CHOICE OF ENTITY IN MICHIGAN UNDER THE CORPORATE INCOME TAX

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One of the fundamental responsibilities of a business or tax attorney is to advise clients about the tax implications involved in choice of entity. As Michigan's new corporate income tax ("CIT") became effective as of January 1, 2012, your authors thought it might be helpful to run through a few scenarios and look at the tax implications for Michigan entities. For those readers familiar with this area, the material which follows is unlikely to yield many surprises. Our goal is to begin the process of familiarizing members of the Bar with the new CIT and to provide materials which may be helpful when explaining to clients the tax ramifications of the various types of entities.

There are three issues which we wish to point out at the start, lest the reader misunderstand our premise for the article. First, this is not an all-inclusive review of the many issues associated with choice of entity. We are not undertaking a review of liability concerns or management concepts. This article is solely about the impact of taxes, including the CIT, on the various types of entities. Second, this article is not a full review of all provisions of the CIT. Regardless of the assumed state of formation, we assume all entities will have all income derived from Michigan sources, so there will be no significant discussions of nexus or apportionment. Nor will we deal with those parts of the CIT addressed to insurance companies and financial institutions. Third, as with all tax articles showing scenarios with different assumptions, there are a myriad of scenarios which may be possible, each of which could have different implications. We have endeavored to make our analysis as generic as possible, in the hopes that it will have the greatest applicability. In the pages that follow, we have tried to explain what assumptions we are making and the tax impact of choice of entity on those assumptions.

THE BASIC STRUCTURE OF THE CIT

For those looking for the Chapter of the Michigan Complied Laws specific to the CIT, the search will be in vain. Unlike the Single Business Tax and the Michigan Business Tax, the CIT was added to the provisions of the already existing Michigan Income Tax Act.[1] The portions of the CIT addressing the subject of this article are primarily contained in Chapter 10[2], Chapter 11[3], and Chapter 15[4] of the Income Tax Act.

Under the CIT, a taxpayer is subject to the tax if the taxpayer has more than $350,000.00 of gross receipts or if the taxpayer owns or has a beneficial interest in a flow-through entity with substantial nexus in Michigan.[5] The tax is imposed on the "corporate income tax base" at a rate of 6.0%.[6] A corporate income tax base is defined as a taxpayer's "business income" subject to various adjustments which are beyond the scope of this article.[7] Business income is defined as federal taxable income,[8] which is in turn defined to mean taxable income described in Section 63 of the Internal Revenue Code ("IRC") excluding the impact of IRC Sections 168(k) and 199.[9] Two other terms merit definition for purposes of this article. First, "corporation" is defined as an entity that elects to file as a C-corporation under the IRC.[10] Second, a "flow-through entity" is an entity which elects to be taxed as an S-corporation or a partnership (which for state law purposes includes limited liability companies (LLCs)) under the IRC.[11] This allows us a starting place for certain hypothetical scenarios. In all of the scenarios which follow, we assume a for-profit entity with varying amounts of business income.

Under the CIT, once an entity meets the gross receipts and nexus requirements, there is only one credit available to reduce the tax, available to smaller entities.[12] This credit is available to those entities with less than $20,000,000 in gross receipts and that have business income which does not exceed $1,300,000 (adjusted for inflation).[13] The credit is reduced by 20% if compensation and director's fees to any single shareholder or officer exceeds $160,000, with an additional reduction of 20% for each increment of $5,000, until the credit is completely phased out when such compensation and fees to the single highest paid shareholder or officer exceeds $180,000.[14] Note the definition of compensation for this credit is very broad, and includes "all wages, salaries, fees, bonuses, commissions, and other payments" made to an officer, as well as payments subject to or exempt from withholding under IRC Sections 3401-3406.[15] The credit is also phased out for those entities with gross receipts in excess of $19,000,000, with the credit being reduced by 1% for each $10,000 of gross receipts in excess of $19,000,000.[16] For example, an entity with gross receipts totaling $19,620,000, would only be entitled to 38% of the credit.

