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Public Comments in Response to the House Ways and Means Committee Tax Reform Working Group Request for Comments

These comments request changes to the federal income tax laws, which currently impose 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 companies to expand and create new jobs, which will aid in the U.S. economic growth.

Overview

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

Corporations are subject to graduated tax rates, and if a Personal Service Corporation (PSC), subject to a flat 35% rate. S corporations are not subject to a corporate level tax.

In 1988, under Rev. Rul. 88-76, the IRS ruled that Wyoming's LLCs 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.

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

Unfortunately, C corporations, S corporations and PSCs cannot convert tax-free or tax deferred to the more popular and favorable LLC structure.

LLCs are preferred because:

- There is no limit on the number of owners (S corporations have a 100 owner limit).
- There is no restriction on types of owners.
- No flat tax rate as with PSC and C corps.
- Flexibility in allocation of the economic operational income.
- Flexibility of merging for growth purposes.
- Flexibility in restructuring the company for business purposes.
- No double tax issues.
- Step-up of underlying assets on economic transfers of ownership.
- Provide liability protection to its owners.

A tax toll charge is imposed on the deemed liquidation/conversion to the LLC structure from a C or S structure because of the 1986 repeal of General Utilities doctrine. This repeal now creates a tax on the conversion gain i.e., a tax on the value of the company.

Issue

Professional and Personal Service Corporations (PSC) reporting for tax purposes as either a C corporation or S corporation are subject to unintended and unfair tax burdens which taints business growth and thus economic expansion.

Request

Modify the current tax laws by reinstating tax-free liquidations/conversions (General Utilities doctrine) or provide an exception to allow for a tax deferral into an LLC or LLP entity from a corporate tax structure. The

repeal of the General Utilities doctrine unfairly targets small to medium sized professional and personal service corporations that need to operate as an LLC but are trapped under the current corporate structure.

Background

Owners of professional service businesses historically, 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 service arena. These businesses are small to medium sized companies providing much of the backbone and fabric to the US economy. Originally, the corporate structure was preferred over operating as an individual sole proprietor or general partnership because these 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 professional and 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 imposes a tax on the liquidation or conversion of a corporation into an LLC.

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

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.

S corporations are also particularly burdened because there is also a 100-shareholder limit. Once S corp. ownership hits 100 they cannot convert to an LLC tax free in order to allow for additional ownership. Despite the "flow through" tax treatment of S corporation income,(like the LLC), the liquidation, merger, or conversion to an LLC, 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 of \$2,237,500 and \$750,000, respectively by converting to an LLC based on a \$5 million valuation and no basis at current income tax rates.

This impedes growth.

Request Tax Law Modification to Spark Economic Growth and Create Fairness

Allow professional service companies trapped operating as C, S or PSC's to convert to an LLC under a tax deferral regime provided the historical business operations and ownership continues.