

Tax Considerations in Choice of Business Entity – It’s Not Just a Federal Question

By Kurt G. Rademacher¹

Every business lawyer has faced the following scenario. A client telephones the attorney’s office with a business proposition and requests that her lawyer “file the papers” to form the proper legal entity. Although the client may view entity formation as a simple matter of filing some forms with the Secretary of State, the well informed advisor knows better.

In determining which entity to recommend to their clients, practitioners should examine a multitude of factors unrelated to taxation. For instance, what type of business does the client wish to form, and is operating that business legally permissible under the particular entity statute?² Is the business risky, and what liability protection does a particular business entity provide for the enterprise? How long will the business operate? How will it be financed? Who will run the business, and will they expect to become equity owners at a later date?

In addition to non-tax factors, the advisor should also pay special attention to both the federal and state income tax consequences that accompany operations in a particular business entity. The attorney should take care to consider not only the tax consequences of operations, but the ultimate tax cost associated with the client’s exit strategy - including Mississippi income taxes on the sale of the business. Failing to consider the end game could cost the client unnecessary tax dollars down the road.

The Options

Depending upon the particular busi-

ness venture into which the client plans to delve, the following business entity alternatives exist under Mississippi law:³

1. A Mississippi business corporation;
2. A Mississippi professional corporation (a “PC”);
3. A Mississippi general partnership (a “GP”);
4. A Mississippi limited partnership (an “LP”);
5. A Mississippi limited liability partnership (an “LLP”);
6. A Mississippi limited liability company (an “LLC”); and
7. A Mississippi professional limited liability company (a “PLLC”).

Although there are seven potential Mississippi business entities, only four potential tax classifications exist:

1. the sole proprietorship;
2. the C corporation;
3. the S corporation; and
4. the partnership.

Under the “check-the-box” regulations, the default classification for GP’s, LP’s, LLP’s, LLC’s and PLLC’s is the partnership tax regime.

Sole Proprietorship

Many individual business owners choose to practice as sole proprietors. The reasons for this choice could not be more clear - low cost and simplicity. After all, operating as a sole proprietorship eliminates the professional fees associated with

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forming and maintaining a separate entity, like legal fees for the formation and accounting fees for filing annual income tax returns. In addition, this option eliminates the practical headaches that inevitably accompany any artificial financial separation of an individual from his business.

No substantial tax impediments exist to operating as a sole proprietorship. Non-tax disadvantages, however, abound. First, by definition, only one person can own the business. Moreover, sole proprietors risk exposure of their personal assets to any

potential claims in contract or in tort against the business. The proprietor may be disappointed to learn that a lawsuit plaintiff could potentially end up receiving not only the business, but his home as well.

One middle ground solution for sole proprietors involves the formation of a single member LLC or PLLC. Although forming the entity still requires up front attorneys' fees, future operations do not generate accounting fees for preparation of annual income tax returns because the IRS has chosen to disregard the existence

of single member LLC's and PLLC's for tax purposes. Hence, this alternative provides the best of both worlds to an individual business owner by offering state law liability protection in conjunction with tax law transparency.

C Corporation


Before the proliferation of LLC statutes, most new enterprises chose to incorporate to obtain the liability shield of the business corporation statutes. Those entities that could not meet the stringent requirements of subchapter S of the Internal Revenue Code, or those that simply chose not to make an S election, were taxed by default under subchapter C - thus referred to as C corporations.

For federal tax purposes, a C corporation is a separate taxpayer. Tax rates on C corporation income generally range between 15 percent and 35 percent.⁴ However, professional services corporations pay a flat 35 percent rate.⁵ In addition, dividend distributions from the C corporation to its shareholders generally subject recipients to an additional shareholder-level tax of at least 15 percent.⁶ The double tax imposed under subchapter C generally makes this option less desirable for taxpayers, at least for those who do not plan to go public.

In the past, many C corporations dealt with the double-tax problem by simply paying deductible salaries to shareholder-employees in order to "zero out" corporate income. This strategy eliminated any corporate level tax and created the effective equivalent of flow-through taxation for the shareholders since they only paid tax on the salaries they received.