The credit allowed under the CIT is a credit which reduces the tax imposed by the CIT to the extent it exceeds 1.8% of the entity's business income.[17] Thus, an entity entitled to full use of the credit should never pay more than 1.8% of its business income as calculated under the CIT. To the extent the entity has a shareholder or officer receiving compensation in excess of $160,000, or gross receipts in excess of $19,000,000, the value of the credit will be reduced.

SIMPLIFYING ASSUMPTIONS

In preparing the charts detailing the results of our various scenarios, numerous assumptions were made to help simplify the process. First, we assume that the entity's owner is active in the business, so that either wages from either an S-corporation or C-corporation are appropriate or the distributions from an LLC would be subject to self-employment taxes.[18] Additionally, we ignore the possible impact of loss carry-forwards or carry-backs or any of the multitude of special credits or deductions available in special circumstances. We also assume that all entities described herein have at least $350,000 in gross receipts from Michigan. We have used the 2011 tax charts for all calculations, and at the individual level we have assumed the owner is married, filing jointly and takes only the standard deduction.[19] The charts that follow are designed to give a basic overview of the tax-costs to the owner of the different types of entities at varying income levels.

A brief walk-through of our first chart should explain our process and help to show the impact of the CIT on the choice of entity analysis.

Chart 1

Entity's Income before Owner Wages	$	250,000.00
C-Corp Wages:	$	75,000.00
S-Corp Wages:	$	75,000.00
LLC Payment for Services:	$	249,580.00
C-Corp Dividend:	$	113,564.29

	LLC/Partnership	S-Corp	C-Corp	
Entity Level Tax				
Federal Income Tax	-	-	45,147.66	
Employment Taxes				
Social Security (OASDI)	-	4,650.00	4,650.00	*
Medicare (Hospital Insurance)	-	1,087.50	1,087.50	
FUTA/SUTA	420.00	420.00	420.00	**
Michigan Corporate Income Tax	-	-	10,130.55	
Total Entity Level Tax	420.00	6,157.50	61,435.71	
Individual Level Tax				
Federal Income Tax on Ordinary Income	56,460.37	57,922.53	8,400.00	
Federal Income Tax on Dividends	-	-	17,034.64	
Social Security (OASDI)	-	4,650.00	4,650.00	
Medicare (Hospital Insurance)	-	1,087.50	1,087.50	
Self-Employment Tax (Social Security)	13,652.40	-	-	
Self-Employment Tax (Medicare)	6,684.13	-	-	
State Income Tax	10,101.21	10,293.95	7,889.35	
Total Individual Level Taxes	86,898.11	73,953.97	39,061.49	
Total Taxes	87,318.11	80,111.47	100,497.20	
Effective Tax Rate (Both Owner and Entity)	34.93%	32.04%	40.20%	

* Not taking into account the 2% reduction for the first two months in 2012 given that it is likely a one-time exclusion and the 2% is "recaptured" under the act for high income earners and will not be available in future years. Also, for all tables the authors used the 2011 tax tables, but the 2012 taxable wage base.

** Given that the Michigan Unemployment Tax due will vary from year-to-year, we have assumed that the employer will be due the maximum FUTA rate for the owner.

In Chart 1 we see three entities each having $250,000 in income after all expenses except payments to the owner and taxes. In each instance, the owner receives $75,000 in payments for services, and then all available income is distributed to the owner. In the S-corporation and C-corporation situations, the entity will then pay Old Age, Survivors and Disability Insurance (referred to as OASDI or Social Security)[20] and Hospital Insurance (referred to as Medicare)[21] withholding taxes on those wages (equal to one-half of the total amount paid for these taxes), allowing each entity deductions for those expenses. Additionally, all three entities will be responsible for paying the federal or state unemployment tax.[22] After these expenses are considered, the taxable income of each entity can be calculated, and in the case of a C-corporation, the entity's federal income tax can be calculated ($45,147.66 in Chart 1). Additionally, because we can calculate the federal taxable income, that is the C-corporation's business income. The C-corporation's business income is in turn the start of calculating the corporate income tax base upon which CIT is imposed (with an additional tax owing under the CIT of $10,130.55 in Chart 1). For purposes of this article, your authors have assumed that the C-corporation's federal taxable income is equivalent to the entity's business income and corporate income tax base.

