-employee of a C Corporation or S Corporation. Hopefully, this potential inequity will be resolved by future Treasury regulations. ■

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