In 2001, the Tax Court decided *Pediatric Surgical Associates, P.C.*⁷ In that case, the Court recharacterized a C corporation's purported salary payments to shareholders as dividends. Thus, the Court prevented the C corporation from escaping subchapter C's double-tax burden. Not only did the Court apply the double-tax, but it also affirmed the imposition of a 20 percent negligence penalty. In light of this decision, the C corporation as an operating entity generally will not provide taxpayers with the most tax-efficient vehicle.⁸

Mississippi tax laws generally follow federal law with respect to the taxation of a C corporation's income from operations, although some exceptions do exist. For



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example, Mississippi has chosen to “decouple” from federal tax law with respect to many of the economic stimulus tax cuts that the Bush administration pushed through Congress during 2002 and 2003 - including, significantly, the new bonus depreciation rules.⁹

Under Mississippi law, both the C corporation and the shareholder receiving dividends are subject to a maximum income tax rate of 5 percent.¹⁰

S Corporation

Eligible corporations may elect taxation under subchapter S of the Internal Revenue Code. When the election occurs, the corporation itself no longer exists as a taxpayer. Instead, corporate income flows through to the shareholders and is taxed only once at their individual tax rates. Despite the elimination of the C corporation double tax, many corporations find meeting the strict qualification requirements of subchapter S impossible. For instance, the S corporation may have not more than 75 shareholders; its shareholders must generally all be individuals who are not nonresident aliens; and it must not have, either in form or in economic reality, more than one class of stock.¹¹ If, however, the proposed business model meets these stringent requirements, subchapter S likely provides a more tax-efficient alternative than subchapter C.¹²

Some tax advisors have touted employment tax savings as one benefit weighing in favor of operating as an S corporation. The purported savings occur because while salaries paid to shareholder-employees are subject to employment taxes, dividends from S corporations generally are not.¹³ Hence, one often encounters financial advisors who have counseled S corporation shareholders to pay themselves very little or no salary and draw all of the income out of the S corporation as dividends, free from employment taxes.¹⁴

The Tax Court specifically rejected such a technique in *Veterinary Surgical Consultants, P.C.*¹⁵ In light of this authority, S corporations that continue to pay shareholder-employees little or no salary do so at their peril. Instead, the careful practitioner should insist that the S corporation pay a “reasonable salary” to the shareholder-employee.¹⁶ Any amounts in excess of this reasonable salary may be distributed as a dividend free from self-

employment taxes.¹⁷

For Mississippi purposes, S corporations are recognized.¹⁸ Hence, income will flow through for Mississippi purposes subject to the 5 percent maximum Mississippi income tax rate.¹⁹

Partnership Taxation

For federal and state income tax purposes, the partnership provides the most flexible vehicle. Income earned in the partnership flows through to the partners and is, thus, taxed only one time.

Since the tax losses an owner can take from a partnership or S corporation are limited to her basis in the entity, an owner of a partnership interest may be permitted to take tax losses in a tax year when a similarly situated S corporation shareholder is not.²¹ This benefit may be especially important for a new enterprise that does not expect profitability during the initial start-up period.

Tax partnerships possess numerous benefits unavailable in the C corporation context. The first is pass-through taxation. Although this benefit also exists in an S corporation, it comes with the high price of strict ownership and distribution rules. In the partnership context, however, a business can retain an enormous amount of flexibility regarding profit and loss allocations, admission and retirement of partners, and contributions and distributions of property.

The partnership is also generally preferable to the S corporation when one considers the effect of entity debt on the owner’s basis in his interest. In short, partners receive basis for their respective share of entity debt, whereas S corporation shareholders do not.²⁰ Since the tax losses an owner can take from a partnership or S corporation are limited to her basis in the entity, an owner of a partnership interest

may be permitted to take tax losses in a tax year when a similarly situated S corporation shareholder is not.²¹ This benefit may be especially important for a new enterprise that does not expect profitability during the initial start-up period.

Exit Strategy

In determining the proper business entity to recommend, one must look ahead to the client’s ultimate exit strategy. Generally, most business purchasers will insist upon buying assets rather than stock or membership interests for liability reasons. Under such circumstances, the C corporation shareholder will owe more taxes on the sale of her business than the owner of a pass-through entity. This result occurs because in the C corporation context, the corporation will pay tax once on all of the gain in its assets, and the shareholders will pay tax again when the corporation distributes the sales proceeds to them in liquidation. In contrast, owners of pass-through entities will only pay tax once on the gain in their assets.