After the total taxes paid at the entity level have been calculated, the analysis continues at the owner level. For the owners of the S-corporation and C-Corporation, each will be responsible for payments of the remaining one-half of the OASDI and Hospital Insurance taxes (though these were withheld when payroll was paid). For the member of the LLC, she will be responsible for self-employment taxes against not just the $75,000, but the entire $250,000 allocated to her.[23] The owner of the LLC and the S-corporation will then also owe federal and state income taxes on the income allocated to them from the entity.[24] For the owner of the C-corporation, not only will she have to pay federal and state income tax on her wages, but to receive a distribution of the balance of the funds available to distribute to her in the corporation will require a dividend, which are currently taxed at the capital gains rate ($17,034.64 in Chart 1).[25] Note that because of the payment of federal income tax by the C-corporation, there is significantly less cash available to be distributed to the owner as a dividend as compared to the S-Corporation. For ease of comparison, we have totaled all of the taxes and created a total effective tax rate (total taxes paid divided by the entity's taxable income before owner's wages/payment for services).

Chart 2

Entity's Income before Owner Wages	$ 250,000.00
C-Corp Wages:	$ 239,284.18
S-Corp Wages:	$ 239,284.18
LLC Payment for Services:	$ 249,580.00
Distributions/Dividends to Owner:	$ -

	LLC/Partnership	S-Corp	C-Corp	
Entity Level Tax				
Federal Income Tax	-	-	-	
Employment Taxes				
Social Security (OASDI)	-	6,826.20	6,826.20	*
Medicare (Hospital Insurance)	-	3,469.62	3,469.62	
FUTA/SUTA	420.00	420.00	420.00	**
Michigan Corporate Income Tax	-	-	-	
Total Entity Level Tax	420.00	10,715.82	10,715.82	
Individual Level Tax				
Federal Income Tax on Ordinary Income	56,460.37	56,418.28	56,418.28	
Federal Income Tax on Dividends	-	-	-	
Social Security (OASDI)	-	6,826.20	6,826.20	
Medicare (Hospital Insurance)	-	3,469.62	3,469.62	
Self Employment Tax (Social Security)	13,652.40	-	-	
Self Employment Tax (Medicare)	6,684.13	-	-	
State Income Tax	10,101.21	10,095.66	10,095.66	
Total Individual Level Taxes	86,898.11	76,809.76	76,809.76	
Total Taxes	87,318.11	87,525.58	87,525.58	
Effective Tax Rate (Both Owner and Entity)	34.93%	35.01%	35.01%	

* See note on Chart 1

** See note on Chart 1

ANALYSIS OF THE CIT'S IMPACT

After gaining familiarity with the process to create Chart 1, a review of the material presented should make clear to the practitioner the impact of the CIT on the already tax-disadvantaged C-corporation. Not only does the owner-employee of a C-corporation pay two levels of federal income tax on dividends, she must suffer a state entity level tax that applies only to the C-corporation. In terms of the Effective Tax Rate, this additional tax increases the rate over 4%, from what would have been a 36.15% Effective Rate to a 40.20% Effective Rate. While C-corporations that distribute significant income to their owners via dividends were never tax efficient, the CIT makes them practically a non-option in Michigan.

