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Dear Committee on Small Business/Pass Throughs:

Re: Support for the Tax Law Change

This letter requests your support in recommending to Congress a change in the tax law that impacts many corporations, especially 'S' corporations needing and desiring to change to an LLC, LP, or LLP tax structure.

Many professional service corporations have elected S status to minimize the potential exposure to double taxation along with other business and tax reasons. However, unlike partnerships, 'S' corporations have many restrictions that negatively impact their operations such as: 1) the type and number of shareholders, 2) tax inefficiency in mergers and reorganizations, 3) restriction on economic profit and loss allocations.

Why shouldn't partnership tax rules apply to 'S' corporations?

Thus, a more favorable, economic enhancing tax law change would allow 'S' corporations to operate as a partnership without a tax toll change on the gain from a deemed sale of the operating assets. An alternative to the mirror rules, would be to apply partnership tax rules to 'S' corporations that would allow a conversion from an 'S' corporation to a partnership on a tax deferred basis, similar to the current BIG (Built-in-Gain) rules.



On behalf of WithumSmith+Brown, we are requesting your support in the cause to have Congress create parity in partnerships and 'S' corporations.

Partnerships and 'S' corporations should have the same tax rules!

The attached position paper discusses in more detail the purpose of this request.

Thank you in advance in your anticipated support for this proposal.

Very truly yours,

A handwritten signature in blue ink, reading 'David A. Springsteen'. The signature is fluid and cursive, with a long horizontal line extending to the right from the end of the name.

DAVID A. SPRINGSTEEN, CPA, MBA, CGMA

TAX PARTNER



APPENDIX

ALLOWING S CORPORATIONS TO CONVERT TO PARTNERSHIPS ON A TAX DEFERRED BASIS

This report discusses the need for changes to the federal income tax laws, which currently imposes an unfair tax burden and impedes the economic growth on the professional (personal) service industry.

The requested tax law change will assist small to medium sized professional service companies to expand and create new jobs which will aid in U.S. economic growth.

Overview

Many professional service companies (doctors, lawyers, architects, engineers, accountants, etc.) are incorporated and operate as corporations under the various state statutes. The corporate form was the preferred "choice of entity" prior to the LLC statutes legislated by the states.

Corporations are subject to graduated income tax rates, and if they are a Personal Service Corporation (PSC), they are subject to a flat 35% rate. S corporations are generally not subject to a corporate level tax unless the built in gain tax applies. The S corporation income is taxed at the shareholder level and subject to the individual rates up to 39.6%, plus a potential 3.8% Medicare tax.

In 1988, under Rev. Rul. 88-76, the IRS ruled that LLC's formed under Wyoming's statutes would be taxed as a partnership. Since then all 50 states have enacted their own LLC statutes. Newly formed LLCs now outpace the formation of corporations even though the number of S corporations is significant.

The main reason for incorporating prior to the states passing the LLC statutes was the liability protection afforded the shareholders of corporations under state law. Sole proprietorships and general partnerships did not offer the same liability protection as professional service corporations did.



Under current tax laws, C corporations, S corporations and PSCs cannot convert tax-free or tax-deferred to the more popular and favorable LLC, LLP or LP tax structure.

LLCs, LLPs and LPs are preferred from both a tax and business standpoint because:

- There is no limit on the number of owners (S corporations currently have a 100 owner limit).
- There is no restriction on types of owners, as S corporations generally are restricted to individuals and certain trusts as owners.
- There are no flat tax rates as with PSC and large C corps.
- There is flexibility in the allocation of the operational income to partners, but not S shareholders.
- Mergers and reorganizations for growth purposes create less tax hurdles and related pitfalls.
- There is flexibility in restructuring the company for business purposes.
- No double tax as with C corporations and S corporations BIG.
- The step-up of underlying assets on the transfers of ownership interest is allowed in partnership.
- Partnerships provide tax flexibility to its owners in contribution of appreciated property by owners.

In summary, a tax toll charge is imposed on the "deemed" liquidation/conversion to the LLC, LLP, LP structure from a C or S structure because of the 1986 repeal of the General Utilities doctrine. This repeal now creates a potential tax on the conversion gain deemed a sale (i.e., a tax on the value of the company's assets including intangible assets over its basis).

The Issue

PSC reporting for tax purposes as either a C corporation or S corporation are subject to unintended and unfair tax burden in converting to an LLC, LP, or LLP which inhibits business growth and thus economic expansion.



Tax Law Changes Needed

Modify the current tax law by allowing a tax deferred conversion into an LLC, LP or LLP entity from an S corporate tax structure. The repeal of the General Utilities doctrine unfairly targets small to medium sized professional and personal service corporations that need for business growth reasons to operate as an LLC, LP or LLP but are trapped as an S corporation under the current S and C corporate structure due to the tax toll charge. This is NOT a change in our tax policy rather a tax neutral change targeted at small to medium sized businesses in the professional services arena.

Analysis

Owners of professional service businesses, prior to the 1990's have used the various state statutes to provide limited liability protection to its shareholders (especially licensed professionals) operating in the personal service arena. These businesses are small to medium sized companies providing much of the backbone and fabric to the U.S. economy. Originally, the corporate structure was preferred over operating as an individual sole proprietor or general partnership because these later structures did not provide liability protection to the owners and subjected their personal assets to the claims of potential creditors.

LLCs became popular in the 1990s for licensed professionals. In many states LLCs created an opportunity for newly formed personal service companies but a trap for the existing "C", "S" or "PSCs". Why? Because of the tax law change in 1986, the repeal of General Utilities doctrine results in a tax on the liquidation or conversion of a corporation into an LLC, LP or LLP. Even flow through "S" corporations are deemed to sell the assets creating a gain taxed to the shareholders on conversions even though the historic business and owners continue.

The liquidation "toll charge" tax prevents PSC, C, and S corporations from converting to the preferred LLC, LP or LLP structure by imposing a tax toll charge even though the historic business operations and ownership would be continued in the LLC, LP or LLP structure.



There are many tax-deferred provisions in the tax law such as like-kind exchanges for real estate, automobiles and equipment, tax free incorporation, and tax free reorganization, mergers and spinoffs of corporations, and rollover of pensions, etc.

S corporations are also particularly burdened because there is also a 100 shareholder limit. LLC, LP or LLPs have no limits on the number of owners. Once S corporation ownership hits 100 they cannot convert to an LLC tax free in order to allow for additional ownership and growth. Despite the "flow through" tax treatment of S corporation income,(like the LLC), the liquidation, merger, or conversion into an LLC, LP, or LLP creates a "deemed" sale of the S corporation assets creating a current gain, taxed then even though the entity continues to operate its historic business and needs to convert to facilitate growth.

An example of the liquidation tax burden on conversion to an LLC follows: a C corporation and S corporation would face a liquidation tax in excess of \$210,000 and \$750,000, respectively by converting to an LLC based on a \$5 million valuation and no basis at current income tax rates. In 2013, depending on a shareholders involvement, this gain may also be subject to the 3.8% Medicare tax.

This tax toll charge impedes growth and opportunity.