Mississippi law contains an incentive for businesses entities to form in this state that advisors should keep in mind when recommending a particular business entity.²² Under the statute, certain entities and their owners may completely avoid Mississippi taxable income on the ultimate sale of their businesses.

The exclusion generally applies to corporate gain on the sale of at least 90 percent of the assets of a Mississippi corporation, provided: 1) the corporation has held the assets for more than one year, and 2) the corporation is totally liquidated and dissolved within one year from the date of sale. Previously deducted depreciation does not qualify for the exclusion.

One potential pitfall in the gain exclusion statute relates to taxpayers who elect to treat a stock sale as an asset sale under IRC 338. Under such circumstances, the gain exclusion will not apply even if all of the other requirements of the statute are met.²³

Only business corporations and PC’s will qualify for the Mississippi asset gain exclusion. However, the statute also contains an exclusion for gain on the sale of stock or interests in “domestic corporations, domestic limited partnerships or domestic limited liability companies”,

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provided such stock or interests have been held for more than one year.²⁴

The exclusion is extremely broad in that it applies Mississippi corporations, PC's, LP's, LLC's and PLLC's. It does not specifically apply, however, to GP's or LLP's, and representatives of the Tax Commission have expressed their intention to disallow the exclusion for sales of interests in those entities. For this reason, tax practitioners should think carefully before recommending Mississippi GP's or LLP's to a client.

Conclusion

Choosing a particular business entity requires consideration of a multitude of factors - including the federal and state tax consequences associated with the business's operations and its ultimate sale. Although each entity has its benefits, the partnership tax regime's flow-through taxation and substantial flexibility generally make entities taxed as partnerships preferable. When one considers the added benefit of the Mississippi gain exclusion on the sale of an interest, certain Mississippi entities possess a clear advantage over others. In most multi-owner circumstances, the Mississippi LLC or PLLC will be the entity of choice.²⁵ ■

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²For example, non-professionals are considered "disqualified persons" who may not own stock in PC's or membership interests in PLLC's. Whether professionals may practice in business corporations or LLC's is not entirely clear under Mississippi law.

³One may also choose to form an entity in another jurisdiction. Practitioners often cite Delaware's well developed corporate laws in support of their recommendation to form entities in that jurisdiction. The pros and cons of non-Mississippi business entities are beyond the scope of this article.

⁴IRC 11(b)(1).

⁵IRC 11(b)(2).

⁶Provided the distribution constitutes "qualified dividend income" under JGTRRA of 2003. See IRC 1(h)(11).

⁷TC Memo 2001-81.

⁸Current C corporations that routinely zero out income through salary or bonus payments to shareholders should consider carefully the potential application of Pediatric Surgical Associates.

⁹See IRC 168(k). This decoupling applies with respect to all taxpayers, and not only C corporations.

¹⁰Miss. Code Ann. 27-7-5.

¹¹IRC 1361(b)(1).

¹²The S corporation format also avoids the Accumulated Earnings Tax and, at least with respect to corporations that make an S election for their first business year, the Personal Holding Company Tax. Both of these taxes potentially apply to C corporations.

¹³Rev. Rul. 59-221, 1959-1 CB 225; Ding, TC Memo 1997-435, aff'd 200 F.3d 587 (9th Cir 1999).

¹⁴This technique does not eliminate any income tax obligations of the shareholder since taxable income flows through the S corporation to its shareholders.

¹⁵TC Memo 2003-48, aff'd 93 AFTR.2d 2004-1273 (3rd Cir. 2004).

¹⁶Since employment taxes on wages or self employment income over \$87,900 are only subject to a 2.9 percent tax rate, the employment tax benefit for high income individuals is not significant.

¹⁷See note 12.

¹⁸Miss. Code Ann. 27-8-7; Miss. Inc. Tax Reg. 803.

¹⁹Miss. Code Ann. 27-7-5.

²⁰The allocation of this debt among partners depends in part upon the economic risk of loss associated with nonpayment. See IRC 752.

²¹For this reason, S corporations should consult a tax expert before incurring substantial debt to determine if alternate strategies could achieve increased stock basis for the shareholders.

²²Miss. Code Ann. 27-7-9(f)(10)(B).

²³Miss. Code Ann. 27-7-9(j)(5).

²⁴Miss. Code Ann. 27-7-9(f)(10)(A).

²⁵The LP, although eligible for the gain exclusion, must have a general partner. It is thus often ruled out for liability reasons.

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