Another point to be noted in Chart 1 is the advantage of the S-corporation over the LLC. The member of the LLC pays self-employment taxes on all of her distributive share,[26] whereas the S-corporation and its shareholder-employee pay OASDI and Hospital Insurance taxes on only the wages paid (and not on the balance of the distributable profits). This causes a savings to the S-corporation shareholder-employee. The total amounts of OASDI and Hospital Insurance taxes paid in the S-corporation situation are $11,475.00, whereas the LLC's member's self-employment tax payments total $20,336.53. Despite the LLC member being allowed to deduct one-half of this total payment, that tax benefit is not sufficient to make up for the extra dollars paid in the self-employment context on the distributive share.[27]

In Chart 2, we have built off of the Chart 1 scenario, except that now we are assuming that the entity pays out all of the income to the owner as wages or payment for services (for the LLC member). When the full amount available to be paid to the owner is paid in wages, notice the dramatic impact it has on the total effective rate in the C-corporation column. As the amount is paid out in full, there is no taxable income to the C-corporation at the federal level, which also results in there being no corporate income tax base for the CIT to be imposed against. This provides the basis for an important planning opportunity for the CIT – if the C-corporation can legitimately payout all of its profits each year in wages or by another deductible method, the impact of the CIT is effectively neutralized.

Chart 3

Entity's Income before Owner Wages	$ 50,000.00
C-Corp Wages:	$ 46,056.67
S-Corp Wages:	$ 46,056.67
LLC Payment for Services:	$ 49,580.00
Distributions/Dividends to Owner:	$ -

	LLC/Partnership	S-Corp	C-Corp
Entity Level Tax			
Federal Income Tax	-	-	-
Employment Taxes			
Social Security (OASDI)	-	2,855.51	2,855.51*
Medicare (Hospital Insurance)	-	667.82	667.82
FUTA/SUTA	420.00	420.00	420.00**
Michigan Corproate Income Tax	-	-	-
Total Enetity Level Tax	420.00	3,943.33	3,943.33
Inidivual Level Tax			
Federal Income Tax on Ordinary Income	6,061.59	6,058.50	6,058.50
Federal Income Tax on Dividends	-	-	-
Social Security (OASDI)	-	2,855.51	2,855.51
Medicare (Hospital Insurance)	-	667.82	667.82
Self Employment Tax (Social Security)	5,677.60	-	-
Self Employment Tax (Medicare)	1,327.83	-	-
State Income Tax	1,691.16	1,690.27	1,690.27
Total Individual Level Taxes	14,758.19	11,272.10	11,272.10
Total Taxes	15,178.19	15,215.43	15,215.43
Effective Tax Rate (Both Owner and Entity)	30.36%	30.43%	30.43%

* See note on Chart 1

** See note on Chart 1

Additionally, notice in Chart 2 that when the S-corporation and C-corporation pay out all of the profits as wages, the C-corporation's effective tax rate is identical to the S-corporation's effective tax rate. In this scenario the LLC actually has the lowest effective tax rate because the calculation of self-employment tax includes a slight reduction in the amount subject to those taxes.[28] This concept is can be seen again in Chart 3, showing an analysis of a smaller (or less profitable) entity.

While the analysis of Chart 3 is identical to Chart 2, the lesson for practitioners is that, for the smaller entity, if the entity intends to either stay small, or will be looking for growth via outside sources of money and not retained earnings, the CIT may not cause the C-corporation to be as much of an afterthought as it was in the Chart 1 situation. Also, because the CIT only applies to those entities with at least $350,000 in gross receipts, if an entity will never reach that threshold, its owners do not need to factor in the impact of the CIT on the choice-of-entity analysis. While a small entity is likely to qualify for the credit available under the CIT, the C-corporation would still be responsible for taxes of at least 1.8% of its business income, causing it to be in a disadvantaged position compared to an LLC or S-corporation. The analysis related to payroll taxes remains the same as above.

An example working through the value of the small business credit to the CIT is found in Chart 4. In this scenario, each entity has $250,000 in profit excluding the owner's payments, and it makes payments to the owner of only $75,000 (with no other distributions or dividends). As the entity did not exceed $160,000 in payments to its owner/officer, and we assume it had less than $19,000,000 in gross sales, it qualifies in full for the credit.

This leads to the interesting result that, due to the credit, the C-corporation ends up with the lowest Effective Tax Rate. Due to the graduated corporate income tax rates and the credit, the money retained in the C-corporation is in a more advantageous entity than the money in an S-corporation or an LLC. However, if the C-corporation cannot ultimately distribute that money in a deductible manner (either as wages to the owner or otherwise to grow the business), and the owner takes the distribution via a dividend, the net result will not be efficient from a tax perspective.

Chart 5 describes a larger (or more profitable) entity looking for further growth. We assume that, as the entity grows, its owner increases her compensation. In this instance, we assume $1,000,000 in taxable income before payments to

Chart 4

Entity's Income before Owner Wages	$	250,000.00		
C-Corp Wages:	$	75,000.00		
S-Corp Wages:	$	75,000.00		
LLC Payment for Services:	$	249,580.00		
Distributions/Dividends to Owner:	$	-		
		LLC/Partnership	S-Corp	C-Corp
Entity Level Tax				
Federal Income Tax		-	-	47,913.30
Employment Taxes				
Social Security (OASDI)		-	4,650.00	4,650.00 *
Medicare (Hospital Insurance)		-	1,087.50	1,087.50
FUTA/SUTA		420.00	420.00	420.00 **
Michigan Corporate Income Tax		-	-	3,039.17
Total Entity Level Tax		420.00	6,157.50	57,109.97
Individual Level Tax				
Federal Income Tax on Ordinary Income		56,460.37	57,922.53	8,400.00
Federal Income Tax on Dividends		-	-	-
Social Security (OASDI)		-	4,650.00	4,650.00
Medicare (Hospital Insurance)		-	1,087.50	1,087.50
Self Employment Tax (Social Security)		13,652.40	-	-
Self Employment Tax (Medicare)		6,684.13	-	-
State Income Tax		10,101.21	10,293.95	2,949.30
Total Individual Level Taxes		86,898.11	73,953.97	17,086.80
Total Taxes		87,318.11	80,111.47	74,196.77
Effective Tax Rate (Both Owner and Entity)		34.93%	32.04%	29.68%

* See note on Chart 1

** See note on Chart 1

Chart 5

Entity's Income before Owner Wages	$ 1,000,000.00			
C-Corp Wages:	$ 200,000.00			
S-Corp Wages:	$ 200,000.00			
LLC Payment for Services:	$ 999,580.00			
Distributions/Dividends to Owner:	$ -			
	LLC/Partnership	S-Corp	C-Corp	
Entity Level Tax				
Federal Income Tax	-	-	252,437.27	
Employment Taxes				
Social Security (OASDI)	-	6,826.20	6,826.20	*
Medicare (Hospital Insurance)	-	2,900.00	2,900.00	
FUTA/SUTA	420.00	420.00	420.00	**
Michigan Corporate Income Tax	-	-	47,391.23	
Total Entity Level Tax	420.00	10,146.20	309,974.70	
Individual Level Tax				
Federal Income Tax on Ordinary Income	312,650.54	316,320.33	44,069.50	
Federal Income Tax on Dividends	-	-	-	
Social Security (OASDI)	-	6,826.20	6,826.20	
Medicare (Hospital Insurance)	-	2,900.00	2,900.00	
Self Employment Tax (Social Security)	13,652.40	-	-	
Self Employment Tax (Medicare)	26,770.25	-	-	
State Income Tax	42,289.34	42,745.44	8,386.80	
Total Individual Level Taxes	395,362.53	368,791.97	62,182.50	
Total Taxes	395,782.53	378,938.17	372,157.20	
Effective Tax Rate (Both Owner and Entity)	39.58%	37.89%	37.22%	

* See note on Chart 1

** See note on Chart 1

the owner and $200,000 in payments to the owner. As this amount is more than the $180,000 upper-end limit of compensation in the CIT credit, the credit is not available. If the entity looks at retained earnings as a method to finance growth, the CIT could come into play with a vengeance. While the preferred method to finance growth cannot always be known at the time of formation of the entity, in some circumstances this issue is part of the conversation which should be had with the entrepreneur.

As was mentioned immediately above, Chart 5 outlines a situation where a larger entity desires to finance future growth through retained earnings.[29] In this instance the impact of the CIT is significant ($47,391.23 in this scenario). This is a clear example of those entities subject to the CIT who cannot avail themselves of the credit nor find deductible methods to reduce their business income will be subject to a significant tax burden. However, if the goal is only to finance future growth of the entity, the C-corporation may still have value in the choice of entity decision process, because there is not flow-through taxation of the additional money retained within the entity to the owner. This point is made clear because in Chart 5 the C-corporation actually has the lowest effective tax rate, which is due to individual owner being liable only for those taxes associated with the $200,000 in wages paid to her, while the LLC member and S-corporation shareholder each had significant income tax liabilities due to the flow-through nature of those entities.[30]

CONCLUSION

The new CIT is unlikely to cause most practitioners significant challenges when discussing choice of entity with entrepreneurs. Overall, most state income taxes are ancillary issues to the larger federal taxes. In the case of the CIT, it merely amplifies the tax benefits and costs of various entity structures inherent in the federal system. In the future, there may be planning strategies other than those addressed herein to minimize the CIT, but as the tax in many instances can be entirely avoided by an election, practitioners are well advised to be wary about recommending a C-corporation to a Michigan entrepreneur.

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ENDNOTES

1 MCL 206.1 *et. seq.*

2 MCL 206.601 *et. seq.*

3 MCL 206.621 *et. seq.*

4 MCL 206.671 *et. seq.*

5 MCL 206.621(1).

6 MCL 206.623(1).

7 MCL 206.623(2).

8 MCL 206.603(2).

9 MCL 206.607(1).

10 MCL 206.605(1).

11 MCL 206.607(2).

12 Note that certain other credits may carry over for existing entities, but for an entrepreneur facing the choice of entity question for a new entity, those credits would not be applicable.

13 MCL 206.671(1). It is worth noting that in defining the credit, business income starts with federal taxable income, but then adds back in compensation and directors' fees of active shareholders. MCL 206.671(10)(b).

14 MCL 206.671(1)(b)(*i*)-(*iv*).

15 MCL 206.671(10)(d). Though not explicit in the statute, the reference to IRC §3406 appears to make dividend payments includible in the definition of compensation.

16 MCL 206.671(5).

17 MCL 206.671(4).

18 See Internal Revenue Code ("IRC") § 1402 for definitions regarding what is subject to the self-employment income tax.

19 Your authors realize that the standard deduction is very unlikely, if for no other reason than the various deductions available on the Charts. However, in an effort to standardize the scenarios, we have kept the standard deduction.

20 IRC §3101(a), and is limited by the taxable wage base per IRC §3121(a)(1).

21 IRC §3101(b), and is not limited by the taxable wage base.

22 IRC §3301, and note the credit for payments to approved state unemployment funds under IRC §3302.

23 IRC §164(f) one-half of the self-employment amount is deductible to the member, as the S-corporation and C-corporation get to deduct one-half of the Social Security and Medicare taxes they pay on behalf of the employee.

24 See §61(a)(13) for an LLC member and §1366(c) for the S-corporation shareholder.

25 We assume all dividends qualify as "qualified dividends" under IRC §1(h)(11). We have assumed a 15% tax-rate.

26 The LLC member will only pay that portion of self-employment taxes for social security up to the taxable wage base (IRC §1402(b)(1)), but will pay Hospital Insurance taxes on the entire allocated amount.

27 The authors assume that the wages paid to the S-corporation's shareholder-employee are reasonable under the circumstances. A review of the risks and justifications of this technique are outside the scope of this article.

28 See Schedule SE (Form 1040) 2011, Part I, Line 4a.

29 The authors wish to thank Michael S. Flintoff, CPA, J.D., LL.M., for pointing out that there are other reasons a corporation may want to retain cash, including to fund the redemption of an owner.

30 The authors note that because of the assumption of the individual taking only the standard deduction, this circumstance is very unlikely. In each instance the individual is leaving over $30,000 in deductions unclaimed, which would certainly alter the total effective tax rate, and make both entities more competitive with the C-corporation situation.